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29 September 2010 By email:commentletters@hkicpa.org.hk & post

Mr. Steve Ong
Director, Standard Setting
Hong Kong Institute of Certified Public Accountants
37th Floor, Wu Chung House
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Wanchai
Hong Kong

Dear Steve

Re: The Proposed FASB Accounting Standards Update - "Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities"

We refer to your letter dated 3 June 2010 and would like to set out below our comments on the Financial Accounting Standards Board's ("FASB") proposed Accounting Standards Update on Financial Instruments and Derivatives and Hedging ("Exposure Draft"). We support the ongoing convergence efforts of the FASB and the International Accounting Standards Board ("IASB") and believe that the movement towards a set of high quality converged standards should remain a priority for the Boards. In the area of financial instruments and derivatives, we believe that a converged standard is of particular importance.

We have previously commented on the IASB's proposals regarding amortised cost and impairment of financial instruments. Our comments on the FASB's proposal are consistent, where applicable, with our earlier comments to the IASB. Our responses to the detailed questions posed in the FASB Exposure Draft are attached. The following summarizes our significant comments:

- We do not support the FASB's proposal that all financial assets and liabilities should be measured at fair value. We believe that an amortised cost category should exist for financial assets that are intended to be held for collection of principal and interest. In addition, we believe that the default measurement for liabilities should be amortised cost rather than fair value.

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

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

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

- We generally support the FASB's proposal to require earlier recognition of impairment losses on financial assets. However, we believe that estimates of credit losses should allow for management judgment to take into account expected changes in future economic and credit conditions that are either highly likely or are based upon objective evidence (e.g. bond market behavior).

- While we support the earlier provisioning of credit losses, we believe that the related impairment expense should be spread over the life of the financial asset to better match interest income with impairment expense. Therefore, we support a model that recognizes on the balance sheet expected losses in the period of origination but records the related impairment expense to other comprehensive income with recycling through net income over the life of the financial asset.

- We believe that changes in the fair value of liabilities due to own credit risk should be classified in other comprehensive income because changes in own credit risk are often not realisable. We do not believe that bifurcating changes in the cost of credit from changes in own credit risk is practical or meaningful.

- We support the modification of the effectiveness threshold for hedge accounting from "highly effective" to "reasonably effective". The current threshold can result in recording through net income all changes in the fair value of a derivative (either because the hedge relationship is not initially highly effective or because the relationship subsequently fails to meet the highly effective criteria) even when that derivative provides an effective economic offset.

We would be happy to further clarify or discuss any of the above points should you so wish.

Yours sincerely

Rita Liu
Secretary

Enc.

Response to Specific Questions in FASB Proposed Accounting Standards Update: Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities

Scope

Questions for All Respondents

Question 1

Do you agree with the scope of the financial instruments included in this proposed Update? If not, which other financial instruments do you believe should be excluded or which financial instruments should be included that are proposed to be excluded? Why?

We agree with the scope of the proposed Accounting Standards Update ("ASU").

Question 2

The proposed guidance would require loan commitments, other than loan commitments related to a revolving line of credit issued under a credit card arrangement, to be measured at fair value. Do you agree that loan commitments related to a revolving line of credit issued under a credit card arrangement should be excluded from the scope of this proposed Update? If not, why?

As discussed further below, we believe that an amortized cost category should exist for financial assets that are intended to be held for collection of principal and interest. We do not believe that any related commitment for the acquisition or origination of such financial assets should be measured at fair value. For loan commitments for which the underlying loan will be recorded at fair value through net income (typically loans that are intended for sale or securitization), we would support measuring the commitment at fair value.

While we do not support measuring the loan commitment at fair value for loans that we believe amortized cost would be the more appropriate measurement basis, we would support including such undrawn commitments in the evaluation of credit impairments. In addition, we believe that undrawn commitments that may not be legally binding but which represent constructive obligations (such as credit card lines) should be factored into the impairment model.

Question 3

The proposed guidance would require deposit-type and investment contracts of insurance and other entities to be measured at fair value. Do you agree that deposit-type and investment contracts should be included in the scope? If not, why?

We agree that "insurance contracts" that do not transfer insurance risk should be within the scope of the ASU.

Question 4

The proposed guidance would require an entity to not only determine if they have significant influence over the investee as described currently in Topic 323 on accounting for equity method investments and joint ventures but also to determine if the operations of the investee are related to the entity consolidated business to qualify for the equity method of accounting. Do you agree with this proposed change to the criteria for equity method of accounting? If not, why?

For equity investments, we generally believe that fair value is the appropriate measurement basis. However, for certain strategic investments, realization of the investment value is less likely to be derived from changes in market values. We do not agree with the proposed change to limit equity method accounting to only those investee's that have similar operations to the investor. The concept of what is similar may vary considerably across industries and countries. We believe that the only relevant criterion is whether or not the investor has significant influence over the investee, which is generally an indicator that the investment is strategic in nature.

Questions for Users

Question 5

The proposed guidance would require financial liabilities of investment companies to be measured at fair value with changes in fair value recognized as a net increase (decrease) in net assets. Do you believe that the effect on net asset value will provide decision-useful information? If yes, how will the information provided influence your analysis of the entity? If not, why?

Question not applicable to HKAB.

Question 6

The proposed guidance would require money market funds that comply with Rule 2a-7 of the Investment Company Act of 1940 to measure their investments at fair value rather than amortized cost. Do you believe that reporting those investments at fair value rather than amortized cost will provide decision-useful information? If yes, how will the information provided influence your analysis of the fund? If not, why?

Question not applicable to HKAB.

Question 7

The proposed guidance would require brokers and dealers in securities to apply the proposed guidance for measuring financial liabilities, which could mean that qualifying changes in fair value would be recognized in other comprehensive income. Do you believe that this will provide decision-useful information? If yes, how will the information provided influence your analysis of the entity? If not, why?

