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By website: [www.ifrs.org](http://www.ifrs.org)

Sir David Tweedie  
Chairman  
International Accounting Standards Board  
30 Cannon Street  
London EC4M 6XH  
United Kingdom

Dear Sir David

**Supplement to ED/2009/12**  
**Financial Instruments: Amortised Cost and Impairment**

We are pleased to respond to your Supplement to ED/2009/12 Financial Instruments: Amortised Cost and Impairment.

We recognize the significant efforts that the Board is making to respond to the concerns raised by constituents in its original Exposure Draft ("ED") and support the development of a single converged model for impairment under both International Financial Reporting Standards ("IFRS") and United States' Generally Accepted Accounting Principles.

Overall, we consider the proposals in the supplementary document helpful; and we support impairment models based on the differentiation between good and bad book as well as the de-coupling of interest income from credit loss estimate. However, we have serious concerns with the operational difficulties and subjectivity of allowing management to determine expected losses for remaining life time of asset portfolio. While we agree that there is a need for provisioning for future credit losses and to use more forward looking information, we would prefer an extension of the current incurred loss model to include an element of future expected losses that are either highly likely or based upon objective evidence as mentioned in our response to Questions 3 and 4 below. In addition, we strongly encourage the International Accounting Standards Board ("IASB") to perform field testing of the proposals in the ED before issuing a final IFRS.

Our comments on the specific questions raised in the supplementary document are attached. Since the Supplement is piecemeal in nature, our response is only in the context of the proposals discussed in this document. Our final comment is subject

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*Vice Chairmen* The Hongkong and Shanghai Banking Corporation Ltd  
Standard Chartered Bank (Hong Kong) Ltd  
*Secretary* Eva Wong Mei Seong

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to seeing the complete revised exposure draft on Financial Instruments: Amortised Cost and Impairment. Meanwhile, we would be happy to further clarify or discuss any of the above points should you so wish.

Yours sincerely

A handwritten signature in black ink, appearing to be 'Eva Wong', is written over the typed name.

Eva Wong  
Secretary

Enc.

**Responses of the Hong Kong Association of Banks (“HKAB”) to Specific Questions in the International Accounting Standards Board’s Supplement to the Exposure Draft on Financial Instruments: Amortised Cost and Impairment**

**Question 1**

*Do you believe the approach for recognition of impairment described in this supplementary document deals with this weakness (ie delayed recognition of expected credit losses)? If not, how do you believe the proposed model should be revised and why?*

HKAB’s response: We generally believe that the proposed approach can address the “too little, too late” concerns inherent in the current incurred loss methodology. The proposed model which uses more forward-looking information and are more closely linked with credit risk management practices can provide better information to users of financial statements.

While we understand the IASB’s desire to reflect the relationship between the pricing of financial assets and expected credit losses, we have serious concern that there may be a practical limitation for entities to foresee credit losses that would occur for the remaining expected life of portfolio assets both initially and prospectively. There is also significant room for management judgment in estimates, and the degree of variation in estimates will increase as the time horizon that the estimates covers becomes longer (please see further elaboration in our response to Questions 3 and 4) .

**Question 2**

*Is the impairment model proposed in the supplementary document at least as operational for closed portfolios and other instruments as it is for open portfolios? Why or why not? Although the supplementary document seeks views on whether the proposed approach is suitable for open portfolios, the boards welcome any comments on its suitability for single assets and closed portfolios and also comments on how important it is to have a single impairment approach for all relevant financial assets.*

HKAB’s response: We believe that the model can be applied to both open and closed portfolio of loans and debt securities. Estimating the timing and amount of expected credit losses is very difficult at the individual financial asset level initially and generally becomes more reliable at the portfolio level. We support a consistent approach to measure the impairment for all financial assets carried at amortised cost, but only to the extent that it is practicable to apply such an approach.

### Question 3

*Do you agree that for financial assets in the 'good book' it is appropriate to recognise the impairment allowance using the approach described above? Why or why not?*

See response to Question 4 below.

### Question 4

*Would the proposed approach to determining the impairment allowance on a time-proportional basis be operational? Why or why not?*

HKAB's response to Questions 3 and 4: The proposed impairment approach to recognize impairment allowances based on the higher of the time-proportional expected life-time credit losses and the foreseeable future losses seems sound conceptually. However, in practice it may be too difficult and complicated to apply. The biggest operational challenge, in our opinion, relates to the projection of remaining life-time expected losses, i.e. to go beyond the foreseeable into the unforeseeable.

