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1 March 2013

By post and email: commentletters@hkicpa.org.hk

Mr Simon Riley
Director, Standard Setting Department
Hong Kong Institute of Certified Public Accountants
37th Floor, Wu Chung House
213 Queen's Road East
Wanchai, Hong Kong

Dear Mr Riley

IASB's Exposure Draft of Classification and Measurement: Limited Amendments to IFRS 9

We refer to your letter dated 11 December 2012 inviting our comments on the International Accounting Standards Board's Exposure Draft of Classification and Measurement: Limited Amendments to IFRS 9.

Our comments on the specific questions raised in the exposure draft are attached. Should you have any questions, please do not hesitate to contact our Senior Business Manager Ms Caris Wan at 2521 1855.

Yours sincerely

Boey Wong
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 Boey Wong

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Response of the Hong Kong Association of Banks ("HKAB") to the Specific Questions in the International Accounting Standards Board's Exposure Draft ("ED"): Classification and Measurement: Limited Amendments to IFRS 9

Contractual cash flow characteristics assessment

Question 1

Do you agree that a financial asset with a modified economic relationship between principal and consideration for the time value of money and the credit risk could be considered, for the purposes of IFRS 9, to contain cash flows that are solely payments of principal and interest? Do you agree that this should be the case if, and only if, the contractual cash flows could not be more than insignificantly different from the benchmark cash flows? If not, why and what would you propose instead?

We agree that a financial asset with a modified economic relationship between principal and interest can in many situations be considered to contain cash flows that are solely payments of principal and interest. However, we find the term "insignificantly different" too restrictive. We suggest that the threshold should be that the modification does not materially alter the nature of the payments as a whole as principal and interest. The purpose of the assessment is to determine the correct classification and measurement of a financial asset in its entirety. It would not be meaningful to classify and measure one financial instrument at amortized cost while another similar financial instrument is measured at fair value due solely to cash flow streams in one instrument that do not meet a narrow theoretical definition of interest, particularly when the cash flow stream in question would not otherwise meet the definition of a derivative. (See our further comments on materiality in response to Question 3 below.)

The ED defines interest as consideration for the time value of money and for the credit risk associated with the principal amount outstanding during a particular period of time. This definition is too narrow and does not reflect other components of interest that represent compensation for liquidity risk, origination costs (which are required by IFRS to be recognized as interest expense when charged as an upfront fee) and the profit margin that is inherent in the risk premium. The basis for conclusions to IFRS 9 acknowledges a broader interpretation of the definition of interest. Paragraph BC4.22 in IFRS 9 states: "*... interest is consideration for the time value of money and the credit risk associated with the principal amount outstanding during a particular period of time, which may include a premium for liquidity risk.*" We suggest that the Board consider a more expansive definition of interest.

We agree that the measurement of the significance of the modification should be made against the appropriate benchmark cash flows for the financial asset in question. However, we strongly disagree with the manner in which the benchmark interest rate has effectively been defined in the ED, which is an interest rate that is reset where the frequency of the reset matches the tenor of the interest rate (i.e., a three month rate for a three month interest accrual period.) Constant maturity loans (where the interest rate resets based on the original tenor of the loan rather than the remaining period to maturity) would represent an instrument with a modified economic relationship as defined in the ED. In legal environments where interest rates are highly regulated, a constant maturity loan may be the only legally permissible lending instrument.

Specifically, the contractual interest rates on retail and corporate loans denominated in local currency in Mainland China are reset according to the original maturity of the loans when the official interest rates regulated by the central bank are reset. For example, a 3-year loan with a remaining maturity of 1 year will re-price to the new 3 year rate. While there is an interest rate mismatch feature based on the principles in the ED, the contractual cash flows of the loan are economically only solely payments of principal and interest and the cash flows do not have leverage (i.e. the lender is being compensated for lending without any possibility of obtaining a non-lending return).

Notwithstanding that the manner in which the interest rates are reset is a central bank requirement (the lenders have no choice), these constant maturity loans will fail the solely payments of principal and interest test ("SPPI Test") thus having a "modified economic relationship" as defined in the ED, from both a qualitative and quantitative perspective, because interest rates are generally higher for loans with longer tenor (3 year rate) than those with shorter remaining tenor (1 year rate). Therefore, the contractual cash flows of these loans could be more than insignificantly different from the "benchmark" cash flows, and they would have to be measured at fair value through profit or loss under the ED.

