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9 June 2010 By email: commentletters@hkicpa.org.hk & by post

Mr Steve Ong
Director, Standard Setting
Hong Kong Institute of Certified Public Accountants
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Dear Mr Ong

IASB Exposure Draft of Financial Instruments: Amortised Cost and Impairment

We refer to your letter dated 30 November 2009 and would like to set out below our comments on the above ED for your consideration.

We support the IASB's issuance of an exposure draft ("ED") to include forward looking credit expectations within the impairment model. However, we have significant concerns with the "expected cash flow" model as proposed in the ED.

Fundamental concerns:

In summary, we have the following fundamental concerns with the proposed ED:

- We do not agree with the ED's proposal to present impairments (including expected losses) together with effective interest. We believe that impairment should be classified separately from effective interest on the income statement. Mixing the two will also be confusing to readers of financial statements and may require extensive disclosure to explain the numbers.
- We do not agree with the ED's proposal to combine actual incurred losses and future expected credit losses. It is reasonable to assume that readers of financial statements will want to know how much has actually been incurred as opposed to the amount that is expected to be incurred in the future. It is therefore more practical and useful to separate the two. We acknowledge that there is a grey area between incurred and expected losses, particularly for portfolio impairment provisions on an incurred basis. However, consideration should be given to refining this area rather than combining incurred and expected losses.

Chairman Standard Chartered Bank (Hong Kong) Ltd
Vice Chairmen Bank of China (Hong Kong) Ltd
The Hongkong and Shanghai Banking Corporation Ltd
Secretary Rita Liu

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- We disagree with the ED's proposal to estimate expected cash flows over the entire life of the relevant financial asset and across a whole range of possible outcomes. It is impractical to assume that management can estimate cash flows over the entire life of a financial asset. We agree that there is a need for provisioning for future credit losses, but this could be accomplished by leveraging existing practice with appropriate adjustments (i.e., utilise data on historical losses with appropriate adjustment for expected changes in future economic and credit conditions.)
- The ED proposes that any subsequent changes to estimates of credit losses should result in an immediate cumulative catch up adjustment. This is inconsistent with the proposal to spread the initial estimates of credit losses. This will also increase profit and loss account volatility, and changes being taken to the profit and loss account may be more reflective of management's ability to predict future credit losses rather than the credit risk of financial assets.
- It is also not clear how changes in estimates of credit losses for loans which are assessed on a portfolio basis and for which the portfolio is open will be estimated. This is because the ED proposes that initial estimates of credit losses should be spread whilst subsequent changes should be recognized upfront.
- We disagree with the ED's proposal that management should consider weighted average probabilities of future cash flows in determining expected losses. From an operational perspective, this is very difficult to implement and results in numbers which are difficult to explain and verify.
- We disagree with the ED's proposal to re-estimate cash flows for floating rate financial assets with revised estimates of credit losses and changes in benchmark interest rates. This will result in a revaluation of the interest rate risk component which is inconsistent with the ED's objective of only estimating future expected credit losses.
- We do not agree with the ED's proposal to recognize expected losses on trade receivables upfront as a deduction against revenue. This is potentially confusing to readers of financial statements and adds little value given that such receivables are very short term in nature.
- From a practical perspective, many banks will simply not have enough detailed and reliable historical data to estimate future credit losses. This is particularly true for smaller banks and many banks in Hong Kong and Asia, who are not currently adopting a model based approach for Basel 2.
- Even for banks who have adopted a model based approach for Basel 2, it is clear from the recent financial crisis that many banks do not really have a good understanding of future loss rates. For example, it can be seen from recently published Basel 2 Pillar 3 disclosures that there is a large gulf between actual and expected probability of defaults and loss given defaults.

- We do not consider that the practical expedients proposed by the ED are useful, as the reporting entity is required to prove that the effect of using the practical expedient is immaterial as compared to following the ED in full.
- From a practical perspective, huge system changes will be needed to implement these proposals, on a much larger scale than when all of IFRS was initially implemented. A very long implementation period will be required and given the high subjectivity and low reliability of the likely results, it is unlikely that the costs will outweigh the benefits.

In summary, we believe that conceptually the expected cash flow model will result in increased subjectivity. As a result, the expected losses which will be recognized in the profit and loss account may be more volatile and procyclical than under the current incurred loss model. In addition, the readers of financial statements may find it very difficult to understand and interpret the numbers given the high degree of subjectivity and the combining of credit losses with interest. From a practical perspective, the proposed model is extremely complex and hence will be very difficult and costly to implement.