For each asset portfolio in the Good Book, entities need to estimate the expected credit losses for the remaining expected life or the foreseeable future, as appropriate. In B11, the foreseeable future is defined as a period over which specific projections are possible and credit losses can be reasonably estimated. Estimation is not a precise science and paragraph B13 clearly states that it heavily depends on an entity's ability to forecast. *Given the inherent uncertainty with forecasted information, estimating the amount and timing of credit losses for the remaining expected life of asset portfolio would be extremely difficult to make, and management forecast would be highly subjective and sensitive to assumptions.*

The Supplement has not defined the methodology of determining expected credit losses. It simply states that entity has to consider all available information including historical data, data on current economic conditions and reasonable and supportable information relating to forecast of future events and conditions that is consistent with currently available information. There is no guideline on what is considered supportable and reasonable. Also, the term current is not sufficiently clear and does not provide a clear boundary between what would be considered and what would not be considered in forecasting.

Judgment would be required to determine what type of data about future economic conditions may be considered to be reasonable and supportable. To the extent that those information originate from reputable sources, they all could be argued to meet the reasonable test. And, at any one time, a number of different economic data may exist. Hence, the estimation of expected losses may include management forecast based on selected information that is at the discretion of management. The high degree of judgment is likely to reduce comparability among entities and whether these judgments are auditable is in question.

We agree that there is a need for provisioning for future credit losses and to use more forward looking information. In doing so, we would support the use of information that is currently available and is objectively verifiable. As suggested in our comment letter to the IASB on 9 June 2010, we would prefer an extension of the current incurred loss model to include an element of future expected losses. We believe expected loss can be estimated based on historical loss experience, adjusted to reflect 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. This portfolio impairment provisions can cover 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 are either highly likely or 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 also 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.

We believe that restricting the use of forward looking information with the introduction of a verifiability parameter would foster discipline and consistency in the implementation of the new impairment model and in doing so strike the right balance of making best use of information that is available to the entity without requiring the entity to make predictions or forecast without objective evidences.

We are also concerned about the granularity and duration of data available. From a practical perspective, for smaller banks and many banks in Hong Kong and Asia, they will not have enough detailed and reliable historical data to determine the expected losses for each group of assets with similar characteristics over a full macro-economic cycle. In addition, the weighted average expected life of the portfolio is not as simple as calculating the weighted average life based on contractual maturities. In developing the expected life for a portfolio, entities will need to consider prepayment options, call options, extension options, other options and asset defaults. Therefore, entities may need to consider external factors such as movements in interest rates and other factors correlated to prepayment and call options.

Given the above, we would suggest allowing sufficient lead time for data gathering, system implementation and process development.

#### **Question 5**

*Would the proposed approach provide information that is useful for decision-making? If not, how would you modify the proposal?*

HKAB's response: We believe that a decoupling approach that allow entities to decouple the interest revenue and credit loss calculation can provide more useful information for analysis and decision making purpose.

Since subjective judgments are required in estimating the parameters for impairment model, which include life-time expected losses as well as choosing 'foreseeable future period' when determining the 'floor' amount, readers may find it very difficult to understand and interpret the numbers given the high degree of subjectivity. In addition, we believe that there will be significant diversity in how the "Bad Book" is defined (see further comments in Questions 6 and 7.)

In addition, the guidance on measuring expected credit losses is limited, which may result in reduced comparability among entities.

#### **Question 6**

*Is the requirement to differentiate between the two groups (ie 'good book' and 'bad book') for the purpose of determining the impairment allowance clearly described? If not, how could it be described more clearly?*

HKAB's response: Paragraph 3 describes that the distinction is based on the degree of

uncertainty about the collectability of financial asset and internal risk management objective changes from receiving regular payments to recovery of the financial assets. And Paragraph B3 gives examples on recovery of assets such as enforcement of security interest and debt restructuring etc. These examples of credit risk management activities relating to the bad book usually take place long after the initial identification of credit problems in an asset. On the other hand, some of the activities (e.g., collection calls, etc.) in the example relate to management of delinquent but not defaulted assets that would occur in the very early stages of an asset's credit decline. Therefore, we would suggest the examples in B3 be revised.