In fact, a "benchmark" does not exist for these loans, this is because there are no market-oriented benchmark interest rates for local currency lending in Mainland China. Under the ED, if no actual benchmark instrument is available, an entity may use a hypothetical instrument to perform the assessment. An entity would construct the benchmark cash flows using the appropriate unmodified rate. The ED does not propose to mandate a method on how to perform the assessment.

For example, an instrument originated in Mainland China with a 5 year maturity that resets every 6 months to a 5 year rate (mandated by regulation) must be compared against a "benchmark" rate. Since there is no appropriate benchmark or unmodified rate to use from a comparable instrument that does not contain the modification (as all other instruments of these types in the jurisdiction are reset in the same manner), a hypothetical instrument must be devised. The ED states that the appropriate comparable financial instrument is a contract of the same credit quality and with the same contractual terms (including, when relevant, the same reset periods), except for the contractual terms under evaluation. Based on this, the hypothetical instrument should have an interest reset period of 6 months. The implementation issue is what is the appropriate interest rate – is it a rate of the same yield curve that the actual lending rate is derived from, or an inter bank lending rate? The actual instrument reflects a PBOC rate that is a published interest rate by the People's Bank of China specifically for consumer and commercial lending. SHIBOR (Shanghai Inter-bank Offered Rates) are rates on inter-bank market and bond markets that act as a reference for short term rates (less than 3 month) but not beyond 3 months. The SHIBOR-6M rate is also available and could be used as a hypothetical "benchmark" rate; however, in practice the SHIBOR has very limited liquidity for more than 3 month funding and therefore it would be inappropriate to use as an unmodified rate. Whether the 6 month PBOC or SHIBOR rate is used, the resulting hypothetical instrument will bear no resemblance to any instrument that is actually available in the market.

In addition, the conclusion of the ED that the compensation to the lender that is in excess of the benchmark interest is not in fact interest raises the question then as to what is the nature of this excess compensation. For the example above, we considered whether the "double-double" test would be satisfied under IAS 39, thus making the feature an embedded derivative. The condition that the embedded derivative in the constant maturity loan *"could*

result in a rate of return that is at least twice what the market return would be for a contract with the same terms as the host contract" is not satisfied. The condition is not satisfied because the PBOC interest rates are considered market / benchmark rates to use in pricing retail and corporate loans in China, and the interest rate reset feature for these loans (resetting the rate based on original maturity) is required by the local regulator. Therefore the return yielding from the host contract could not have doubled the market return compared to a similar contract since interests in other similar contracts are also reset in the same manner. Accordingly, the constant maturity feature in the constant maturity loan is considered closely related to the host contract and no bifurcation is required under IAS 39.

To suggest that a published, legally required, and universally applicable interest rate does not result in benchmark cash flows is to adopt a theoretical approach that does not result in useful information for users of financial statements. If the Board proceeds with this approach, there is the very real possibility that the classification and measurement of financial assets will simply be differentiated among reporting entities by the geographical location of the originator of the financial asset rather than any real difference in the nature of the underlying cash flows. Potentially all local currency retail and corporate loans in Mainland China with a vanilla lending business model must be measured at fair value through profit or loss under the ED.

The ED states that the reason why a rate is set in a particular way (including when the rate is required to be set in a particular way) is not relevant to the analysis. We see no reason why the benchmark cash flows should be derived from anything but the required rate when a rate is required to be set in a particular way. An entity's business model is highly dependent on its regulated environment. Given that the objective is to align the classification and measurement of financial assets with an entity's business model, we believe that it is entirely consistent to consider that environment in the definition of principal and interest cash flows.

It would seem a punitive accounting outcome, if in the light of the government's interest rate setting, and the fact lenders have no choice on the legal pricing basis in the jurisdiction, the proposals would render all local currency plain vanilla loans in Mainland China to be measured at (hypothetical) fair value through profit or loss. In the light of the sizeable local currency retail and corporate loans in Mainland China, the accounting impact would be significant.

We suggest that benchmark cash flows should be determined using the benchmark interest rate in the originating jurisdiction. We agree with the suggestion in the IASB Staff Paper that would allow a scope exception to permit classification of a financial asset at other than fair value through profit or loss (subject to business model) if the base interest rate is consistent with and required by a stated interest rate structure that is set by the government or central bank and that represents the legal pricing basis for domestic currency transactions available in the jurisdiction.

Question 2

Do you believe that this ED proposes sufficient, operational application guidance on assessing a modified economic relationship? If not, why? What additional guidance would you propose and why?

