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International Accounting Standards Board
1st Floor
30 Cannon Street
London
EC4M 6XH

Ref.: Discussion Paper / DP/2009/2 / Credit Risk in Liability Measurement

Dear Sirs,

The International Swaps and Derivatives Association ("ISDA") is pleased to provide the following comments with respect to the above mentioned Discussion Paper (DP) issued by the International Accounting Standards Board ("IASB").

ISDA has over 820 member institutions from 56 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. As such, we believe that ISDA brings a unique and broad perspective to the work of the IASB.

In this letter we outline our key messages in response to the DP and in the Appendix we provide our more detailed responses to the specific questions. Please note that our responses focus on financial liabilities only and any references to own credit in the fair value of financial liabilities relates to initial measurement for all financial liabilities and on subsequent measurement for those financial liabilities held at fair value on a recurring basis.

Key Messages:

- ISDA members believe that where credit risk affects the value at which a financial liability could be exited, this should be reflected in the fair value of the liability. This will be the case whenever the price of a transaction between a willing buyer and seller would reflect the entity's credit risk.

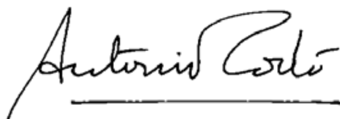
- However, as set out in more detail in our response to Questions 1 and 2, application of this principle needs to reflect the extent to which credit is actually considered in the pricing of transactions on initial recognition and by market participants to whom a liability is transferred. Our members note that although derivatives subject to cash collateral arrangements (and so subject to only limited credit risk) are often transferred, it is relatively uncommon for uncollateralized derivatives to be transferred. Consequently, there is debate amongst our members as to how much of a credit adjustment would, in reality, be made in pricing the transfer of a financial liability such as a derivative, and so the extent to which changes in the price of credit should be reflected in the instrument's fair value. Notwithstanding the difference in opinions on this point, to the extent that there is considered to be a gain or loss (if any) that would be realized on transfer, members believe that changes in the price of credit risk for financial liabilities held for trading (i.e. derivatives) should be reported in profit or loss.

- In regards to other financial liabilities not held for trading (i.e. debt issuances) which are held at fair value on a recurring basis, the majority of our members propose to incorporate own credit in the balance sheet but report the change in other comprehensive income (OCI). A minority of our members believe that own credit would not affect the transfer price and as such it should not be reported in the core financial statements; rather they support disclosure in the footnotes to the financial statements.

We hope you find ISDA's comments useful and informative. Should you have any questions or would like clarification on any of the matters raised in this letter please do not hesitate to contact the undersigned.

Yours sincerely,

Charlotte Jones
Deutsche Bank AG
Chair, European Accounting Policy Committee



Antonio Corbi
International Swap and Derivatives Association
Risk and Reporting

Attachments: Appendix – Responses to specific questions raised by the IASB

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Appendix – Responses to specific questions raised by the IASB

We set out below our comments relating to specific questions outlined in the invitation to comment.

Question 1

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

a) If the answer is 'sometimes', in what cases should the initial measurement exclude the price of the credit risk inherent in the liability?
b) If the answer is 'never':
    a. What interest rate should be used in the measurement?
    b. What should be done with the difference between the computed amount and cash proceeds (if any)?

Our members believe that where credit risk affects the value at which a financial liability could be exited (whether settled, closed out or transferred), this should be reflected in the fair value of the liability on initial recognition. This will be the case whenever the price of a transaction between a willing buyer and seller would reflect the entity's credit risk.

For instruments such as derivatives, where there is limited or even no initial funding, a market participant such as a bank will take account of the potential future exposure to its customer in pricing the instrument and so, from the perspective of the customer, the transaction price will include its own credit risk. However, there is mixed practice as to the extent to which banks reflect their own credit risk in pricing such instruments and hence there are mixed views held by our members as to whether the price of the bank's credit should be included in the derivative's initial recognition.

The banks who do not reflect their own credit risk in pricing derivatives believe that customers enter into derivative transactions only with banks of a high credit standing, and therefore do not expect the bank's credit risk to be a material component of the transaction price. Consequently, they believe it is not normally appropriate to incorporate the bank's own credit risk in the fair value on initial recognition of a derivative.