Question not applicable to HKAB.

Initial Measurement

Questions for All Respondents

Question 8

Do you agree with the initial measurement principles for financial instruments? If not, why?

We generally agree that financial instruments should initially be measured at fair value, which for originated loans and debt securities typically is equal to the transaction price absent other elements to the transaction. We do not believe that subsequently measuring all financial assets at fair value is meaningful to the readers of the financial statements, because it can give a misleading picture of how the entity is performing against the management objectives of the entity. In addition, accounting and financial reporting should reflect the activities of the entity and not drive the activities of the entity, which may be the case when management attempts to manage short term fluctuations in reported performance that are not relevant to the fundamental objective of the entity's business model.

The ASU's proposal is that all financial instruments (other than short term non-lending receivables and payables due within one year which are proposed to be measured at amortized cost) be measured initially and subsequently at fair value. We strongly believe that there should be an amortized cost measurement category for those financial assets that are managed to collect the contractual cash flows that relate solely to principal and interest. Loans and debt securities that are originated or purchased for subsequent sale, securitization or trading should be recorded at fair value, as fair value information is relevant to how those types of assets are managed.

The basis for conclusions states that the Board's decision to allow certain financial instruments to be measured at fair value with qualifying changes in fair value recognized in other comprehensive income reflects an acknowledgment of the merits of both sides of the fair value accounting debate. We do not believe that "splitting the difference" by presenting the balance sheet at fair value and bifurcating the change in fair value between interest income (on an amortized cost basis) and other comprehensive income ("OCI") (for the remaining change in fair value, if any) is an appropriate resolution to the issue. Loans and other instruments held for the collection of principal and interest that are recorded on an amortized cost basis should be

reflected as such on the balance sheet. Fair value information for such instruments would be more appropriately disclosed in the notes.

Question 9

For financial instruments for which qualifying changes in fair value are recognized in other comprehensive income, do you agree that a significant difference between the transaction price and the fair value on the transaction date should be recognized in net income if the significant difference relates to something other than fees or costs or because the market in which the transaction occurs is different from the market in which the reporting entity would transact? If not, why?

As noted above, we believe that amortized cost is the appropriate classification basis for certain financial assets. Consistent with an amortized cost basis, we believe that the transaction price would typically reflect fair value unless there are other elements to the transaction such as performance obligations or related parties. This is particularly relevant to originated loans, for which both US GAAP and IFRS currently prohibit the recognition of "day one" profit. The proposals could be understood to require that every originated financial asset be compared against market comparable pricing to determine if the transaction price represents fair value. Such an approach is neither practicable nor desirable. Absent other elements to the transaction, we believe that the ASU should clearly indicate that there is a presumption that the transaction price represents fair value upon initial recognition for originated and purchased loans and debt securities that are more appropriate to be held on an amortized cost basis.

Notwithstanding our position that amortized cost should be permitted, if an asset were to be measured at fair value through OCI, we believe that the balance sheet amount should reflect fair value as that is defined elsewhere in GAAP. Whether day one differences should be reflected through net income should be addressed in the converged fair value measurement project, not in this project.

Question 10

Do you believe that there should be a single initial measurement principle regardless of whether changes in fair value of a financial instrument are recognized in net income or other comprehensive income? If yes, should that principle require initial measurement at the transaction price or fair value? Why?

See responses to Questions 8 and 9 above.

Question 11

Do you agree that transaction fees and costs should be (1) expensed immediately for financial instruments measured at fair value with all changes in fair value recognized in net income and (2) deferred and amortized as an adjustment of the yield for financial instruments measured at fair value with qualifying changes in fair value recognized in other comprehensive income? If not, why?

We agree that where the change in fair value will be entirely recorded in net income, transaction fees and costs should be expensed immediately. Where the amount recorded through net income is intended to be consistent with a financial asset measured at amortized cost, transaction fees and costs should not be expensed immediately to the extent that such amounts are incremental and directly related to the transaction. Fee income related to the provision of value added services to borrowers should be recognized as revenue consistent with other revenue recognition guidance rather than deferred and amortized as an adjustment to interest. The initial measurement principle states that certain loan origination costs and fees should be deferred. However, it is not clear whether these amounts should be reflected as an adjustment to the fair value reported on the balance sheet or recorded as a separate asset or liability.

Questions for Preparers and Auditors

Question 12

For financial instruments initially measured at the transaction price, do you believe that the proposed guidance is operational to determine whether there is a significant difference between the transaction price and fair value? If not, why?

As discussed above, we do not believe that it is operational in most cases, particularly when there are no other elements to the transaction, to determine whether a financial asset is originated at a price that is different than fair value.

Subsequent Measurement

Questions for All Respondents

Question 13

The Board believes that both fair value information and amortized cost information should be provided for financial instruments an entity intends to hold for collection or payment(s) of contractual cash flows. Most Board members believe that this information should be provided in the totals on the face of the financial statements with changes in fair value recognized in reported stockholders equity as a net increase (decrease) in net assets. Some Board members believe fair value should be presented parenthetically in the statement of financial position. The basis for conclusions and the alternative views describe the reasons for those views. Do you believe the default measurement attribute for financial instruments should be fair value? If not, why? Do you believe that certain financial instruments should be measured using a different measurement attribute? If so, why?

As discussed above, we believe that certain financial instruments should be measured subsequently at amortized cost. We believe that fair value information for financial instruments measured at amortized cost and amortized cost information for financial instruments measured at fair value should be disclosed in the notes to the financial statements. Disclosures required on the face of the financial statement should be considered in connection with the financial statement presentation project. If the

requirements for the presentation of the face of the financial statements become overly prescriptive, compliance with such requirements may become impractical.