Generally, the migration between performing and default stages does not change in one go, but there are many intermediate situations that can be identified. Therefore, we would suggest uncertainty about the collectability of financial asset should be based upon internal risk management processes when assets are first identified to be doubtful or problematic.

#### **Question 7**

*Is the requirement to differentiate between the two groups (ie 'good book' and 'bad book') for the purpose of determining the impairment allowance operational and/or auditable? If not, how could it be made more operational and/or auditable?*

HKAB's response: There is no clear dividing line for loans to be transferred between 'good book' or 'bad book'. Credit risk management practices differ among entities; with the result that inconsistent treatment for the same borrower may happen across different reporting entities i.e. one reporting entity may recognize a full expected loss while another may spread it.

We would therefore suggest the transfer be based upon some objectively verifiable loss events, such as those currently listed under IAS 39 paragraph 59

#### **Question 8**

*Do you agree with the proposed requirement to differentiate between the two groups (ie 'good book' and 'bad book') for the purpose of determining the impairment allowance? If not, what requirement would you propose and why?*

HKAB's response: We agree that an impairment allowance approach based on the two groups is appropriate, as it is aligned with the way many banks manage their loan portfolios. Loans that had become non-performing are transferred from the "good

book” (performing) to the “bad book” (non-performing) to be managed individually or in a separate pool. The proposed impairment model that is based on an entity’s management of assets (in this case, the ‘good’ book/’bad’ book concept) is also consistent with the IASB’s previous decisions to align the classification of financial assets under IFRS 9 with the entity’s business model.

As the proposed approach will apply to all IFRS preparers, the IASB should ensure that the guidance is also appropriate for entities outside the financial services industries.

### **Question 9**

*The boards are seeking comment with respect to the minimum allowance amount (floor) that would be required under this model. Specifically, on the following issues:*

*(a) Do you agree with the proposal to require a floor for the impairment allowance related to the ‘good book’? Why or why not?*

*(b) Alternatively, do you believe that an entity should be required to invoke a floor for the impairment allowance related to the ‘good book’ only in circumstances in which there is evidence of an early loss pattern?*

*(c) If you agree with a proposed minimum allowance amount, do you further agree that it should be determined on the basis of losses expected to occur within the foreseeable future (and no less than twelve months)? Why or why not? If you disagree, how would you prefer the minimum allowance to be determined and why?*

*(d) For the foreseeable future, would the period considered in developing the expected loss estimate change on the basis of changes in economic conditions?*

*(e) Do you believe that the foreseeable future period (for purposes of a credit impairment model) is typically a period greater than twelve months? Why or why not? Please provide data to support your response, including details of particular portfolios for which you believe this will be the case.*

*(f) If you agree that the foreseeable future is typically a period greater than twelve months, in order to facilitate comparability, do you believe that a ‘ceiling’ should be established for determining the amount of credit impairment to be recognised under the ‘floor’ requirement (for example, no more than three years after an entity’s reporting date)? If so, please provide data and/or reasons to support your response.*

HKAB’s response: Reporting entities would need to determine what period represents the “foreseeable future” for working out the minimum allowance floor, subject to the condition that it should not be less than 12 months after an entity’s reporting date. As reporting entities have discretion to choose the period of “foreseeable future”, this



may result in different expected loss calculation for similar items across different reporting entities.

We believe that most of the available internal or external information used in the expected loss estimate is usually of near-term nature (i.e. over a one-year time horizon) as it is always difficult to forecast future events or future economic indicators. Therefore, we think that a fixed period of one-year time horizon is more preferred as this will enhance comparability of expected loss calculation across reporting entities and is also in line with the requirement of Basel as regards expected loss calculation.

#### **Question 10**

*Do you believe that the floor will typically be equal to or higher than the amount calculated in accordance with paragraph 2(a)(i)? Please provide data and/or reasons to support your response, including details of particular portfolios for which you believe this will be the case.*

HKAB's response: The interaction between the time-proportional amount and the foreseeable future expected losses will depend on the expected loss curve pattern, which can vary considerably across different portfolios. Conceptually, the 'floor' amount will likely to be equal to or higher than the time-proportional amount for portfolio comprising financial assets with high possibility of early loss pattern.

