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By email: ong@hkicpa.org.hk & by post

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Exposure Draft (ED/2010/4) – Fair Value Option for Financial Liabilities

Dear Steve:

We refer to your letter dated 13 May 2010 and would like to set out our comments on the International Accounting Standards Board's ("Board") Exposure Draft – Fair Value Option for Financial Liabilities. We generally support the Board's aims to remove the impact of changes in "own credit" risk from profit and loss. We believe that recording such changes through other comprehensive income is more appropriate given that changes in "own credit" risk are often not fully realizable and recording such amounts in profit and loss is counterintuitive.

Our comments on the specific questions raised in the exposure draft 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.

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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Response to Questions in IASB Exposure Draft: Fair Value Option for Financial Liabilities

Question 1

Do you agree that for all liabilities designated under the fair value option, changes in the credit risk of the liability should not affect profit or loss? If you disagree, why?

We believe a clear distinction should be made between own credit risk (i.e., credit risk of the reporting entity) and the credit risk of a liability that arises by reference to the assets which secure it. Some secured debt may have an element of own credit risk where there is recourse to the reporting entity. In other cases, secured debt may be contractually linked to assets (e.g., on-balance sheet securitizations) such that there is no recourse to the reporting entity. In a contractually linked situation, the liability has credit risk associated with the contractually linked asset but does not have own credit risk. We acknowledge that the guidance on identifying the change in the fair value of a liability due to credit risk in paragraph 10(a) of IFRS 7 states: "For contracts that include a unit-linking feature, changes in market conditions include changes in the performance of the related internal or external investment fund." However, we do not believe it is clear whether this relates to contractually linked assets or liabilities linked to an index (e.g., commodity or equity linked debt) or both.

We believe that all changes in the fair value of liabilities designated under the fair value option due to own credit risk should not affect profit or loss. Changes in own credit risk will often not be fully realizable by the reporting entity because of restrictions on transfer and other market factors that prevent extinguishment of the liability at an amount that reflects changes in own credit risk. In addition, we believe that recognizing changes in own credit risk through profit and loss is counter-intuitive; gains should reflect improvements in an entity's financial position and not declines in such positions. Changes in credit risk of liabilities related to contractually linked assets should be recorded in profit and loss to off-set the related change in the linked asset.

Question 2

Or alternatively, do you believe that changes in the credit risk of the liability should not affect profit or loss unless such treatment would create a mismatch in profit or loss (in which case, the entire fair value change would be required to be presented in profit or loss)? Why?

As discussed above, we believe that a distinction should be made between own credit risk and the credit risk of a liability that arises by reference to the assets that secure it. The exposure draft states that some have suggested that the proposals could create an accounting mismatch, and "that might be the case if the entity is managing liabilities designated under the fair value option with financial assets that are measured at fair value through profit or loss." Providing an exception to the classification of changes in fair value of liabilities for liabilities that are "managed" with specified assets is too broad and may encompass situations where the liability is not contractually linked to an asset. Rather than provide an exception, we believe that the scope of the proposed amendment should be limited to own credit risk.

We believe that the change in the own credit risk of the liability should not affect profit or loss even in the case of a mismatch between assets and liabilities. Changes in the credit spreads of financial assets are realizable by the owner of that asset. Consistent with our view stated above, the change in fair value of liabilities due to changes in own credit risk will not be realizable, in many cases, even if those liabilities are managed with specific assets.

We believe that credit risk that arises from a contractually linked interest in specified assets should affect profit and loss. In such cases, the change in the fair value of the liability will be realizable because the change in the value of the contractually linked asset is being passed through to the holder of that liability. Reporting such changes in profit and loss would avoid a true mismatch between assets and liabilities that are clearly contractually linked.

Question 3

Do you agree that the portion of the fair value change that is attributable to changes in the credit risk of the liability should be presented in other comprehensive income? If not, why?

We agree that changes in fair value attributable to own credit risk of the liability should be presented in other comprehensive income. We believe that incorporating own credit risk into the fair value of liabilities reported on the balance sheet may provide useful information to users of financial statements as well as maintain a consistent definition of fair value for all financial liabilities, whether required to be recorded at fair value (e.g. derivatives) or elected to be recorded at fair value through the fair value option (e.g., indebtedness). However, as stated above, we believe that changes in fair value attributable to own credit risk should not be recorded in profit or loss; therefore, such changes should be recorded in other comprehensive income.