Question 14

The proposed guidance would require that interest income or expense, credit impairments and reversals (for financial assets), and realized gains and losses be recognized in net income for financial instruments that meet the criteria for qualifying changes in fair value to be recognized in other comprehensive income. Do you believe that any other fair value changes should be recognized in net income for these financial instruments? If yes, which changes in fair value should be separately recognized in net income? Why?

We believe that the proposed guidance captures those items that are appropriately classified within net income.

Question 15

Do you believe that the subsequent measurement principles should be the same for financial assets and financial liabilities? If not, why?

We do not believe that the appropriate default measurement basis for liabilities is fair value, because most liabilities are not managed on a fair value basis. While measuring all financial liabilities at fair value creates symmetry with measuring all financial assets at fair value, as discussed above, we do not believe it is appropriate to measure all financial assets at fair value.

Question 16

The proposed guidance would require an entity to decide whether to measure a financial instrument at fair value with all changes in fair value recognized in net income, at fair value with qualifying changes in fair value recognized in other comprehensive income, or at amortized cost (for certain financial liabilities) at initial recognition. The proposed guidance would prohibit an entity from subsequently changing that decision. Do you agree that reclassification should be prohibited? If not, in which circumstances do you believe that reclassification should be permitted or required? Why?

Since the classification of financial instruments will turn in part on a reporting entity's business model, we believe that reclassification should be permitted when a reporting entity changes its business model with appropriate limitations on excessive reclassifications.

Question 17

The proposed guidance would require an entity to measure its core deposit liabilities at the present value of the average core deposit amount discounted at the difference between the alternative funds rate and the all-in-cost-to-service rate over the implied maturity of the deposits. Do you believe that this remeasurement approach is appropriate? If not, why? Do you believe that the

remeasurement amount should be disclosed in the notes to the financial statements rather than presented on the face of the financial statements? Why or why not?

We do not believe that deposits should be remeasured as they are generally funded by financial assets held for collection of principal and interest. This is consistent with our view that the related financial assets should be measured at amortized cost. We would not object to the remeasurement amounts being disclosed in the financial statement notes. However, we question a remeasurement basis that uses an average core deposit amount when the amounts to be remeasured are period end amounts.

Question 18

Do you agree that a financial liability should be permitted to be measured at amortized cost if it meets the criteria for recognizing qualifying changes in fair value in other comprehensive income and if measuring the liability at fair value would create or exacerbate a measurement attribute mismatch? If not, why?

As discussed above, we believe that the default measurement basis for financial liabilities should be amortized cost. We believe that a financial liability should only be measured at fair value if it is held for trading or if doing so would eliminate or reduce a measurement inconsistency or the liability is managed on a fair value basis.

Question 19

Do you believe that the correct financial instruments are captured by the criteria in the proposed guidance to qualify for measurement at the redemption amount for certain investments that can be redeemed only for a specified amount (such as an investment in the stock of the Federal Home Loan Bank or an investment in the Federal Reserve Bank)? If not, are there any financial instruments that should qualify but do not meet the criteria? Why?

We are not aware of any additional instruments that should be measured at redemption value that are not captured by the criteria in the proposed guidance.

Question 20

Do you agree that an entity should evaluate the need for a valuation allowance on a deferred tax asset to a debt instrument measured at fair value with qualifying changes in fair value recognized in other comprehensive income in combination with other deferred tax assets of the entity (rather than segregated and analyzed separately)? If not, why?

We agree with the proposed approach. It is inconsistent to assume for income tax accrual purposes that a financial asset would be held to maturity when it is otherwise measured at fair value, regardless of where the change in fair value is recorded. We agree that it is more appropriate to assess the need for a valuation allowance on a deferred tax asset in combination with other deferred tax assets.

Question 21

The Proposed Implementation Guidance section of this proposed Update provides an example to illustrate the application of the subsequent measurement guidance to convertible debt (Example 10). The Board currently has a project on its technical agenda on financial instruments with characteristics of equity. That project will determine the classification for convertible debt from the issuer perspective and whether convertible debt should continue to be classified as a liability in its entirety or whether the Board should require bifurcation into a liability component and an equity component. However, based on existing U.S. GAAP, the Board believes that convertible debt would not meet the criterion for a debt instrument under paragraph 21(a)(1) to qualify for changes in fair value to be recognized in other comprehensive income because the principal will not be returned to the creditor (investor) at maturity or other settlement. Do you agree with the Board application of the proposed subsequent measurement guidance to convertible debt? If not, why?

While we believe that the example appropriately applies the guidance in paragraph 21 of the ASU, it should be noted that not all convertible debt is classified as a liability in its entirety. Paragraph 20 of the ASU states that an entity shall include in net income for the current period all changes in the fair value of its financial instruments except for specified changes in the fair value of a debt instrument that meets the criteria in paragraph 21. Under ASC 470-20-25-22 (previously FSP APB 14-1), for convertible debt that may be settled in cash, the equity conversion option is separated from the host debt instrument and classified in equity if it does not meet the definition of a derivative. This is acknowledged in the scope exceptions of the ASU which include an equity component that has been bifurcated from a hybrid instrument. The guidance in paragraph 20 of the ASU should be clarified such that only the change in fair value of the portion of convertible debt classified as a liability should be recorded in net income if it does not meet the criteria in paragraph 21. Additionally, clarification should be made as to whether convertible debt for which the principal is paid in cash and the conversion option is net settable in cash or shares meets the criteria to qualify for changes to be recognized in OCI.

