



31 August 2009

Sir David Tweedie
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sir David:

re: Comments on Discussion Paper
“Credit Risk in Liability Measurement”

The Corporate Accounting Committee (CAC) of the Securities Analysts Association of Japan (SAAJ) is pleased to comment on the discussion paper, “Credit Risk in Liability Measurement”, put out by the International Accounting Standards Board (the Board). The SAAJ is a not-for-profit organization providing investment education and examination programs for securities analysts. Its certified members exceed 22,000. The CAC is a standing committee of the SAAJ composed of 12 members, most of whom are users including equity and credit analysts, and portfolio managers, while a few others are academicians and public accountants.

General remarks

In the first place, the CAC is against the mandatory application of fair value valuation of financial liabilities for all corporations. Non-financial companies typically borrow money to finance investments in production facilities. Production facilities and associated intangible assets are not valued at fair value. If financial liabilities were valued at fair value in these companies, it would lead to a mismatch. Further, in most cases, these liabilities of non-financial companies are refinanced. Recording changes in the value of liabilities to be refinanced is not meaningful (a liability’s price changes between issuance and maturity, offsetting each other).¹

However, the CAC thinks the revaluation of liabilities rational for financial companies (entities whose income accrues from intentional mismatching between financial assets

¹ The CAC does not assert that the market value of the liabilities of general corporations has no information value. Typical corporate valuation uses discounted future cash flows assuming companies are going concerns. It is true that we sometimes estimate liquidation value. In this case, the market value of liabilities is important, but it is sufficient to show it in the notes. In other words, the market value of liabilities sometimes offers useful financial information, but it is not appropriate to show such in financial statements.

and liabilities).² The income of a financial company is generated from one of the following three sources: (i) duration mismatching i.e. borrowing short term and lending long term (as the yield curve is typically positive [short-term rates < long-term rates], the mismatch will yield income), (ii) credit risk mismatching i.e. lending to companies with lower credit, and (iii) which is both (i) and (ii) combined. Investors and analysts are eager to monitor whether these mismatches are yielding intended results or not. To achieve this, both assets and liabilities should be remeasured at market.

However, the CAC is opposed to including company specific credit risks in the remeasurement of the financial liabilities because doing so would obscure the purpose of monitoring the results of intended mismatches at financial companies. Let's see some examples.

Example 1: Initial position

Entity A's asset and liability are both fixed rate financial instruments. The asset is marked to market.

| | 31 December |
|-------------------|-------------|
| | 20X1 |
| Asset | 1,000 |
| Liability | (900) |
| Equity, beginning | (100) |

Example 2: Duration mismatch

Entity A borrows short term and invests long term. One year later, both short- and long-term rates increase by the same degree (parallel upward shift of the yield curve). There is no credit risk mismatching between the asset and liability and credit risk premium does not change over the year.

| | 31 December | 31 December |
|-----------------------------|-------------|-------------|
| | 20X1 | 20X2 |
| Asset | 1,000 | 900 |
| Liability | (900) | (850) |
| Equity, beginning | (100) | (100) |
| Loss from remeasuring asset | | 100 |

² It would be difficult for the IASB to develop standards to be applied only to the financial industry because the definition of the industry is different from country to country while IFRS are adopted all over the world. The CAC thinks it appropriate to make the revaluation of financial liabilities optional and strongly encourages use of this option for companies whose main income accrues from intentional mismatching between financial assets and liabilities.

| | | |
|---------------------------------|-------|------|
| Gain from remeasuring liability | _____ | (50) |
| Equity, ending | (100) | (50) |

Increased rates would reduce the value of both asset and liability. Part of the loss caused by lower asset value would be offset by the gain in decreased liability value, but not all the loss would be recouped. This is because the interest sensitivity of long-term financial instruments is greater than for short-term ones. Therefore, the parallel upward shift of the yield curve would force a long-term instrument's price to fall more than that of a short-term one. If only the asset is remeasured and the liability is kept at cost, then entity A's equity at year-end 20X2 would be zero. This is too pessimistic a view of A, as credit risk attaching to the asset stands still. The above is a good example where liability remeasurement would give a better picture of a financial institution.

Example 3: Credit risk mismatch (credit risk of liability remeasured)

Assume entity A's credit rating is AA, and it invests in an entity with a lower credit profile (say rated BBB). One year later, the investee company's business deteriorates and its rating is downgraded to BB. There is no duration mismatching with respect to either asset or liability and interest rates do not change over the year.

| | 31 December 20X1 | 31 December 20X2 |
|---------------------------------|---------------------|---------------------|
| Asset | 1,000 | 900 |
| Liability | (900) | (810) |
| Equity, beginning | (100) | (100) |
| Loss from remeasuring asset | | 100 |
| Gain from remeasuring liability | _____ | (90) |
| Equity, ending | (100) | (90) |

The asset price declines by 10% because of the investee company's credit downgrading. Reflecting this, entity A's credit rating is downgraded to 'A'. The associated increase in the refinancing rate lowered A's liability by 10% in value, bringing about the same valuation gains. In this case, the equity of A barely changes, and the financial statement does not help achieve the objective of monitoring the real picture of A. This is a good example of the paradox found in financial liability remeasurement.