<u>Key principles:</u>

We believe that an impairment model should be built around the following key principles:

- The presentation of impairment should be separate from effective interest;
- The calculation of incurred and expected losses should be disclosed separately;
- Incurred losses should be calculated largely in accordance with current IAS39 requirements;
- Expected losses should be calculated on a portfolio basis and should be applicable for both open and closed portfolios;
- The expected loss calculation should be based on historical loss experience but should allow management judgment to take into account expected changes in future economic and credit conditions that are either highly likely or are based upon objective evidence (e.g., bond market behavior, etc.);
- As undrawn commitments are legally binding commitments which the reporting entity will have to honour, we believe that any expected losses on these commitments should also be factored into the impairment model. In addition, expected losses on undrawn commitments that may not be legally binding but which represent constructive obligations (such as credit card lines) should be factored into the impairment model as such loss accruals would better match expense with revenue recognized directly or indirectly from such relationships;

- The impact of the presentation of impairment reserves on the balance sheet on coverage ratios, which are an important indicator for financial analyst and other users of financial statements, should be considered. For example, when calculating the coverage ratio, if expected losses for undrawn commitments are reflected in the impairment reserve, the coverage ratio will be overstated. To ensure that coverage ratios are appropriately calculated and consistent with historical practice, we believe that the impairment reserve should be presented separately for incurred losses, expected losses for recognized loans, and expected losses for undrawn commitments; and
- Overall, the benefits to users of financial statements of a revised impairment model should outweigh the costs. The resulting numbers should be easily understood and comparable between companies.

The Framework to International Financial Reporting Standards ('Framework') states that the objective of financial statements is 'to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions'. We agree that it should be possible to achieve more forward looking provisioning in financial statements by using a broader range of credit information, but are of the view that the introduction of excessive subjectivity into provisioning methodology, or approaches that seek to accumulate a prudential 'buffer' during benign periods in order to stabilise reported earnings during times of stress, will reduce the objectivity of financial reports and damage market confidence. The reduction in objectivity which would result from applying the proposals in the ED will also negatively impact other qualitative characteristics of financial statements, in particular, reliability and comparability. We consider that the proposals as drafted would result in less useful and significantly less reliable information being provided to users of financial statements. In addition to introducing excessive subjectivity, the ED would not reflect the way in which credit risk is managed by financial institutions and would result in a disconnect between risk management disclosures required by IFRS 7 and the numbers in the financial statements. We do not believe that this would enhance the usefulness of financial statements.

The Framework also notes that 'the benefits derived from information should exceed the cost of providing it' and that 'standard-setters...should be aware of this constraint'. In our view, the proposals in the ED reflect an unreasonable balance between costs and benefits and will, in fact, result in costs exceeding benefits in contravention of the intention of the Framework.

Our comments on the ED reflect our view that implementation of the proposals in the ED would undermine the usefulness of financial statements as well as carry implementation costs that significantly outweigh any perceived benefits. In evaluating alternative impairment models, we considered whether a model that leverages the Basel 2 internal ratings based approach would represent an appropriate approach. We concluded that a Basel approach would not be appropriate because it would lead to

specific banking and capital markets industry guidance and would not necessarily be consistent with accounting objectives given that future expected credit losses will not be the same as those estimated under Basel's long run or stressed scenarios. In addition, not all banks will have adopted an internal ratings model for their Basel capital calculations. Similarly, non-banks will not have these models. For these banks and non-bank companies, the adoption of an impairment model which is based on Basel will be very costly and require significant time and effort to implement.

Based on the above, we propose a possible alternative model that reflects an extension of the current incurred loss model. We believe this model achieves the goals of incorporating forward looking credit expectations while being practical and cost sensitive.

Extension of the current incurred loss model:

The current incurred loss model could be extended to include an element of future expected losses. Currently when incurred losses are calculated for assets which are individually assessed for impairment, a portfolio impairment provision is usually calculated to take account of losses which although have been incurred may not yet be apparent. The portfolio impairment provision is determined by taking into account historical experience, management's judgment as to whether the current economic and credit conditions are such that the actual level of incurred losses is likely to be greater or less than that suggested by historical experience and the emergence period, which is the estimated period between a loss occurring and the loss being identified. This portfolio impairment provision could be extended to cover expected loss by both eliminating the emergence period thus covering the entire expected life of the loan (such that the cumulative annual expected losses on a portfolio are accrued at initial recognition using historical experience) and adjusting for expected changes in future economic and credit conditions that either are highly likely or are based upon objective evidence. Similarly, for homogeneous groups of assets which are currently assessed for impairment on a portfolio basis (e.g. credit cards), the current portfolio impairment provision typically utilizes a flow rate methodology which takes into account historical trends of the probability of default and amount of consequential loss. This calculation could be adjusted to cover future expected losses by adjusting the probabilities of default and losses to take into account expected changes in future economic and credit conditions that either are highly likely or are based upon objective evidence. Such an approach should not preclude reporting entities from using weighted average probabilities of future cash flows in determining expected losses where the requisite data and expertise are available. The above approach would be applicable to a "good book" of loans but not a "bad book" since the existing methodology for calculating the "bad book" impairment reserve already fully reflects expected losses.

