Room 525, 5/F., Prince's Building, Central, Hong Kong
Telephone: 2521 1160, 2521 1169 Facsimile: 2868 5035
Email: info@hkab.org.hk Web: www.hkab.org.hk

香港中環太子大廈5樓525室
電話：2521 1160, 2521 1169 圖文傳真：2868 5035
電郵：info@hkab.org.hk 網址：www.hkab.org.hk

10 September 2009

By fax 2865 6776 & by post

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

2009 SEP 14 PM 4:15
HKICPA

Dear Mr Ong

Exposure Draft of International Accounting Standards Board (IASB) on Classification and Measurement of Financial Instruments

We refer to your letter dated 20 July 2009 and would like to set out below our members' comments on the above Exposure Draft.

Question 1

Does amortised cost provide decision-useful information for a financial asset or financial liability that has basic loan features and is managed on a contractual yield basis? If not, why?

We consider that amortized cost does provide decision-useful information in assessing a bank's ability in managing its net interest margin which is one of the key performance indicators. Fair value information could be disclosed in the notes to the accounts but should not be reflected in the income statement or the statement of financial position because this would not provide relevant information to users of financial statements in predicting future cash flows. Measurement of such assets and liabilities at fair value would not reflect a bank's business model. In particular, for the traditional business of commercial banks which involves taking deposits and advancing loans, amortised cost is the most relevant measure for both the income statement and the statement of financial position.

Question 2

Do you believe that the exposure draft proposes sufficient, operational guidance on the application of whether an instrument has 'basic loan features' and 'is managed on a

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

主席 香港上海匯豐銀行有限公司
副主席 渣打銀行（香港）有限公司
中國銀行（香港）有限公司
秘書 張學欣

Incorporated by Ordinance, Cap. 364
根據條例第364章成立

contractual yield basis'? If not, why? What additional guidance would you propose and why?

Per BC27, some investment tranches issued by a structured investment vehicle receive a higher return because they provide credit protection to other tranches and therefore do not have basic loan features. We do not agree with this argument as the same principle can be applied to subordinated loans as these investors receive higher returns for higher credit risk, compared with the senior loans.

Per BC29, if a financial asset is acquired at a discount that reflects incurred credit losses, it does not have basic loan features. While we would agree that such an asset would not be "managed on a contractual yield basis" if it is acquired with the intention of re-sale, we disagree that such assets cannot have "basic loan features". In our view, it would be inappropriate to apply the same principle to a situation where an entity acquired a group of financial assets under business combination or a portfolio of non-performing loans from a secondary market and where the business model is such that these loans will be managed in the same way as originated loans. We consider that the accounting treatment for acquired non-performing loans should be the same as originated non-performing loans i.e. at amortised cost, if after acquisition, the loans are to be managed in the same way as originated non-performing loans.

Additional clarification is required for "incurred credit losses" and "discount". Do incurred credit losses mean actual default or a credit risk downgrade? Do incurred credit losses cover renegotiated loans? What is the definition of a discount? Further, it may be difficult to distinguish discounts for credit risk from the discounts for interest rate risk or liquidity risk.

Further, we believe that there is not enough guidance on the application of "managed on a contractual yield basis" and its relevance. For instance, paragraph B13(b) in the application guidance states that a financial asset that is acquired at a discount that reflects incurred credit losses is not "managed on a contractual yield basis" but no rationale is given.

<u>Question 4</u>

(a) Do you agree that the embedded derivative requirements for a hybrid contract with a financial host should be eliminated? If not, please describe any alternative proposal and explain how it simplifies the accounting requirements and how it would improve the decision-usefulness of information about hybrid contracts.

We consider that the IASB should permit an entity to separately account for an embedded derivative if a separate instrument with the same terms as the embedded derivative could meet the definition of a derivative.

Many structured deposits issued by retail banks are for attracting new depositors with embedded derivatives as sweeteners and very often the banks will close out the risk associated with the embedded derivatives and manage the interest rate risk of the cash component (i.e. the non-derivative host) of the structured deposits as if they were normal bank deposits. If bifurcation is not allowed, the banks will be forced to value their liabilities at fair value because of the "sweeteners".

We consider that bifurcation of derivatives that are not closely related to the host contract should be retained.