The 'floor' amount determined also depends on the entity's ability in forecasting the future events and developing projections, which may be varied from entity to entity. More sophisticated entities (possibly with more advanced credit risk management systems) may be able to project over longer periods and are more likely to arrive at a larger 'floor' amount than less sophisticated ones.

#### **Question 11**

*The boards are seeking comment with respect to the flexibility related to using discounted amounts. Specifically, on the following issues:*

*(a) Do you agree with the flexibility permitted to use either a discounted or undiscounted estimate when applying the approach described in paragraph B8(a)? Why or why not?*

*(b) Do you agree with permitting flexibility in the selection of a discount rate when using a discounted expected loss amount? Why or why not?*

HKAB's response: IFRS generally requires cash flows that will occur in the future to

be discounted. This requirement is based on the presumption that time value of money should be considered in a measurement based on future cash flows. Therefore, we think that the use of a discounted amount for expected losses allocation is conceptually sound where the timing of expected credit losses is required to be estimated. We note that the Board has not redeliberated the measurement basis for expected losses and whether probability weighted cash flows for different outcomes over multiple time periods will be required; therefore, it is difficult to comment on a discount rate methodology.

BC43 allows an entity to use any reasonable rate between (and including) the risk-free rate and the effective interest rate as determined according to the current IAS 39. There is no definition of “reasonable rate” or guideline on the selection of appropriate rate. It is not clear how an entity would decide whether the risk-free rate or effective interest rate, or some rate in between, should apply. This will lead to diversity in practice that would reduce comparability. To this extent, we would like to see guidance developed that would require an entity to determine the most appropriate rate. Such guidance should be consistent with the requirement in paragraph 47 of IAS 37 that the discount rate should not reflect risks for which future cash flow estimates have been adjusted.

#### **Question 12**

*Would you prefer the IASB approach for open portfolios of financial assets measured at amortised cost to the common proposal in this document? Why or why not? If you would not prefer this specific IASB approach, do you prefer the general concept of the IASB approach (ie to recognise expected credit losses over the life of the assets)? Why or why not?*

HKAB’s response: Subject to our suggestions above, we would prefer the common proposal to IASB’s initial approach. As actual losses occur over the life of a portfolio of financial assets, recognising expected credit losses over the expected life better reflects the economics of the lending transactions.

#### **Question 13**

*Would you prefer the FASB approach for assets in the scope of this document to the common proposal in this document? Why or why not? If you would not prefer this specific FASB approach, do you prefer the general concept of this FASB approach (ie to recognise currently credit losses expected to occur in the foreseeable future)? Why or why not?*

HKAB's response: Although the general concept of FASB's approach may cater for the 'too late, too little' credit loss allowance as criticized in existing 'incurred loss' model, this approach may lead to the issue of 'too early, too large' when recognizing all expected losses at one point of time. We believe this does not reflect the underlying economics of lending transaction. Therefore, we would give our preference to the common proposal than FASB's initial approach.

**Question 14Z**

*Do you agree that the determination of the effective interest rate should be separate from the consideration of expected losses, as opposed to the original IASB proposal, which incorporated expected credit losses in the calculation of the effective interest rate? Why or why not?*

HKAB's response: We support that the determination of effective interest rate should be separate from credit loss. Decoupling is acceptable and necessary not only as a practical approach but also to help distinguish between contractual factors reflected in the EIR and credit expenses which are of different aspects when assessing the performance of an entity.

To this extent, interest revenue should continue to be recognized on the basis of the effective interest rate and should not factor in expected credit losses. The IAS 39 concept of EIR should be retained.

**Question 15Z**

*Should all loan commitments that are not accounted for at fair value through profit or loss (whether within the scope of IAS 39 and IFRS 9 or IAS 37) be subject to the impairment requirements proposed in the supplementary document? Why or why not?*

HKAB's response: We agree with the IASB's rationale that loan commitments and loans are often managed using the same business model and information systems. However, the nature of loan and loan commitments is very different; the former is a recognized asset of the entity whilst the latter is just a commitment (a promise to lend by an entity) and it may end up not being utilized by the borrower. It is reasonable to charge impairment losses against a recognized loan asset to avoid overstating recoverable amount from loan asset by an entity. However, it is not appropriate to apply the same impairment concept on loan commitment, which is still a promise to lend and yet to become an asset of the entity. The current requirement under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, making provision only

when the outflow of economic resources is probable and the loss can be estimated reliably, or otherwise requiring disclosure by way of notes is believed to be adequate in conveying the information to readers of financial statements about the amount that an entity is committed to lend. More concrete or specific requirements on how to apply the proposed impairment model on loan commitment is needed for future re-deliberations.

