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20 August 2009

By fax 2865 6776 & by post

Mr Steve Ong
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Hong Kong Institute of Certified Public Accountants
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2009 AUG 21 AM 11:48
HKICPA

Dear Mr Ong

International Accounting Standards Board (IASB) –
Request for Information ('Expected Loss Model')
Impairment of Financial Assets: Expected Cash Flow Approach

We refer to your letter dated 10 July 2009 and would like to set out below our members' comments on the above discussion paper for your consolidation.

First of all, we commend the IASB for their efforts to review the existing impairment model. However, we are not supportive of the proposed expected loss model and have a number of significant concerns, particularly from an operational aspect, as it is currently drafted.

Our initial view is that implementation of an expected cash flow approach will involve significant operational challenges. Also, we believe the description in the Staff Papers on application of the expected cash flow approach is relatively high level and it is not sufficiently clear for it to be applied on a consistent basis across all entities and all assets within the scope of IAS 39 *Financial Instruments: Recognition and Measurement*.

Our key concerns are explained as follows:

1. Data availability

The implementation of the expected cash flow approach will require the availability of many data, including historical loss experiences, loan portfolio compositions, contractual and behaviouralised cash flows, etc. One of the major concerns a financial institution may face is data availability. It is expected that

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financial institutions may not have data with sufficient history and granularity for the entire economic cycle for the use of loan loss provisioning purposes for all portfolios of assets held at amortised costs. This is particularly difficult for institutions that are on the standarised approach under Basel II or those that are on the internal-ratings based approach but still maintain a certain percentage of their portfolios on the standardised approach.

2. Management judgement and subjectivity

While both incurred loss and expected loss models are dependent on management expectation, the proposed expected cash flow model requires the use of a higher level of management judgement, in particular, about the long run future economic trends. This prediction is highly complex and subjective. The reliability of forecasts may also become uncertain as it moves farther into the future. Given the level of subjectivity involved, it will introduce more potential for diversity in the application of the proposed cash flow model among entities, hence reducing comparability across entities. Furthermore, users of financial statements may also find it difficult to distinguish management judgement from earnings management.

3. System changes and resource requirements

It is expected that the implementation of the proposed expected cash flow model will pose significant operational challenges for many financial institutions. For example, the estimation of expected losses, with continuous updates, into the long run up to maturity of the amortised cost assets would require significant modelling efforts where the industry does not yet have a developed experience in. Also, a firm-wide change to existing system, process, and control structure will likely be required. Most importantly, the implementation of the expected cash flow model will require skill sets from a vast number of highly qualified professionals, which will pose significant additional competing resource requirements on all financial institutions.

4. Transition arrangements, presentation of comparatives and effective date

The IASB Exposure Draft - Financial Instruments: Classification and Measurement proposes to require retrospective application of the new requirements. We note that the IASB expects to complete the replacement of IAS 39 during 2010 although mandatory application will not be before January 2012. Given the changes required for the proposals, we contemplate that a significant lead time will be needed for the transition from the incurred loss model to the expected loss model in terms of data readiness, both current data and comparatives. This would inevitably hinge on process and system readiness, which will also take time to build up. This proposed timeframe means that entities will have less than two years to get ready, which is definitely extremely demanding, if not unachievable.

5. <u>The expected loss model</u>

The name of the proposed model, the "Expected Loss Model", as it currently stands seem to suggest that the proposed model is akin to the expected loss model which is currently used by financial institutions under Basel II. This may potentially create an expectation and potential misunderstanding that financial reporting and regulatory reporting are going to align. Neither the IASB Request for Information nor the Staff Papers explain whether there is an intention to align with the Basel II model or whether an attempt has been made to have an active dialogue with the Basel Committee concerning the proposal.

The IASB papers available reveal an obvious difference between the two "expected loss model", namely the time horizon used in predicting the expected loss. Basel II uses one-year probability of default while the proposed model requires expected loss till maturity. We expect that there are further differences as the IASB works out further details of the proposed model. We encourage the IASB to place due consideration into addressing the interaction between the financial reporting and regulatory frameworks such that both preparers and users of financial statements can understand the impact of the proposed changes.

The purposes of financial reporting and regulatory reporting may not be the same but maintaining two sets of data for the purpose of is, nevertheless, a real concern for financial institutions. We note that the differences between the incurred loss model under the current IAS 39 and the expected loss model under Basel II have already imposed significant burden on financial institutions, both financially and operationally. We have reservation in introducing a similar, but in fact different, expected loss model which would put further strain on financial institutions and may also cause confusion in the market.

Yours sincerely

Jennifer Cheung
Secretary

c.c. Chief Executive, Hong Kong Monetary Authority