(b) Do you agree with the proposed application of the proposed classification approach to contractually subordinated interests (i.e. tranches)? If not, what approach would you propose for such contractually subordinated interests? How is that approach consistent with the proposed classification approach? How would that approach simplify the accounting requirements and improve the decision usefulness of information about contractually subordinated interests?

We do not agree that only the most senior tranches of the debt securities issued by Special-Purpose Entities (SPEs) will have basic loan features as the IASB has assumed that the less senior tranches are all leveraged. In terms of risk and return, theoretically we cannot see the difference between a BBB rated bond issued by an entity and a BBB rated tranche (a less senior tranche) issued by an SPE. However, the IASB's proposal would result in different accounting treatments for instruments with similar risk profiles and which are held for the same business purpose.

Question 7

Do you agree that reclassification should be prohibited? If not, in what circumstances do you believe reclassification is appropriate and why do such reclassifications provide understandable and useful information to users of financial statements? How would you account for such reclassifications, and why?

We consider that an entity should be allowed or required to reclassify their positions if there is a change in business model. This should be a rare event, but might, for example, occur as a result of a business combination.

Question 8

Do you believe that more decision-useful information about investments in equity instruments (and derivatives on those equity instruments) results if all such investments are measured at fair value? If not, why?

We consider that generally the fair value of equities could provide more useful information for decision making purposes.

Question 9

Are there circumstances in which the benefits of improved decision-usefulness do not outweigh the costs of providing this information? What are those circumstances and why? In such circumstances, what impairment test would you require and why?

While there are circumstances in which determining the fair value of some unquoted equity investments can involve much subjective judgement, we do not consider that the added complexity of an additional impairment test would enhance benefits to users.

Question 10

Do you believe that presenting fair value changes (and dividends) for particular investments in equity instruments in other comprehensive income would improve financial reporting? If not, why?

We consider that the exclusion of dividends in the income statement may not be an appropriate treatment because entities which invest in equity instruments for long term or strategic purposes may desire to capture dividend income as a return on their investment and to match the associated funding costs. If dividend is not allowed to be recognised in the income statement, this may result in a mismatch with funding costs which are presented in the income statement and would affect users of financial statements in evaluating the return on assets and capital of reporting entities.

Question 11

Do you agree that an entity should be permitted to present in other comprehensive income changes in the fair value (and dividends) of any investment in equity instruments (other than those that are held for trading), only if it elects to do so at initial recognition? If not, (a) how do you propose to identify those investments for which presentation in other comprehensive income is appropriate? Why? (b) should entities present changes in fair value in other comprehensive income only in the periods in which the investments in equity instruments meet the proposed identification principle in (a)? Why?

Subject to our comments in question 10, we consider that the election should only be allowed at initial acquisition.

Question 12

Do you agree with the additional disclosure requirements proposed for entities that apply the proposed IFRS before its mandated effective date? If not, what would you propose instead and why?

We do not agree with the additional disclosure requirements proposed for entities that apply the proposed IFRS before its effective date because this would be unduly

burdensome and would appear to offer little real value to users because the disclosures would not reflect the business model and classification decisions at the time of transition.

Question 13

Do you agree with applying the proposals retrospectively and the related proposed transition guidance? If not, why? What transition guidance would you propose instead and why?

We do not agree with applying the proposals retrospectively because in many cases these would involve the use of hindsight. In addition, the restated comparatives would not reflect the decisions made at the time and would be of limited usefulness to users of financial statements. We consider that an approach similar to that set out in IFRS 1 would be more appropriate.

Question 14

Do you believe that this alternative approach provides more decision-useful information than measuring those financial assets at amortised cost, specifically: (a) in the statement of financial position? (b) in the statement of comprehensive income? If so, why?

We do not support this approach as we believe that it would confuse readers of the financial statements.

Question 15

Do you believe that either of the possible variants of the alternative approach provides more decision-useful information than the alternative approach and the approach proposed in the exposure draft? If so, which variant and why?

The approach proposed in the exposure draft is a better approach and would give rise to less issues rising from the transition from the existing IAS39 *Financial Instruments: Classification and Measurement*.

Yours sincerely

Jennifer Cheung
Secretary

c.c. Chief Executive, Hong Kong Monetary Authority