Questions for Users

Question 22

Do you believe that the recognition of qualifying changes in fair value in other comprehensive income (measuring the effects of subsequent changes in interest rates on fair value as well as reflecting differences between management and the market expectations about credit impairments) will provide decision-useful information for financial instruments an entity intends to hold for collection or payment(s) of contractual cash flows? If yes, how will the information provided influence your analysis of an entity? If not, why?

Question is not applicable to HKAB.

Question 23

The proposed guidance would establish fair value with all changes in fair value recognized in net income as the default classification and measurement category for financial instruments. An entity can choose to measure any financial instrument within the scope of this proposed Update at fair value with all changes in fair value recognized in net income, except for core deposit liabilities which must be valued using a remeasurement approach. Do you believe that a default classification and measurement category should be provided for financial instruments that would otherwise meet the criteria for qualifying changes to be recognized in other comprehensive income? If not, why?

Question is not applicable to HKAB.

Question 24

The proposed guidance would provide amortized cost and fair value information on the face of the financial statements. The Board believes that this would increase the likelihood that both measures are available to users of public entity financial statements on a timely basis and that both measures are given equal attention by preparers and auditors. Do you believe that this approach will provide decision-useful information? If yes, how will the information provided be used in the analysis of an entity? If not, would you recommend another approach (for example, supplemental fair value financial statements in the notes to the financial statements or dual financial statements)?

Question is not applicable to HKAB.

Question 25

For hybrid financial instruments that currently would require bifurcation and separate accounting under Subtopic 815-15, do you agree that recognizing the entire change in fair value in net income results in more decision-useful information than requiring the embedded derivative to be bifurcated and accounted for separately from the host contract? If yes, how will the information provided be used in the analysis of the entity? If not, for which types of hybrid financial instruments do you believe that it is more decision useful to account for the embedded derivative separately from the host contract? Why?

Question is not applicable to HKAB.

Question 26

IFRS 9 requires hybrid financial assets to be classified in their entirety on the basis of the overall classification approach for financial assets with specific guidance for applying the classification approach to investments in contractually linked instruments that create concentrations of credit risk. Also, for hybrid financial liabilities, the IASB, in order to address the effects of changes in the credit risk of a liability, tentatively has decided to retain existing guidance that requires embedded derivatives to be bifurcated and accounted for separately

from a host liability contract if particular conditions are met. Do you believe that the proposed guidance for hybrid financial instruments or the IASB model for accounting for financial hybrid contracts will provide decision-useful information? Why?

Question is not applicable to HKAB.

Question 27

Do you believe that measuring certain short term, receivables and payables at amortized cost (plus or minus any fair value hedging adjustments) will provide decision-useful information? If yes, how will the information provided be used in your analysis of an entity? If not, why?

Question is not applicable to HKAB.

Questions for Preparers and Auditors

Question 28

Do you believe that the proposed criteria for recognizing qualifying changes in fair value in other comprehensive income are operational? If not, why?

We believe that the proposed criteria are operational, although it may require a significant effort for some entities depending on the number and complexity of financial instruments held. However, we believe that the requirement that there not be any bifurcatable embedded derivative will result in many instruments being accounted for at fair value through net income. This is because in many financial instruments there are embedded derivatives of small or nominal value (i.e. "acorn" derivatives) that do not significantly change the profile of the instrument. We believe that a derivative should significantly change cash flows in order for the presence of that derivative to result in the entire financial asset being classified at fair value.

Question 29

Do you believe that measuring financial liabilities at fair value is operational? If not, why?

There are circumstances under both US GAAP and IFRS where liabilities are currently being measured at fair value. While there may be complexities associated with such valuations that are not present in valuing financial assets, we believe that valuing financial liabilities is operational. However, the fact that it is operational should not be used to support fair value as the default measurement basis for financial liabilities. As discussed above, we believe that amortized cost is a more appropriate default category.

Question 30

Do you believe that the proposed criteria are operational to qualify for measuring a financial liability at amortized cost? If not, why?

We believe that the proposed criteria is operational, although as discussed above, we believe that fair value should not be the default measurement basis for financial liabilities.

Question 31

The proposed guidance would require an entity to measure its core deposit liabilities at the present value of the average core deposit amount discounted at the difference between the alternative funds rate and the all-in cost-to-service rate over the implied maturity of the deposits. Do you believe that this remeasurement approach is operational? Do you believe that the remeasurement approach is clearly defined? If not, what, if any additional guidance is needed?

We do not believe that the remeasurement approach is operational in a way that would lead to meaningful and consistent reporting across entities. There may not be an alternative funds rate that is comparable for large balances of deposit liabilities. In addition, estimating the implied maturities will be a highly subjective exercise.

Presentation

Questions for All Respondents

Question 32

For financial liabilities measured at fair value with all changes in fair value recognized in net income, do you agree that separate presentation of changes in an entity's credit standing (excluding changes in the price of credit) is appropriate, or do you believe that it is more appropriate to recognize the changes in an entity's credit standing (with or without changes in the price of credit) in other comprehensive income, which would be consistent with the IASB tentative decisions on financial liabilities measured at fair value under the fair value option? Why?

We believe that it is more appropriate to present changes in fair value of liabilities due to own credit risk in OCI rather than in net income. In addition, we do not believe that the price of credit should be distinguished from own credit risk. 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. However, 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 33

Appendix B describes two possible methods for determining the change in fair value of a financial liability attributable to a change in the entity credit standing

(excluding the changes in the price of credit). What are the strengths and weaknesses of each method? Would it be appropriate to use either method as long as it was done consistently, or would it be better to use Method 2 for all entities given that some entities are not rated? Alternatively, are there better methods for determining the change in fair value attributable to a change in the entity's credit standing, excluding the price of credit? If so, please explain why those methods would better measure that change.