Our comments on the specific questions raised in the ED are attached. We would be happy to further clarify or discuss any of the above points should you so wish.

Yours sincerely,

Rita Liu
Secretary

Enc.

Responses to Specific Questions/Points

Question 1

Is the description of the objective of amortised cost measurement in the exposure draft clear? If not, how would you describe the objective and why?

We consider that the description of the objective of amortized cost in general is clear although we do not agree with the objective to mix impairment and the effective return together as this will be misleading to the readers of financial statements.

Question 2

Do you believe that the objective of amortised cost set out in the exposure draft is appropriate for that measurement category? If not, why? What objective would you propose and why?

According to the ED, the amortized cost of a financial instrument has to be "revalued" at each reporting date in response to the change in its expected cash flows. Change in expected cash flows may be due to changes in expected credit loss, expected maturities or coupons reset with benchmark rates (e.g. 1-month HIBOR for a floating rate instrument).

We consider that this requirement is not consistent with the historical cost concept and will create a value akin to fair value but without reflecting all pricing parameters (e.g. liquidity premium). Also, per the ED, the change in the "fair value" has to be recognized in the income statement immediately; however, this may simply reflect a change in management assumptions on expected credit losses or expected maturities instead of an actual change in the underlying risk factors. We do not understand the rationale behind why the initial expected credit loss should be spread over the expected life of a financial instrument while changes in subsequent estimates of expected loss should be recognized in the income statement immediately. We believe that this will create unnecessary income statement volatility (which does not reflect actual events during the reporting period) and create room for manipulation as these assumptions can be subjective in nature. Explaining the income statement volatility will also be difficult as the change in net income may partly come from changes in underlying risk factors and partly come from "rectification" of the assumptions which are difficult to justify by any objective measure.

We also strongly disagree with the objective to include expected credit losses in the computation of effective returns as it will create confusion to the users of financial statements and create unnecessary operational burdens to preparers of financial statements. Currently, interest income in the financial statements represents the contractual interest received/receivable and it is generally accepted that higher credit risk will be compensated by a higher interest return. If the EIR/interest return is required to be reduced by the expected credit loss, the relationship between interest income and credit risk will no longer be transparent to the readers of financial statements. The

majority of Asian banks are commercial banks, many of which are deposit-led and therefore net interest margin is considered meaningful and comparative.

In order to reduce the complexity of this ED, we suggest that the amortized cost measurement should follow the existing treatment under IAS39 while the expected loss concept should be treated as an impairment provision to be separately reported in financial statements.

Question 3

Do you agree with the way that the exposure draft is drafted, which emphasizes measurement principles accompanied by application guidance but which does not include implementation guidance or illustrative examples? If not, why? How would you prefer the standard to be drafted instead, and why?

Given the complication involved in implementing this ED, we consider that the Board should provide more implementation guidance and illustrative examples.

We note that the IASB has already provided some illustrative examples such as an IASB staff example which demonstrates how to perform re-measurement of amortized cost for fixed rate papers and floating rate papers. We suggest the Board should either include these examples as part of the finalized standard or provide clear references in the standard. Similarly, we understand that the IASB Expert Advisory Panel is discussing the implementation issues of this standard (e.g. how to measure the expected credit loss). We consider that the Board should issue a paper similar to "IASB Expert Advisory Panel - Measuring and disclosing the fair value of financial instruments in markets that are no longer active" to facilitate implementation of this Standard.

Question 4

(a) Do you agree with the measurement principles set out in the exposure draft? If not, which of the measurement principles do you disagree with and why?

As mentioned above, we disagree with the ED's proposal to include expected credit losses in the measurement of amortized cost. We also disagree with the ED's proposal to revalue the amortized cost due to the change in benchmark interest rates.

(b) Are there any other measurement principles that should be added? If so, what are they and why should they be added?

As mentioned above, we suggest that the amortized cost measurement should follow the existing treatment under IAS39 while the expected loss concept should be treated as an impairment provision to be separately reported in financial statements.

Question 5

(a) Is the description of the objective of presentation and disclosure in relation to financial instruments measured at amortised cost in the exposure draft clear? If not, how would you describe the objective and why?

We agree that the objective is clear although we do not believe that meeting these disclosure requirements can meet the objective.