However, the banks which do take account of their own credit risk in pricing derivative transactions with customers include it in the fair value of the instrument on initial recognition.

These banks value the instruments at the price at which they could be exited with an unrelated knowledgeable counterparty who, they believe, would take account of the credit risk of all parties to the transaction. They believe this is evidenced by observed transactions and has been particularly apparent during recent periods where the impact of own credit risk was magnified. They do not see any distinction between own credit risk and any other risk.

It should be noted that the majority of derivative transactions between banks occur on a collateralised basis so that there will be limited potential future credit risk to take into account in pricing such transactions or measuring their fair value on initial recognition.

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?

For financial liabilities held at fair value on a recurring basis, our members believe that where credit risk affects the value at which a financial liability could be exited, this should be reflected in the fair value of the liability subsequent to initial recognition. This will be the case whenever the price of a transaction between a willing buyer and seller would reflect the entity's credit risk.

In the case of derivatives, the transfer of uncollateralised derivative transactions is relatively uncommon and our members have differences of view, as expressed in our response to Question 1, as to whether, the extent and in what circumstances, the price of such a transaction would take the entity's own credit risk into account. Notwithstanding the difference in opinion on this point, to the extent that there is considered to be a gain or loss (if any) that would be realized on exit, members believe that changes in the price of credit risk for financial liabilities held for trading such as derivatives should be reported in profit or loss.

In the case of other financial liabilities not held for trading (i.e. debt issuances), again due to the lack of actual transfer transactions for such liabilities, there are divergent views amongst our members on whether a market participant would factor it into the exit price.

The majority of our members hold the view that market participants would factor own credit in the exit price and as such the fair value of financial liabilities not held for trading in the balance sheet should reflect own credit. However, as reporting changes in own credit through profit or loss does not, in the view of the majority of these members, provide decision-useful information to investors, they propose to report changes in own credit in other comprehensive income (OCI) rather than in profit or loss. This is because such instruments are generally used for funding and are not expected to be bought back, settled, closed out or transferred. There may also be economic restrictions on the ability of the entity to exit the liability. Consequently, any changes in the price of credit are seldom expected to be realized. Reporting gains or losses arising from

changes in own credit on these instruments through profit or loss is likely to provide misleading information and has been disregarded by the users of financial statements.

The members who do not believe that own credit would be factored into the exit price (which represents a minority of our members) believe that subsequent changes in the price of credit should not be reflected in the fair values of financial liabilities which are measured at fair value but not held for trading, since it would be misleading to incorporate a change in fair value for which there is no market evidence and which is unlikely ever to be realized. As such own credit would not be reported in either the balance sheet or in the profit or loss statement. Rather these members believe that own credit is more appropriately disclosed in the notes to the financial statements.

Question 3

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

There are a number of different methods of determining the impact of credit risk on the fair value or fair value movement of a liability. These methods will vary depending on the instruments available for a specific entity which give different transparency on credit. In principle, the approach is to identify an instrument sensitive to own credit, observe the change in fair value of that instrument and eliminate movements due to other risks, leaving the effect of changes in the price of credit as the residual. For some instruments such as derivatives, the effect of own credit risk will be a calculated component of the overall fair value, so there is no need for it to be 'backed out' of the overall valuation.

Consistent with the work on the greater project of fair value, if the Board seeks any further insight into current practice, our members would be happy to meet with the Board to discuss the guiding principals that our members use in their specific models for their various instruments.

On another note, we believe that when measuring own credit it is necessary that the new standard make a distinction between the own credit risk of financial liabilities which comprise general recourse obligations of the entity that of those which do not comprise such a general recourse obligation, e.g. non-recourse liabilities. A typical example of a non-recourse liability would be notes issued from a consolidated special purpose entity or securitization vehicle where the assets of the SPE are legally ring fenced for the benefit of the note investor. The risk of own credit on such liabilities relates to the performance of the underlying assets and so does not constitute an own credit risk of the entity, in the sense used in the Discussion Paper. To the extent that such liabilities are not held for trading, any gain or loss due to changes in non-performance risk should continue to be reported in profit or loss, not OCI. We recommend that the Board make the distinction in the new standard between these two different types of own credit risk.

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 three approaches presented in the Discussion Paper. Please refer to our recommendations and supporting rationale as described in question 2 above.