Both methods attempt to bifurcate the change in fair value due to own credit risk between the amount due to the change in an entity's credit standing and the price of credit. We do not believe that such an approach is warranted. The entire change due to own credit risk should not be reflected in net income because changes due to the price of credit are not realizable apart from changes in own credit rating. We believe that it is more appropriate to use a method that segregates out market risks from credit risk as is the current approach under IFRS.

Question 34

The methods described in Appendix B for determining the change in fair value of a financial liability attributable to a change in an entity credit standing (excluding the changes in the price of credit) assume that the entity would look to the cost of debt of other entities in its industry to estimate the changes in credit standing, excluding the change in the price of credit. Is it appropriate to look to other entities within an entity's industry, or should some other index, such as all entities in the market of a similar size or all entities in the industry of a similar size, be used? Is so, please explain why another index would better measure the change in the price of credit.

The proposed approaches would not be operational for many unrated companies because both methods 1 and 2 assume that the entity's credit rating or credit standing are known. This also further demonstrates the operational difficulties of requiring all entities to fair value their debt despite the fact that the company may be unrated and not have traded debt. If the proposal to require fair value of all liabilities moves forward, clearly, allowing an entity to use different benchmarks as may be needed is warranted.

Questions for Users

Question 35

For financial instruments measured at fair value with qualifying changes in fair value recognized in other comprehensive income, do you believe that the presentation of amortized cost, the allowance for credit losses (for financial assets), the amount needed to reconcile amortized cost less the allowance for credit losses to fair value, and fair value on the face of the statement of financial position will provide decision-useful information? If yes, how will the information provided be used in your analysis of an entity? If not, why?

Question not applicable to HKAB.

Question 36

Do you believe that separately presenting in the performance statement significant changes in the fair value of financial liabilities for changes in an entity's credit standing (excluding the changes in the price of credit) will provide decision-useful information? If yes, how will the information provided influence your analysis of the entity? If not, why? Do you believe that changes in the price of credit also should be included in this amount? If so, why?

Question not applicable to HKAB.

<u>Credit Impairment</u>

Questions for All Respondents

Question 37

Do you believe that the objective of the credit impairment model in this proposed Update is clear? If not, what objective would you propose and why?

We believe that the principles are generally clear; however, we believe additional clarity should be provided concerning whether or not credit related "day one" losses should be recognized on originated and purchased financial assets. We believe that it is clear that expected credit losses would be recognized in the period in which the financial asset is originated or purchased because credit assessments must be assessed at each reporting date. Whether this "day two" loss is really a loss at origination or purchase is not clear. The guidance provided in the FASB ASU in regards to calculation of the effective interest rate by means of discounting contractual cash flows for originated financial assets and estimated cash flows for purchased financial assets back to the initial cash outlay appears to support the conclusion that there should not be a day one loss.

Question 38

The proposed guidance would require an entity to recognize a credit impairment immediately in net income when the entity does not expect to collect all contractual amounts due for originated financial asset(s) and all amounts originally expected to be collected for purchased financial asset(s).

The IASB Exposure Draft, Financial Instruments: Amortized Cost and Impairment (Exposure Draft on Impairment), would require an entity to forecast credit losses upon acquisition and allocate a portion of the initially expected credit losses to each reporting period as a reduction in interest income by using the effective interest rate method. Thus, initially expected credit losses would be recorded over the life of the financial asset as a reduction in interest income. If an entity revises its estimate of cash flows, the entity would adjust the carrying amount (amortized cost) of the financial asset and immediately recognize the amount of the adjustment in net income as an impairment gain or loss.

Do you believe that an entity should immediately recognize a credit impairment in net income when an entity does not expect to collect all contractual amounts due for originated financial asset(s) and all amounts originally expected to be collected for purchased financial asset(s) as proposed in this Update, or do you believe that an entity should recognize initially expected credit losses over the life of the financial instrument as a reduction in interest income, as proposed in the IASB Exposure Draft on impairment?

The IASB proposal would require that the contractual interest rate be reduced by an allocation of expected credit losses in arriving at the effective interest rate ("EIR"). We do not support reducing the EIR with impairment expense as proposed by the IASB as this would be confusing to users of the financial statements.

Unlike the IASB approach which spreads expected losses, the FASB proposal would require that credit losses based on historical experience and existing conditions be accrued as an impairment reserve in the first reporting period that a financial asset is originated or acquired. The amount of initial credit losses under the FASB approach should be less than that under the IASB approach because expected losses based on probability weighted expected cash flows (the IASB approach) would likely incorporate scenarios, that while possible, would not have been experienced historically (the FASB approach).

The FASB proposal that expected credit losses be recognized upfront in the first reporting period in which a financial asset is originated or purchased represents a significant difference from the IASB proposal. We believe that the users of financial statements would benefit from understanding management's expectations (although largely based on historical experience) of future credit losses for newly originated or purchased financial assets and the related impact on capital. However, we believe that it is equally important that the income statement properly reflect the matching of interest income with impairment expense. Since the credit spread of a financial asset is intended to compensate for future expected credit losses, we believe that it is appropriate to spread the initial expectation of credit losses over the life of the financial asset. To meet these competing objectives, we would support a model that recognizes an impairment reserve (consistent with our response to Question 46) in the period of origination or purchase; however, we believe that the related impairment expense should be initially recorded to OCI and recycled through net income over the life of the financial asset.

Both the IASB and FASB proposals would immediately record in net income any changes in expected losses from the original or subsequent expectation. Therefore, under the IASB proposal it is possible to record impairments soon after origination if there is any change in expectations. The IASB's proposal to recognize changes in estimates up front is inconsistent with its proposal to spread the initial estimates of credit losses. Consistent with our view that impairments should be spread, we do not support the immediate recognition in net income of impairment expense when there is a change in expected credit losses. In addition, it is not clear how changes in estimates of credit losses for loans which are assessed on a portfolio basis and for which the portfolio is open would be determined.