(b) Do you believe that the objective of presentation and disclosure in relation to financial instruments measured at amortised cost set out in the exposure draft is appropriate? If not, why? What objective would you propose and why?

We consider that the objective stated under 12 (b) in terms of discussion of the effect of the expected losses on the entity's performance should be disclosed as part of management commentary instead.

Question 6

Do you agree with the proposed presentation requirements? If not, why? What presentation would you prefer instead and why?

We disagree with the proposal to include 13(b) "the portion of initial expected credit losses allocated to the period" as part of net interest revenue since this amount simply reflects the original expected credit losses and this information will be meaningless if there are any material changes in expected credit losses, regardless of whether it is due to changes in management assumptions or market conditions.

We also consider that the information under 13 (d), "gains and losses resulting from changes in estimates in relation to financial assets and liabilities that are measured at amortized cost" is not useful and misleading to readers of financial statements as the information simply reflects part but not all of the change in the fair value of financial instruments.

Instead, we consider that the current presentation which separately presents interest income and impairment is appropriate.

Question 7

(a) Do you agree with the proposed disclosure requirements? If not, what disclosure requirement do you disagree with and why?

We agree that disclosure about impairment is required, however, we have the following comments on the proposed disclosure requirements: -

Paragraph 19 ("trend analysis") – it is not clear to us what is the period required for comparison between the development of the credit loss allowance over time and

the cumulative write-off and the meaning of "a qualitative analysis of the effect of changes in credit loss estimates on this comparison if that effect is significant".

Paragraph 20 (stress testing) – Under IFRS 7, an entity is already required to disclose information that enables users of financial statements to evaluate the nature and extent of risks (including credit risk) arising from financial instruments. We consider that it is not necessary to include the stress testing requirement under this ED. In addition, we believe that if this requirement is to be retained, the implication of stress testing and an entity's ability to withstand stress scenarios should be part of the unaudited information in the financial statements, as we believe that this information will be difficult to audit.

Paragraph 22 (Vintage information) – We question the benefit to the readers of financial statements of disclosing the vintage information, as such information will not necessary reflect the risk characteristics of the financial instruments or how the risk is being managed.

(b) What other disclosures would you prefer (whether in addition to or instead of the proposed disclosures) and why?

Given that we believe that the proposals in the ED are conceptually flawed and operationally impractical, we cannot suggest alternative disclosures at this stage.

Question 8

Would a mandatory effective date of about three years after the date of issue of the IFRS allow sufficient lead-time for implementing the proposed requirements? If not, what would be an appropriate lead-time and why?

In view of the operational burden involved (e.g. partially "fair value" the financial instrument at amortized cost and the inclusion of the expected loss in the computation of EIR), significant technological and operational resources will be required. Also, as the IASB Expert Advisory Panel is still discussing the implementation issues (e.g. how to compute the expected credit loss), it is difficult for us to assess the actual lead-time required for implementing this ED at this stage. However, we believe that the lead time required could be greater than three years.

Question 9

(a) Do you agree with the proposed transition requirements? If not, why? What transition approach would you propose instead and why?

We do not agree with the proposed transition requirements as we believe that only a few entities will have the necessary information to determine a revised EIR as proposed under the ED.

(b) Would you prefer the alternative transition approach (described above in the summary of the transition requirements)? If so, why?

We prefer the alternative approach as an entity is not required to recalculate the EIR under the revised approach.

(c) Do you agree that comparative information should be restated to reflect the proposed requirements? If not, what would you prefer instead and why? If you believe that the requirement to restate comparative information would affect the lead-time (see Question 8) please describe why and to what extent.

We do not support the proposal to restate the comparative information in view of the operational burden involved.

Question 10
Do you agree with the proposed disclosure requirements in relation to transition? If not, what would you propose instead and why?

We agree with the proposed disclosure requirements in relation to transition.

Question 11
Do you agree that the proposed guidance on practical expedients is appropriate? If not, why? What would you propose instead and why?

We do not consider that the practical expedients are useful as an entity is required to prove the overall distortion is not material before the practical expendients can be used.

Also, we do not agree with the proposal that the initial estimate of credit loss should be treated as a reduction in the invoice amount in determining the revenue to which the trades receivable relates (e.g. from the sales of goods) as it contradicts with normal market convention. Also for trade receivables with short-term tenors, recognizing such expected losses upfront will create unnecessary confusion to the readers of financial statements.

Question 12
Do you believe additional guidance on practical expedients should be provided?

If so, what guidance would you propose and why? How closely do you think any additional practical expedients would approximate the outcome that would result from the proposed requirements, and what is the basis for your assessment?

As mentioned above, we do not believe that the practical expedients are useful if an entity is required to prove the overall distortion is not material.