We believe that more guidance is required. Greater clarity could be provided around the use of a hypothetical instrument for determining benchmark cash flows. The benchmark cash

flows should be based to the greatest extent possible on actual instruments (reflecting the interest rate environment of the lender and credit risk of the borrower). Hypothetical instruments should generally be limited to situations where it is necessary to interpolate between two observable interest rates (e.g., where the loan has a 4 month reset but observable rates are for 3 or 6 months tenors).

Paragraph B4.1.9D states that "when assessing a modified economic relationship in a financial asset, an entity shall consider variables that could affect cash flows." We suggest that the reference to could be modified to "probably would".

Question 3

Do you believe that this proposed amendment to IFRS 9 will achieve the IASB's objective of clarifying the application of the contractual cash flow characteristics assessment to financial assets that contain interest rate mismatch features? Will it result in more appropriate identification of financial assets with contractual cash flows that should be considered solely payments of principal and interest? If not, why and what would you propose instead?

The ED has provided welcomed clarification that not all modified economic relationships will result in the classification of a financial asset at fair value through profit and loss. However, the clarification only applies to modified economic relationships that do not result in cash flows that are more than insignificantly different from the benchmark cash flows. We have addressed our concerns above regarding the threshold of insignificantly different. We further note that a modified economic relationship only refers to leverage and certain interest rate reset features. However, there will be situations where there exist other features that would meet neither the definition of principal and interest in the ED nor a modified economic relationship. While many of these features would meet the requirements for bifurcation of derivatives under IAS 39, it is not clear from the ED how the related financial asset should be classified when such features result in immaterial differences between the instruments cash flows and benchmark cash flows.

For example, financial assets that have an embedded prepayment option are frequently purchased in the secondary market at premiums or discounts to face value. While the ED provides exceptions for prepayment options under certain conditions, the acceleration or reduction of income related to a discount or premium that occurs upon exercise of a prepayment option would not likely meet the exception in paragraph B.4.1.10 of the ED, which states that the prepayment amount substantially represents unpaid amounts of principal and interest on the principal amount outstanding, which may include reasonable additional compensation for the early termination of the contract. A premium or discount reflects the interest rate and credit environments at the date of purchase, not necessarily anticipated compensation for the early termination of a contract. However, in many cases the amount of the discount or premium will not be significant and would not have required bifurcation under IAS 39. In our view, such small differences should not automatically result in the classification of an instrument at fair value through profit and loss.

We note that the IASB Staff Paper (5A 27 February 2012) states: "*If the financial asset contains a feature (ie a "building block") other than principal, compensation for the time value of money and the credit risk of the instrument, the instrument must be measured at FVPL. For example, that would be the case if interest payments are indexed to commodity prices or equity prices, even if the effect of such indexation is not expected to be significant.*"

This statement is footnoted with the following: *"However, the overall notion of materiality still applies to this condition inasmuch it applies to every item in the financial statements."* It is unclear whether the notion of materiality applies to the assessment criteria (i.e., the alteration of the cash flows is not material to the benchmark cash flows) used to reach a classification conclusion or to the resulting outcome of the classification (i.e., the difference between classifying a financial asset at amortized cost versus fair value through profit or loss is not material). While an embedded feature might not materially alter the cash flows of a financial asset, the difference between classification at amortized cost and classification at fair value through profit and loss would likely be material in many cases.

Classification is an inherently qualitative assessment, so it is difficult to apply the normal rules of materiality, particularly when the ED sets thresholds for some specific features but not others. Excluding modified economic relationships, it is not clear whether it is the intention of the Board that any feature of a financial asset that creates cash flows that differ, even if immaterially, from benchmark cash flows results in classification of that instrument at fair value through profit and loss. If the answer is no, then there is an inconsistency between the concept of materiality and the guidance provided in the ED concerning modified economic relationships and the threshold of insignificantly different. A threshold of "immaterial" might be considered higher than "insignificantly different". Why should the threshold be different for different features? If the answer is yes, then we have serious concerns that such a zero tolerance approach would require that many financial assets be classified at fair value through profit and loss even when their cash flows differ only insignificantly from other financial assets classified as amortized cost. This also increases the likelihood that small embedded features go unnoticed upon initial classification, increasing the risk of subsequent financial statement restatements.