Question 4

Do you agree that the two-step approach provides useful information to users of financial statements? If not, what would you propose instead and why?

We do not believe that a two-step approach is necessary for presenting the change in the fair value of a liability that will be recorded in profit and loss. We believe that this presentation adds additional complexity to financial statements without providing the reader of the financial statements with any additional information, as the total change in the fair value of the liability can easily be determined by combining the amounts reported separately in profit and loss and other comprehensive income.

Question 5

Do you believe that the one-step approach is preferable to the two-step approach? If so, why?

Consistent with our response to Question 4, we believe a one-step approach is preferable.

Question 6

Do you believe that the effects of changes in the credit risk of the liability should be presented in equity (rather than in other comprehensive income)? If so, why?

No. The effect of changes in own credit risk of the liability should be reflected in other comprehensive income rather than equity because it represents an element of comprehensive income, consistent with mark-to-market gains and losses on financial assets. The fair value of the liability assumes an extinguishment of the liability (by settlement under the existing definition of fair value or transferring the liability under the proposed amendments to the definition of fair value). Under IAS 39, a gain or loss on extinguishment is recorded in comprehensive income (albeit through profit and loss). The view that a change in a liability's credit risk represents a wealth transfer between debt holders and equity holders and therefore should be recorded directly in equity is inconsistent with the current treatment of gains and losses on extinguishment of debt under IAS 39, which also represents a wealth transfer between debt holders and equity holders. While we support a review of items that should be included in comprehensive income, the current IASB agenda has a project to reconsider the presentation of other comprehensive income but not the items to be included therein. We believe that it is appropriate to classify in other comprehensive income the effect of changes in the credit risk of the liability, and such classification should not await a future review of the components of other comprehensive income.

Question 7

Do you agree that gains or losses resulting from changes in a liability's credit risk included in other comprehensive income (or included in equity if you responded 'yes' to Question 6) should not be reclassified to profit or loss? If not, why and in what circumstances should they be reclassified?

No. We believe that realized gains and losses should be reclassified to profit and loss consistent with the current classification of gains and losses on extinguishment of debt under IAS 39. Realized gains and losses will only occur if the liability is settled at an amount different than its contractual amount.

Question 8

For the purpose of the proposals in this exposure draft, do you agree that the guidance in IFRS 7 should be used for determining the amount of the change in fair value that is attributable to changes in a liability's credit risk? If not, what would you propose instead and why?

We agree with the default approach in IFRS 7 for determining the amount of the change in fair value attributable to changes in a liability's own credit risk. That approach incorporates both the price of credit and the credit quality of the issuer in determining the change in fair value of the liability due to changes in own credit risk. We are concerned that the guidance in paragraph 10(a) of IFRS 7 which permits the use of an alternative method may create disparity in practice. While we are not opposed to the use of an alternative approach that more faithfully represents the amount of the change in the fair value of a liability that is attributable to changes in the own credit risk of the liability, we

believe that the alternative approach should be clear that it should incorporate both the price of credit and the credit quality of the issuer.

Question 9

Do you agree with the proposals related to early adoption? If not, what would you propose instead and why? How would those proposals address concerns about comparability?

Yes, in part. Given that the effective date for implementing the proposed changes is not until 1 January 2013 (the adoption date for IFRS 9), we believe that early adoption should be encouraged particularly in view of the attention this matter has received (including by the Financial Crisis Advisory Group). However, we do not believe that the early adoption of the proposed changes to the accounting for own credit risk must be made in connection with the full adoption of IFRS 9. The effort necessary to implement the proposed changes should not be significant as much of the necessary information is already required to be disclosed in the notes to the financial statement.

Question 10

Do you agree with the proposed transition requirements? If not, what transition approach would you propose instead and why?

We agree with the proposed transition requirements which will require retrospective application, as we believe this will provide more meaningful and comparative information for users of financial statements. As stated above, given that such information is currently required to be disclosed, we do not believe there would be a significant burden in restating prior periods.