**Question 16Z**

*Would the proposed requirements be operational if applied to loan commitments and financial guarantee contracts? Why or why not?*

HKAB's response: For undrawn commitments that may not be legally binding but represent constructive obligations, entity may need to estimate the expected utilization amount for impairment provisioning.

For the case of financial guarantee contracts, if the proposed model will be used to estimate the expected future liabilities arising from issuing financial guarantees, given the parameters in calculation including the discount rate and the basis for estimating liabilities and their timing can be determinable, the proposal is likely to be operational subject to our comments on the impairment model in Questions 3 and 4. However, the most challenging part is how an entity could arrive at reasonable estimates of the probability of a specified debtor failing to fulfill the obligation which the guarantee covers and the associated cash outflows expected to occur from such a guarantee. We believe the present accounting for financial guarantee works well and that it is unnecessary to change the current practice.

**Question 17Z**

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

HKAB's response: We support the new proposals which present interest revenue (calculated using EIR and exclude credit loss) and impairment losses as two separate line items in the Statement of Comprehensive Income. It reflects the existing practice of many financial institutions, which view net interest margin and impairment losses as key performance indicators.

**Question 18Z**

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

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

HKAB's response: We believe that the disclosures should provide sufficient information to enable users for the assessment of credit risk and the way that judgement is exercised. However, the proposed disclosure requirements seem overly extensive and onerous.

Paragraph Z8 requires the disclosure of nominal amount of financial assets, the amount of expected credit losses and the amount of the impairment allowances for 5 annual periods. We do not believe the disclosure of a time series will significantly increase the information value.

In Paragraph Z12, all entities have to provide qualitative explanation on the differences between the actual credit losses and the previous estimates with additional quantitative analysis for entities that perform back-testing. Comparability is a concern since quantitative analysis is only required for some entities. We believe that the disclosure requirements for all entities should be the same. If quantitative information is not a must disclosure item, we would suggest removing it.

Regarding paragraph Z14 and Z15, we doubt if the disclosure of information about internal credit risk rating grades, particularly those which refer to the grades under the internal rating model, would provide useful information for the readers of financial statements. Financial institutions currently adopting the internal rating approach under Basel II will involve the use of various categories of internal credit risk grades such as the obligor grades and facility grades for assessing the PD and LGD of borrowers. These credit risk grades vary from institution to institution depending on the degree of sophistication of their internal rating models. The result is that even if such information is disclosed in the financial statements, it may be difficult for readers to make meaningful comparison across different reporting institutions. We think that the disclosure of expected loss information by "good book" or "bad book", coupled with a qualitative description of how the internal credit risk grading system is mapped into these 2 groups and the internal credit risk management procedures behind, shall be sufficient for a proper understanding of the impairment figures in the financial statements.

For banks currently implementing the BASEL II Accord, they are already required by their regulatory bodies to make significant disclosures on credit risk management in accordance with Pillar 3 (Market Discipline) of the Accord. These may include the techniques for the assessment of credit risk, the limits on large exposures and credit risk concentrations and the use of credit risk mitigation techniques. We request that the Board consider existing regulatory disclosure requirements to ensure that the proposed IFRS disclosures are not duplicative or inconsistent with these requirements.

**Question 19Z**

*Do you agree with the proposal to transfer an amount of the related allowance reflecting the age of the financial asset when transferring financial assets between the two groups? Why or why not? If not, would you instead prefer to transfer all or none of the expected credit loss of the financial asset?*

When an asset is moved between the two books, an entity will have to re-estimate the amount of expected credit losses in both the good book and bad book and adjust the allowance amount accordingly under a balance sheet approach. Hence, we cannot see the benefits in calculating the individual amount of allowances for the transferred asset.

Currently, financial institutions report separate roll-forwards of the impairment provision for individually assessed accounts and collectively assessed accounts - essentially good book/bad book. We would suggest maintaining the current presentation and no transfer line is required.