Business Model

Question 4

Do you agree that financial assets that are held within a business model in which assets are managed both in order to collect contractual cash flows and for sale should be required to be measured at fair value through OCI (subject to the contractual cash flow characteristics assessment) such that: (a) interest revenue, credit impairment and any gain or loss on derecognition are recognised in profit or loss in the same manner as for financial assets measured at amortised cost; and (b) all other gains and losses are recognised in OCI? If not, why? What do you propose instead and why?

We support the Board's proposal to expand the number of measurement categories to include fair value through OCI. The two measurement categories currently in IFRS 9 are too narrow and does not reflect all business models. In many cases, assets are held to collect contractual cash flows although not necessarily through the maturity of the asset. Such portfolios are often managed primarily on a contractual cash flow basis and providing information in the income statement on such a basis (as opposed to reflecting short-term volatility to changes in the interest rate environment and credit perceptions) will provide useful information to users of financial statements. Meanwhile, providing fair value information in the balance sheet will provide useful information to reflect the potential impact should such assets be sold in the short term. Specifically, the addition of the fair value through OCI category will address concerns raised in the insurance industry that the existing categories in IFRS 9 result in an

accounting mismatch between the accounting for insurance liabilities and the assets used to fund them.

In addition, we support the decision that the classification is mandatory for business models where financial assets are managed both to collect contractual cash flows and for sale.

Question 5

Do you believe that the ED proposes sufficient, operational application guidance on how to distinguish between the three business models, including determining whether the business model is to manage assets both to collect contractual cash flows and to sell? Do you agree with the guidance provided to describe those business models? If not, why? What additional guidance would you propose and why?

We believe that additional clarity could be provided to distinguish among the different measurement categories, particularly given that the criteria "to collect contractual cash flows" is used within two different measurement criteria. Paragraph B4.1.2B provides examples of evidence that support a factual conclusion of an entity's business model. We suggest that specific application guidance be provided for these specific examples. Paragraph B4.1.3 discusses the evaluation of the level and reasons for sales activity. We suggest that the meaning of "infrequent", "insignificant", "close to maturity" and "approximate the collection of the remaining contractual cash flows" in paragraph B4.1.3 be further clarified.

The amortized cost measurement category applies to qualifying financial assets held within a business model to collect contractual cash flows. It would be clearer if the criteria were restated to state that the model is to collect contractual cash flows through maturity of the financial asset, notwithstanding any infrequent or insignificant sales. Example 1 for this category states that the maturity of the entity's financial assets is matched to its estimated funding needs. It would be helpful to elaborate the principle of this criteria by stating in the body of the standard that an entity's funding needs that are shorter than the maturity of the financial assets is inconsistent with a business model to hold financial assets to collect contractual cash flows. Also, we note that there is an inconsistency in the analysis of Example 2. The opening sentence states that the objective of the entity's business model is to hold financial assets to collect contractual cash flows. However, the analysis concludes that the objective of the business model could be to collect contractual cash flows. We do not believe that the concluding sentence is necessary, as the conclusion was already stated in the opening.

The fair value through OCI measurement category applies to qualifying financial assets held within a business model in which assets are managed both in order to collect contractual cash flows and for sale. If the business model to hold financial assets to collect contractual cash flows is intended to apply through the maturity of the financial asset, then such a business model is mutually exclusive from a business model to sell financial assets. Therefore, a business model to both collect contractual cash flows and for sale is logically inconsistent, unless the business model applies differently to different assets within a portfolio, which does not appear to be the intention of the ED. We suggest that the business model criteria for financial assets measured at fair value through OCI be to collect contractual cash flows <u>or</u> to sell. This also appears consistent with the examples in the ED.

For business models to manage assets both to collect contractual cash flows and to sell, we note that Example 1 states that the objective for managing the financial assets is to maximize

the return and the manager responsible for the portfolio is remunerated based on the return generated. This could appear to be more consistent with a business model to sell financial assets. We suggest that the objective we rephrased to state that it is to maximize the return through the collection of principal and interest or capital appreciation or both.

The ED does not provide an example of a business model that is to sell financial assets. We believe that providing such an example would be helpful and provide a complete set of examples to articulate the principles embodied in the business model criteria.

Under the ED, when an entity reclassifies a financial asset out of the fair value through profit or loss measurement category, the new carrying amount of the financial asset would be its fair value at the reclassification date. The effective interest rate is determined based on that carrying amount. However, when an entity reclassifies a financial asset out of the fair value through other comprehensive income measurement category, because the cumulative gain or loss previously recognised in other comprehensive income is removed from equity and adjusted against the fair value of the financial asset at the reclassification date according to paragraph 5.6.5, the new carrying amount of the financial asset at reclassification date would be its amortised cost as if it was measured at amortised cost initially. There is no change in effective interest rate as a result of the reclassification.