Question 39

Do you agree that a credit impairment should not result from a decline in cash flows expected to be collected due to changes in foreign exchange rates, changes in expected prepayments, or changes in a variable interest rate? If not, why?

We generally agree that foreign exchange rates and variable interest rates should not impact the estimation of credit losses as they are market factors unrelated to a particular entity's credit risk. In some cases, such as an interest only strip, non-credit related factors can impact prepayment rates and thus determine whether or not the initial investment is returned. We believe an adjustment in the estimation of prepayments should not be reflected as credit related impairment losses if this only affects the timing but not the collectability of cash flows.

Paragraph 67 of the ASU states that for variable rate assets, in measuring a credit impairment, expected cash flows should be discounted using the appropriate interest rate index as it changes over the life of the asset. We believe that the original effective interest rate should be used to discount principal cash flows when calculating impairments for specific assets or a group of assets, otherwise the amount of impairment will be affected by changes in interest rates. When calculating interest income, the interest rate applied against the contractual balance should change as the index changes.

Question 40

For a financial asset evaluated in a pool, the proposed guidance does not specify a particular methodology to be applied by individual entities for determining historical loss rates. Should a specific method be prescribed for determining historical loss rates? If yes, what specific method would you recommend and why?

We do not believe that a particular methodology should be required as different entities have different methods for managing and tracking credit related losses.

Question 41

Do you agree that if an entity subsequently expects to collect more cash flows than originally expected to be collected for a purchased financial asset, the entity should recognize no immediate gain in net income but should adjust the effective interest rate so that the additional cash flows are recognized as an increase in interest income over the remaining life of the financial asset? If not, why?

We do not support reflecting positive changes in expected cash flows as an adjustment to EIR. For originated financial assets, such changes would be reflected immediately in net income under the IASB proposal. We see no conceptual reason why purchased financial assets should be treated differently from originated financial assets.

Question 42

If a financial asset that is evaluated for impairment on an individual basis has no indicators of being individually impaired, the proposed guidance would require an entity to determine whether assessing the financial asset together with other financial assets that have similar characteristics indicates that a credit impairment exists. The amount of the credit impairment, if any, would be measured by applying the historical loss rate (adjusted for existing economic factors and conditions) applicable to the group of similar financial assets to the individual financial asset. Do you agree with this requirement? If not, why?

We agree with a requirement to consider whether a credit impairment may have been incurred but has not yet emerged. Since the objective is to measure losses over the life of the asset, we believe that it is appropriate to evaluate as a group assets that have been assessed individually for impairment but for which no impairment has been identified. The related impairment analysis should expand the considerations from historical loss rate and existing economic factors and conditions to include expected near term future economic conditions that are either highly likely or are based upon objective evidence.

Questions for Users

Question 43

The credit impairment model in this proposed Update would remove the probable threshold. Thus, an entity would no longer wait until a credit loss is probable to recognize a credit impairment. An entity would be required to recognize a credit impairment immediately in net income when an entity does not expect to collect all of the contractual cash flows (or, for purchased financial assets, the amount originally expected). This will result in credit impairments being recognized earlier than they are under existing U.S. GAAP.

Do you believe that removing the probable threshold so that credit impairments are recognized earlier provides more decision-useful information?

Question not applicable to HKAB.

Question 44

The proposed guidance would require that in determining whether a credit impairment exists, an entity consider all available information relating to past events and existing conditions and their implications for the collectability of the cash flows attributable to the financial asset(s) at the date of the financial statements. An entity would assume that the economic conditions existing at the end of the reporting period would remain unchanged for the remaining life of the financial asset(s) and would not forecast future events or economic conditions that did not exist at the reporting date. In contrast, the IASB Exposure Draft on impairment proposes an expected loss approach and would require an entity to estimate credit losses on the basis of probability-weighted possible outcomes.

Do you agree that an entity should assume that economic conditions existing at the reporting date would remain unchanged in determining whether a credit impairment exists, or do you believe that an expected loss approach that would include forecasting future events or economic conditions that did not exist at the end of the reporting period would provide more decision-useful information?

Question not applicable to HKAB.

Question 45

The proposed guidance would require that an appropriate historical loss rate (adjusted for existing economic factors and conditions) be determined for each individual pool of similar financial assets. Historical loss rates would reflect cash flows that the entity does not expect to collect over the life of the financial assets in the pool. Do you agree with that approach?

Question not applicable to HKAB.

Questions for Preparers and Auditors

Question 46

The proposed guidance would require that in determining whether a credit impairment exists, an entity consider all available information relating to past events and existing conditions and their implications for the collectability of the cash flows attributable to the financial asset(s) at the date of the financial statements. An entity would assume that the economic conditions existing at the end of the reporting period would remain unchanged for the remaining life of the financial asset(s) and would not forecast future events or economic conditions that did not exist at the reporting date. In contrast, the IASB Exposure Draft on impairment proposes an expected loss approach and would require an entity to estimate credit losses on basis of probability-weighted possible outcomes.

Do you agree that an entity should assume that economic conditions existing at the reporting date would remain unchanged in determining whether a credit impairment exists, or do you believe that an expected loss approach that would include forecasting future events or economic conditions that did not exist at the end of the reporting period would be more appropriate? Are both methods operational? If not, why?

We disagree with an expected loss approach as proposed by the IASB. It is impractical to assume that management can estimate cash flows over the entire life of a financial asset and across a whole range of possible outcomes. We generally support the FASB's approach; however, we believe estimates of credit losses should allow for management judgment to take into account expected changes in future economic and credit conditions that are either highly likely or are based upon objective evidence (e.g., bond market behavior, etc.) Such an approach should not preclude reporting entities from using weighted average probabilities of future cash flows in determining expected losses where the requisite data and expertise are available; however, such

expected losses should be based on current economic conditions and highly likely changes in economic and credit conditions.

