The DTC Association

(The Hong Kong Association of Restricted Licence Banks and Deposit-taking Companies)

存款公司公會（香港有限制牌照銀行及接受存款公司公會）

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Our Ref.: 20/00/00
Your Ref.: C/FRSC

7th June, 2010 (Mon)

Mr. Steve Ong, FCA, FCPA,
Director, Standard Setting Department
Hong Kong Institute of Certified Public Accountants
37th Floor, Wu Chung House, 213 Queen's Road East
Wanchai Hong Kong
(Fax No. ©2865-6776) [Pages faxed:- 5]

Dear Mr Ong,

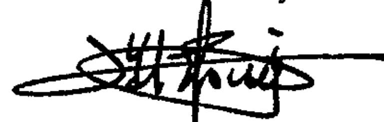
Hong Kong Institute of Certified Public Accountants (CPA)
Invitation to Comment on three IASB discussion documents
(1) IASB Exposure Draft on *Management Commentary*
(2) IASB Exposure Draft of *Financial Instruments: Amortised Cost and Impairment*

We would like to thank you for the letter of 30th November, 2009 inviting our Association members to comment on the two captioned topics. With respect to the first document, we have replied by your suggested deadline of the 8th of February, 2010.

With regard to the 2nd one of the captioned documents, while our Association members have not particularly commented on this occasion, we understand that this issue is a continuation of a previous consultation.[1] We have replied on the subject of "Impairment of Financial Assets: Expected Cash Flow Approach" at this said previous consultation. Our letter dated 10th August, 2009 (Mon) is herewith attached for your ready reference.

It is not apparent to us that the issue we raised at the said letter of 10th August, 2009 has particularly been addressed at your present paper. Thank you,

Yours Sincerely



Pui-Chong LUND
Association Secretary

Enclosure:-

1. Letter in reply to the subject of "Impairment of Financial Assets: Expected Cash Flow Approach" dated 10th August, 2009 (Mon) our Ref.: 20/00/00 addressed to Mr Steve Ong.

[1] Letter from Hong Kong Institute of Certified Public Accountants dated 10th July, 2009 on the captioned subjects of:-
{(1) IASB Discussion Paper on *Credit Risk in Liability Measurement*}
(2) IASB Request for Information ("Expected Loss Model") Impairment of Financial Assets: Expected Cash Flow Approach

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Our Ref.: 20/00/00

10th August, 2009 (Mon)

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,

We attach comment from one of our DTCA members. That firm is engaged solely in consumer lending and has amongst the best risk management science of all lenders in HK. They believe that the Expected Loss Model has issues.

A key problem is trying to apply one concept to all types of financial assets and business organizations. That will be quite complex. We will, however, comment from the perspective of a financial institution.

The paper gives the examples of fixed rate instruments and provides for the future cash flow after credit loss projections to be discounted at the rate originally applied. Then the cover note says "This would better reflect the way that financial assets are priced and the way some companies manage their business." This is not sufficiently correct. The value of a fixed rate instrument is composed of credit risk, interest rate risk and duration risk. Looking at US treasures the market prices still fluctuate significantly based only on the latter two risks because there is perceived to be no credit risk. In addition every financial institution uses its own prediction of the future yield curve to value the assets; the original yield has no bearing on the internally measured value of an instrument today.

In a consumer bank what will happen with this proposal is there will be a one-time upwards adjustment to provisions with a negligible effect thereafter. Leading consumer lenders already use flow rate accounting to estimate collective losses and then apply a given time window for recognizing the amount of loss "embedded" today. The typical time horizon for that is six months, linked in part to the 120 or 150 day individual impairment write-off window. With Expected Loss the implication is all future loss so moving from six months to a year or two is not quite a doubling of provisions but would be material. Thereafter there would seem to be little if any benefit in the ongoing measurement of the P%L. One might also keep in mind that Hong Kong lenders are not selling or trading their loan books so there is not a market price concept of relevance locally.