In order to eliminate this discrepancy so that fair value for an asset previously measured at fair value on the balance sheet becomes the new amortized cost basis regardless of the prior measurement category, we suggest that the existing approach under IAS 39 for assets reclassified from AFS to loans and receivables be adopted. This would require that fair value become the new amortized cost basis, with any difference between fair value and the maturity amount recognized as an adjustment to EIR. Gains and losses previously recognized in OCI would not be reclassified but would be amortized to profit or loss on an EIR basis.

Question 6

Do you agree that the existing fair value option in IFRS 9 should be extended to financial assets that would otherwise be mandatorily measured at fair value through OCI? If not, why and what would you propose instead?

Yes, we support allowing a fair value option for financial assets that would otherwise be mandatorily measured at fair value through OCI. This is consistent with the existing option under IFRS 9 for financial assets at amortized cost. We see no reason why financial assets at fair value through OCI should be treated any differently when an accounting mismatch might otherwise arise.

Early application

Question 7

Do you agree that an entity that chooses to early apply IFRS 9 after the completed version of IFRS 9 is issued should be required to apply the completed version of IFRS 9 (ie including all chapters)? If not, why? Do you believe that the proposed six-month period between the issuance of the completed version of IFRS 9 and when the prohibition on newly applying previous versions of IFRS 9 becomes effective is sufficient? If not, what would be an appropriate period and why?

We believe that the completed version of IFRS 9 should be adopted in its entirety upon initial application, as there will be significant interdependencies between classification and measurement, impairment, and hedge accounting.

We do not believe that it is helpful to users of financial statements for different preparers to be adopting earlier versions of IFRS 9 and then to subsequently adopt the final version. While we understand that the Board does not wish to penalize preparers who have made preparations to adopt earlier versions, we do not see how permitting adoption of earlier versions is helpful to either preparers or users once the final version of IFRS 9 has been issued. Therefore, we believe that the prohibition to adopt earlier versions of IFRS 9 should commence upon the issuance of the final version of IFRS 9.

Presentation of "own credit" gains or losses on financial liabilities

Question 8

Do you agree that entities should be permitted to choose to early apply only the 'own credit' provisions in IFRS 9 once the completed version of IFRS 9 is issued? If not, why and what do you propose instead?

We strongly support the treatment of own credit risk in IFRS 9 and do not see any reason why this particular provision of IFRS 9 need have the same effective date as other provision of IFRS 9. The information to classify own credit risk in OCI should be available to preparers and the changes to the presentation of the financial statements is not onerous.

Consistent with our response to question 7, we do not believe that voluntary early adoption is helpful to users of financial statements as it does not facilitate comparison of result among reporting entities. Therefore, we suggest that the Board consider adopting for the own credit aspects of IFRS 9 a mandatory effective date, without early adoption, that is within 6 months of the issuance of the final version of IFRS 9.

Alternatively, we would request that the Board consider amending IAS 39 to reflect the own credit risk provisions of IFRS 9 with a mandatory effective date within 12 months of amendment. This would have the effect of immediately addressing an issue for which there is wide agreement.

First-time adoption

Question 9

Do you believe there are considerations unique to first-time adopters that the IASB should consider for the transition to IFRS 9? If so, what are those considerations?

As IFRS 9 is required to be retrospectively applied for all entities, we do not see any implementation issues that would be particular to first time adopters.

Other Comments

1. Paragraph B5.6.2 of the ED does not require an entity to separately recognise interest income when a financial asset is measured at fair value through profit or loss. It is suggested that the Board clarify whether the reporting entity has an option to choose to separately recognise interest income in profit or loss or whether recognition of interest income is not allowed.

2. Paragraph 7.2.6 of the ED states that at the date of initial application an entity shall recognize any difference between the fair value of the entire hybrid contract at the date of initial application and the sum of the fair values of the components of the hybrid contract at the date of initial application in the opening retained earnings (or other component of equity, as appropriate). Under the IFRS 9 ED, all hybrid instruments would be classified as FV through P&L, although the host instrument may previously been classified as either held-to-maturity, AFS, or fair value through P&L, while the bifurcated derivative would have been classified as fair value through P&L. It is not clear whether the Board intends that the classification of any difference upon initial application should be based on the prior classification of the host instrument. We suggest that the Board clarify under what circumstances the difference should be recorded in other components of equity.