Question 47

The proposed guidance would require that an appropriate historical loss rate (adjusted for existing economic factors and conditions) be determined for each individual pool of similar financial assets. Historical loss rates would reflect cash flows that the entity does not expect to collect over the life of the financial assets in the pool. Would such an approach result in a significant change in practice (that is, do historical loss rates typically reflect cash flows that the entity does not **expect to collect over the life of the financial assets in the pool or some shorter period)?**

The approach described above would not result in a significant change in practice. Currently under IAS 39, when incurred losses are calculated for assets which are individually assessed for impairment, a portfolio impairment provision is usually calculated to take account of losses which, although have been incurred, may not yet be apparent. The portfolio impairment provision is determined by taking into account historical experience, 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 and the emergence period, which is the estimated period between a loss occurring and the loss being identified. This portfolio impairment methodology could be extended to cover expected loss by eliminating the emergence period thus covering 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). 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. The above approach would be applicable to a "good book" of loans but not a "bad book" since the existing methodology for calculating the "bad book" impairment reserve already fully reflects incurred losses (or expected loss under current conditions).

Interest Income

Questions for All Respondents

Question 48

The proposed guidance would require interest income to be calculated for financial assets measured at fair value with qualifying changes in fair value recognized in other comprehensive income by applying the effective interest rate to the amortized cost balance net of any allowance for credit losses. Do you believe that the recognition of interest income should be affected by the recognition or reversal of credit impairments? If not, why?

Both the FASB and IASB proposals would require that interest be accrued by multiplying the effective interest rate times the outstanding amortized cost balance net

of any allowance for credit losses. Under the IASB approach, the outstanding balance of financial assets reflects expected cash flows discounted at the effective interest rate; therefore, accrual of interest reflects both the amount and timing of expected principal losses. However, because we do not support the IASB's impairment approach, we do not support the IASB's interest accretion approach. The FASB's approach to portfolio impairment would accrue expected losses over the life of the financial asset without discounting. Therefore, the recognition of interest income would not take into account the timing of expected principal losses, thus understating interest income.

We do not believe that the approaches proposed by the FASB and IASB are appropriate. We believe that it is more appropriate to accrue interest income on contractual amounts due and separately assess accrued interest for impairments and allow for suspension of interest income on non-performing assets to the extent deemed appropriate by management. This would not confuse the recognition of interest income with impairment expense.

Question 49

Do you agree that the difference in the amount of interest contractually due that exceeds interest accrued on the basis of an entity's current estimate of cash flows expected to be collected for financial assets should be recognized as an increase to the allowance for credit losses? If not, why?

Notwithstanding our response to Question 48, we believe that the reversal of such differences should be reflected as an adjustment to interest income because, as discussed above, it arises, at least in part, as a result of not recognizing interest income on estimated credit losses that are recognized at par immediately without regards to the timing of such losses.

Question 50

The proposed guidance would permit, but would not require, separate presentation of interest income on the statement of comprehensive income for financial assets measured at fair value with all changes in fair value recognized in net income. If an entity chooses to present separately interest income for those financial assets, the proposed guidance does not specify a particular method for determining the amount of interest income to be recognized on the face of the statement of comprehensive income. Do you believe that the interest income recognition guidance should be the same for all the financial assets?

Yes. We believe that, if interest income is presented separately for financial assets measured at fair value, it should be measured on the same basis used to recognize interest income for all other financial assets.

Question 51

Do you believe that the implementation guidance and illustrative examples included in this proposed Update are sufficient to understand the proposed credit impairment and interest income models? If not, what additional guidance or examples are needed?

Yes. We believe that the examples sufficiently demonstrate the principles in the proposed Update.

Questions for Users

Question 52

Do you believe that the method for recognizing interest income on financial assets measured at fair value with qualifying changes in fair value recognized in other comprehensive income will provide decision-useful information? If yes, how will the information provided be used in your analysis of an entity? If not, why?

Question not applicable to HKAB.

Question 53

The method of recognizing interest income will result in the allowance for credit impairments presented in the statement of financial position not equaling cumulative credit impairments recognized in net income because a portion of the allowance will reflect the excess of the amount of interest contractually due over interest income recognized. Do you believe that this is understandable and will provide decision-useful information? If yes, how will the information provided be used? If not, why?

Question not applicable to HKAB.

Question 54

The proposed guidance would require interest income to be calculated for financial assets measured at fair value with qualifying changes in fair value recognized in other comprehensive income by applying the effective interest rate to the amortized cost balance net of any allowance for credit losses. Thus, the recognition of a credit loss would result in a decrease in interest income recognized. Similarly, a reversal of a previously recognized credit loss would increase the amount of interest income recognized. The IASB Exposure Draft on Impairment proposes that an entity calculate interest by multiplying the effective rate established at initial recognition by the amortized cost basis. The IASB definition of amortized cost basis is the present value of expected future cash flows discounted by the effective interest rate established at initial recognition and, therefore, includes credit losses recognized to date. Thus, as initially expected credit losses are allocated over the life of the instruments, the amount of interest income decreases.

Both the FASB and IASB models for interest income recognition are similar in that the recognition of an impairment reduces the amount of interest income recognized. However, as noted in the questions above, the timing of credit impairments and the determination of the effective interest rate differ in the two proposed models. Thus, the amount of interest income recognized under the two proposed models will differ. Do you believe that the FASB model or the IASB model provides more decision-useful information? Why?

Question not applicable to HKAB.

