Room 525, 5/F., Prince's Building, Central, Hong Kong
Telephone: 2521 1160, 2521 1169 Facsimile: 2868 5035
Email: info@hkab.org.hk Web: www.hkab.org.hk

香港中環太子大廈5樓525室
電話：2521 1160, 2521 1169 圖文傳真：2868 5035
電郵：info@hkab.org.hk 網址：www.hkab.org.hk

26 August 2009   By fax 2865 6776 & by post

Mr Steve Ong
Director, Standard Setting
Hong Kong Institute of Certified Public Accountants
37th Floor, Wu Chung House
213 Queen's Road East
Wanchai
Hong Kong

Dear Mr Ong

Discussion Paper Issued by International Accounting Standards Board (IASB) on Credit Risk in Liability Measurement

We refer to your letter dated 10 July 2009 and would like to set out below our members' comments on the above discussion paper for your consolidation.

Our members welcome the IASB's initiative to issue the discussion paper as the issue of credit risk in liability management has attracted significant criticism in interpreting an entity's results in recent years. Following the number of the specific questions raised in the discussion paper, we would like to set out our specific comments as follows:

Question 1

When a liability is first recognised, should its measurement (a) always, (b) sometimes or (c) never incorporate the price of credit risk inherent in the liability? Why?

Sometimes.

Generally, for traditional borrowing, there is a case to consider for incorporating credit risk at initial measurement as it will affect the cash proceeds an entity receives, i.e. theoretically, it will be equal to the fair value of the future cash flows/coupons obligation recognised by the entity. Normally, under the same market condition and terms of borrowing, an entity with a better credit rating will receive more initial cash consideration than that of an entity with a lesser credit rating.

1

(a) If the answer is 'sometimes', in what cases should the initial measurement exclude the price of the credit risk inherent in the liability?

(i)   Entity's own debts

We believe that in practice, when an entity issues own debts, its inherent credit spread has already been considered in determining the cash flows of the debts (investors require either a higher coupon rate or a discount on debts issued by an entity with a lower credit rating).   Thus, the initial cash proceed received by the entity already is the fair value of the debt issued, incorporated with the price of its inherent credit spread.

(ii)   Other liability

For "other liability", where an entity's credit risk does not play a role in determining the cash flows (e.g. initial consideration for taking up the liability or the ongoing expected cash flows of the liability), we consider that the entity's credit factor should be excluded from the initial measurement of the liability.

For instance, an entity's expected cash flows under its pension obligation do not depend on the entity credit standing, therefore, the price of inherent credit risk should not be incorporated in the initial measurement of such liability.

Question 2

Should current measurements following initial recognition (a) always, (b) sometimes or (c) never incorporate the price of credit risk inherent in the liability? Why? If the answer is 'sometimes', in what cases should subsequent current measurements exclude the price of the credit risk inherent in the liability?

We consider that current measurements following initial recognition should 'sometimes' incorporate the price of credit risk inherent in the liability for subsequent measurements. We consider that:

(i)   For traditional borrowing where the liability is tradable and the entity applies a fair value option at inception, the price of credit should be considered for subsequent measurement as it is expected that the entity can realize the revaluation gain or loss in the market.

However, when an entity issues debt to the market, it may choose to enter into an economic hedge of the interest rate risk of the liability and the fair value option in IAS 39 is chosen to achieve the purpose. Including the effect of the change in credit spread in fair valuing such debt will give rise to larger movement (as

compared to the case where such effect is excluded) which does not reflect the amount of liability to be settled on maturity.

We note that analysts are already discounting the effect of gains or losses from changes in the fair value of own debts in assessing the performance of an entity, as such change does not reflect the performance of an entity's operations. Listed company directors are often seen to adopt the same approach in explaining the results of their companies. This obviates the view of the market that including credit spread in fair valuing certain own debt are seen to produce counter-intuitive results and therefore we do not consider that this to be useful for users of the financial statements when making economic decisions.

(ii)   However, if the entity does not apply a fair value option at inception or the liability is non-tradable, the price of credit risk should not be considered for subsequent measurement. The traditional borrowing should be measured at amortized cost since the revaluation gain or loss is not normally realizable.

(iii)   For "other liability", the entity's credit factor should be excluded from the current measurement of the liability, to be consistent with its initial measurement as mentioned above.

Question 3

How should the amount of a change in market interest rates attributable to the price of the credit risk inherent in the liability be determined?

We consider that the inherent credit risk can be deduced from benchmarking the risk-free papers, such as government securities or AAA-rated papers, which have tenors and maturities similar to the liability. We understand that applying assumption is inevitable but as long as the assumption is reasonable and is consistently applied, the risk of distortion or manipulation should not be material.

Question 4

The paper describes three categories of approaches to liability measurement and credit standing. Which of the approaches do you prefer, and why? Are there other alternatives that have not been identified?

We do not support the base case which uses the prevailing market rate to revalue the liability unless the entity adopts a fair value option at inception or the liability is tradable. This is because the revaluation gain / loss is normally not realizable and may distort the financial position of an entity. For example, an entity can generate revaluation gain due to its deteriorating financial position.

We do not support the example under Illustration 2 "Borrowing Penalty" as it will create a profit or loss on day 1 which is not considered as a reasonable measurement for traditional borrowing. If this measurement is applied to normal retail deposits in the case of a bank, this may generate a significant amount of profit on day 1 if it uses the yield of a government paper as the risk-free rate for the measurement of its deposit liabilities (as normally the customer rate is lower than the market rate of government papers).

The example under Illustration 3 "Shareholder Put" may not be appropriate if the market practice permits an early termination of the liability (e.g. an early uplift of a traditional retail deposit requested by a depositor) under which the early settlement consideration normally will not cover the change in credit risk of the lender. Further, similar to the "Borrowing Penalty" approach, it will create a positive reserve for a bank's retail deposits.

The "Frozen Spread" method under Illustration 4 conceptually is not reasonable since the value generated under this method will not be the fair value of a tradable liability.

As mentioned above, for "other liability", we do not support incorporating any credit spread at initial and subsequent measurements and, in the case of certain own debts referred to above, we do not support incorporating own credit spread subsequent to initial measurement. Therefore, the approaches suggested by the paper are not considered appropriate.

Yours sincerely

Jennifer Cheung
Secretary

c.c. Chief Executive, Hong Kong Monetary Authority