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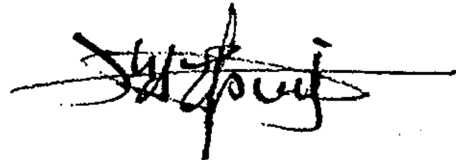
Incorporated Under the Companies Ordinance of Hong Kong and Limited by Guarantee 根據香港公司條例成立之有限保證法團

Putting Expected Loss in place would have the implied desired effect of increasing the level of capital (provisions). But regulators could simply be straightforward and raise the CAR percentage requirement rather than implement this bureaucracy. It would in the current circumstances seem inappropriate for the IASB to require a back-door capital increase via this proposal rather than allowing the regulators to make their final decisions.

Sincerely Yours



Pui-Chong LUND
Association Secretary

Request for Info ("Expected Loss Model")
Impairment of Financial Assets: Expected Cash Flow Approach
Comment A DTC Consumer Lender With Basel II Technical Skill Base

Q1: The approach is not well defined and may face some application challenges. To define the "expected" credit loss, there should be a sound and accurate forecasting model or rating system to calculate the credit loss in a given time period. The time period should be defined clearly. Basel II defines future default event in a period of 1 year. If the expected credit loss is more than 1 year, a separate forecasting model will be required. The majority of DTCs are using non-IRB approach to calculate the capital and disclose their financials. The expectation on credit loss could be very subjective without statistical proof. The changes of external environment including economic, market and sometimes in a particular sector will also affect the outcome on expected credit loss. For variable yield product, a forecasting on the yield movement is required.

Additional guidance would have to be given for practical implementation, including:

- Specific guidelines and examples for the estimates and approach of the expected cash flow and credit loss model, especially for portfolio of high volume and low value items and the re-estimation of the credit loss expectation like the frequency, trigger events, subsequent factors for consideration, etc.
- Specific disclosure requirement in the financial statements as to the impairment loss (profit and loss item), the impairment provision (balance sheet item) and how the changes be accounting for in the first year of adoption, etc. As the main feature of this expected cash flow approach is to recognize interest revenue on the basis of expected cash flows including the expected loss, will the impairment loss (including individually assessed and the changes in the credit loss expectation) be net off with the interest revenue in the profit and loss statement? If yes, it may come to the case that when a company's effective interest rate becomes negative during economy downtime where the loss rate is higher than the interest yield, its interest revenue will be negative. If no, classification and disclosure of impairment changes due to different nature has to be clearly defined.
- Clarification on the interaction between the individual and collective impairment. Is a credit loss from a specific asset in the portfolio a) to be excluded from the portfolio for the expected cash flow model or b) included and in the re-estimation of the credit loss expectation consideration?
- Guidelines on how and when to recognize the individual impairment provision under the new approach. The suggested new approach is to collectively assess the credit loss on a portfolio basis and incorporated into the EIR. However, the paper has not provided any guideline on the assessment on individually impairment provision.

Q2: The approach has significant operational and associated costs for the first time implementation and subsequent monitoring. The major issue is how to estimate the future credit loss. It will take a significant amount of time to collect data and develop the model unless there are simpler approaches / alternatives for AIs. The implementation cost include credit loss forecasting model and IT system development, re-design of reports, development of the estimates and assumptions of the approach, time cost for updating the credit policy and procedures and the financial disclosure, training cost for the affected function, etc. Depending on the frequency and scope required for the continuous re-

estimation of the credit loss expectation, more staff cost will be incurred for the data collection & preparation and MIS analysis under this new model.

Q3: It will require 2 years at least to implement the items mentioned in Q2. And the magnitude of cost incurred is huge.

Q4: No comment.

Q5: We believe in (b). A collective approach will continue to be used for those assets within the portfolio excluding the specific assets with loss identified. But we will consider if the factors contributing the identified loss from those specific asset is going to affect credit loss expectation of the entire portfolio. If yes, the expected loss percentage of the portfolio will be adjusted accordingly. For those specific assets with loss identified (i.e. being excluded from the portfolio), individual impairment loss will be provided.

Q6: A reference of expected credit loss should be developed and AIs can adjust based on their own standings if there isn't a significant model available. A standard template can help to minimize the effort in the implementation. AIs or firms can simply input their internal numbers and get the result afterward.