Question 55

Do you agree that an entity should cease accruing interest on a financial asset measured at fair value with qualifying changes in fair value recognized in other comprehensive income if the entity's expectations about cash flows expected to be collected indicate that the overall yield on the financial asset will be negative? If not, why?

Question not applicable to HKAB.

Hedge Accounting

Questions for All Respondents

Question 56

Do you believe that modifying the effectiveness threshold from highly effective to reasonably effective is appropriate? Why or why not?

We agree with the proposed change to a reasonably effective threshold. The current threshold of highly effective can result in recording all changes in the fair value of a derivative (either because the hedge relationship is not initially highly effective or because the relationship subsequently fails to meet the highly effective criteria) in the income statement even when that derivative provides an effective economic offset.

Question 57

Should no effectiveness evaluation be required under any circumstances after inception of a hedging relationship if it was determined at inception that the hedging relationship was expected to be reasonably effective over the expected hedge term? Why or why not?

We believe that the proposed requirement to evaluate effectiveness when there has been a change in circumstances is appropriate, otherwise the relationship between the derivative and the hedged item could stray significantly such that there is no longer a rational basis for deferring the change in fair value of the derivative.

Question 58

Do you believe that requiring an effectiveness evaluation after inception only if circumstances suggest that the hedging relationship may no longer be reasonably effective would result in a reduction in the number of times hedging relationships would be discontinued? Why or why not?

We believe that the move to a reasonably effective standard and a reassessment only when there is a change in circumstances suggestive that a hedge is no longer reasonably effective will reduce the number of hedges that are discontinued for lack of technical compliance even when the hedge is economically effective.

Questions for Users

Question 59

Do you believe that a hedge accounting model that recognizes in net income changes in the fair value and changes in the cash flows of the risk being hedged along with changes in fair value of the hedging instrument provides decision-useful information? If yes, how would that information be used? If not, why?

Question not applicable to HKAB.

Question 60

Do you believe that the proposed changes to the hedge accounting model will provide more transparent and consistent information about hedging activities? If yes, why and how would you use the information provided? If not, what changes do you disagree with and why?

Question not applicable to HKAB.

Questions for Prepares and Auditors

Question 61

Do you foresee any significant operational concerns or constraints in calculating ineffectiveness for cash flow hedging relationships? If yes, what constraints do you foresee and how would you alleviate them?

No. We do not see any significant operational concerns.

Question 62

Do you foresee any significant operational concerns or constraints in creating processes that will determine when changes in circumstances suggest that a hedging relationship may no longer be reasonably effective without requiring reassessment of the hedge effectiveness at each reporting period? If yes, what constraints do you foresee and how would you alleviate them?

We do not believe that there would be significant constraint in creating appropriate processes for qualitatively monitoring hedge effectiveness. Currently, reporting entities must have in place on-going quantitative processes to evaluate hedge effectiveness. Moving, when appropriate, to a qualitative monitoring process should provide operational relief.

Question 63

Do you foresee any significant operational concerns or constraints arising from the inability to discontinue fair value hedge accounting or cash flow hedge accounting by simply dedesignating the hedging relationship? If yes, what constraints do you foresee and how would you alleviate them?

The inability to dedesignate hedging relationships will place constraints on dynamic hedging strategies that redesignate derivatives in new hedging relationships. We do not see any benefit or reduction in complexity by this proposed change.

Question 64

Do you foresee any significant operational concerns or constraints arising from the required concurrent documentation of the effective termination of a hedging derivative attributable to the entity entering into an offsetting derivative instrument? If yes, what constraints do you foresee and how would you alleviate them?

We do not believe that the preparation of contemporaneous documentation represents a significant constraint; however, as noted above, we question how this proposal reduces complexity.

Disclosures

Questions for All Respondents

Question 65

Do you agree with the proposed disclosure requirements? If not, which disclosure requirement do you believe should not be required and why?

The proposed disclosure requirements would increase the amount of information disclosed on the face of the financial statements, including separate presentation of financial instruments by measurement category, separate presentation of changes in the fair value of debt attributable to own credit risk, etc. When these requirements are combined with the current proposed changes for the presentation of comprehensive income and the anticipated proposals related to financial statement presentation, we are concerned that the requirements related to the presentation of items on the face of financial statements will become unworkable and will reduce the flexibility of management to present financial statements in a clear and meaningful manner.

Questions for Users

Question 66

For purchased financial assets, do you believe that the requirement to disclose the principal balance, the purchaser's assessment of the discount related to credit losses inherent in the financial instrument at acquisition, any additional difference between the amortized cost and the principal balance, and the amortized cost in each period will provide decision-useful information? If yes, how will the information provided influence your analysis of an entity? If not, why?

Question not applicable to HKAB.

Question 67

Are there any other disclosures that you believe would provide decision-useful information and why?

Question not applicable to HKAB.

<u>**Effective Date and Transition**</u>

Questions for All Respondents

Question 68

Do you agree with the transition provision in this proposed Update? If not, why?

We support the transition provisions that would restate the prior period ending balance sheet and record a cumulative-effect adjustment. To restate all prior periods would not be feasible given the scope and breadth of the proposed changes.

Question 69

Do you agree with the proposed delayed effective date for certain aspects of the proposed guidance for nonpublic entities with less than $1 billion in total consolidated assets? If not, why?

We support a later effective date for smaller entities that may not have the current resource capacity and/or capabilities to implement the proposed changes in the shorter term.

Questions for Preparers and Auditors

Question 70

How much time do you believe is needed to implement the proposed guidance?

We believe that a three year time frame would be appropriate, consistent with the implementation time granted for IFRS 9.

Question 71

Do you believe the proposed transition provision is operational? If not, why?

We believe that the transition provisions are operational if sufficient time is given prior to the effective date of the proposals.