Example 4: Credit risk mismatch (credit risk of liability NOT remeasured)

The same assumption as for Example 3, but credit risk changes are not used to remeasure the liability.

| | 31 December 20X1 | 31 December 20X2 |
|---------------------------------|---------------------|---------------------|
| Asset | 1,000 | 900 |
| Liability | (900) | (900) |
| Equity, beginning | (100) | (100) |
| Loss from remeasuring asset | | 100 |
| Gain from remeasuring liability | | <u>(0)</u> |
| Equity, ending | <u>(100)</u> | <u>(0)</u> |

In this example, the decline in asset value is directly reflected in equity, and hence the purpose of monitoring A's performance has been achieved much more than in Example 3.

Example 5: Credit risk mismatch (spread changes)

Assume entity A's credit rating is AA, and it invests in an entity with a lower credit profile (say rated BBB). There is no duration mismatch. One year later, changes in the financial market lift credit spreads pertaining to AA and BBB in parallel. There are no risk-free rate changes over the year or credit risk (ratings) changes in A's asset and liability either.

| | 31 December 20X1 | 31 December 20X2 |
|---------------------------------|---------------------|---------------------|
| Asset | 1,000 | 900 |
| Liability | (900) | (810) |
| Equity, beginning | (100) | (100) |
| Loss from remeasuring asset | | 100 |
| Gain from remeasuring liability | | <u>(90)</u> |
| Equity, ending | <u>(100)</u> | <u>(90)</u> |

In this case, there could be two schools of thoughts. The first is that as general changes in credit spreads influence all financial institutions, just like changes in interest rates, such should be reflected in liability remeasurement. The second is that as the spread is part of the credit risk attaching to financial companies, it should not be reflected in liability remeasurement. The CAC thinks credit risk changes inherent to a particular financial company should not be incorporated but general changes in credit spread should so as to better monitor performance of a financial company. The above example incorporates the spread change for liability remeasurement, resulting in only a little change in equity. If we did not incorporate the spread change for liability remeasurement, ending equity would be zero. Again, an overly pessimistic picture of A

even though the credit standings of its asset and liability do not change at all. Some may think separately measuring spread changes and credit risk changes would be too onerous for the preparers. Remember that our proposal is only for financial institutions whose business is to make the spread a source of income. Of course, we need the market value of the liabilities of a financial institution, including current credit risk, when we estimate liquidation value. As discussed in footnote 1, it is sufficient that this information is shown in notes to financial statements.

Following are our answers to some specific questions in the discussion paper.

Question 1: Credit risk at first recognition

When a liability is first recognized, the CAC thinks the inherent credit risk should be “(b) sometimes” incorporated. When an entity assumes a liability with defined transaction price like a loan or a bond, the transaction price should be the book value. This means that the liability is measured at the agreed upon interest rate which incorporates the credit risk of the borrower. As for other liabilities referred to in paragraph 23 of the staff paper, the risk-free rate or rate for highly-rated corporate bonds should be used for measurement without considering the credit risk of the debtor. Otherwise, if the credit risk inherent in the debtor is incorporated, there would be a paradox where the higher the credit risk, the lower the present value of the liability. As a result, both liabilities that incorporate credit risk, and those that do not, coexist, apparently increasing complexity. This is only a reflection of complex economic reality and this level of complexity is acceptable.

Question 2: Credit risk after initial recognition

The CAC thinks at current measurements, credit risk should “(c) never” be incorporated. See Examples 3 and 4 for reasons.³

Question 3: Determination of credit risk

Changes in an entity’s own credit risk should be measured by the following formulae:
Rate at issuance of liability = risk-free rate at issuance + credit risk (initial spread)
Rate at remeasurement = risk-free rate at remeasurement + general change in spread + change in credit risk inherent to the issuer

³ On very rare occasions, for example when it is certain that an entity will buy back its debt from the market and the amount and/or profit or loss is significant, then the buyback price which incorporates credit risk can be shown on the balance sheet as an exception.

General change in spread is measured separately as, unlike credit risk inherent to an issuer, it should be incorporated in the remeasurement of a liability. See Example 5 above.

Question 4: Three liability measurement categories

Of the three categories proposed, the CAC supports category (c) as it best suits the purpose of monitoring the performance of intentional asset/liability mismatching at financial institutions. However, we oppose that part of category (c) where credit risk spread is fixed at the initial level. As we showed in the formulae to answer Question 3, initial credit risk premium at issuance of a financial liability is equal to “issuance rate minus risk-free rate”. This premium is exactly the same as the spread associated with the credit ranking the entity has (say AA)⁴. Subsequent changes in credit risk premium can be divided into (i) change in credit profile inherent to the entity (say from AA to AAA or A), and (ii) general change in spread for the initial credit rating (AA in this example). As we showed in Example 5, general changes in credit spreads that are not associated with company specific credit changes should be incorporated in remeasurements along with risk-free rate changes.

If you have any questions or need further elaboration, please do not hesitate to contact Sei-Ichi Kaneko, Executive Vice President, SAAJ (s-kaneko@saa.or.jp).

Sincerely yours,



Keiko Kitamura

Chair

Corporate Accounting Committee

⁴ This, of course, is a simplified argument as AA bond spreads fall in a range. However, a bond issuer can easily identify spread on issue date by obtaining the risk-free rate for the same maturity. The same holds true for a loan taker.