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Sent: Friday, April 03, 2009 9:36 AM
To: Adam Van Eperen
Cc: fdunne@iasb.org
Subject: FCAG REQUEST FOR WRITTEN SUBMISSIONS

Mr. Hans Hoogervorst
Mr. Harvey Goldschmid
Co-Chairmen
Financial Crisis Advisory Group

LETTER OF COMMENT NO. 47

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

Mr. Robert H. Herz
Chairman
Financial Accounting Standards Board
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Norwalk, CT 06865-5116, U.S.A

Dear Sirs

Response to FCAG request for written submissions

HSBC welcomes the opportunity to respond to the request for written submissions by the Financial Crisis Advisory Group formed by the IASB and FASB.

HSBC is one of the largest banking and financial services organisations in the world, with assets of US$2,527 billion at 31 December 2008. Headquartered in London, HSBC serves customers worldwide from more than 9,500 offices in 86 countries and territories in five geographical regions. HSBC's businesses encompass a very broad range of financial services and products, including personal financial services, commercial lending, global banking and markets, private banking, asset management and insurance.

HSBC welcomes the formation of this Group as a positive step towards increasing the focus of the IASB and FASB on the urgent accounting issues that have been highlighted by the global financial crisis, and increasing their engagement with the programme and priorities of the G20 and the Financial Stability Forum.

Our responses to the specific questions are as follows:

Question 1
From your perspective, where has general purpose financial reporting helped identify issues of

concern during the financial crisis? Where has it not helped, or even possibly created unnecessary concerns? Please be as specific as possible in your answers.

HSBC believes that in view of the scale of the crisis it is both necessary and appropriate to review all aspects of the financial regulatory framework with the associated reporting requirements to identify improvements that can be made. Certain elements of that framework have an explicit financial stability objective; other elements are focused on market confidence, for example by focusing on transparency of information. HSBC believes that the role of general-purpose financial statements is to provide a wide range of investors and other stakeholders and interested parties with objective and transparent information about the financial performance and position of any entity, which in our view is essential to market confidence. Proposed changes in general purpose financial reporting should therefore be evaluated in terms of the interests of investors and other users of the financial statements.

We believe that there has been a marked improvement in financial reporting in recent years with the development and wider acceptance of IFRSs and the convergence programme with US GAAP. This has resulted in greater transparency for investors and other users of financial statements than would otherwise have been the case.

The areas in which general purpose financial reporting have not helped provide the necessary transparency include certain areas in which the convergence programme has yet to align IFRS and US GAAP requirements, resulting in inconsistency and a lack of transparency for investors, for example consolidation principles. Another example would be different rules on the netting of derivatives, which the users of financial statements find confusing. HSBC has just completed an intensive programme of meetings with institutional investors, and it is very clear from their feedback that these are important issues for them in understanding financial statements. This highlights the need for continued focus on convergence, and the importance of maintaining this focus in the face of short-term pressures for changes in local standards without reference to the wider objective of convergence.

HSBC believes that it is not desireable for accounting measurements to exhibit any bias towards pro-cyclicality, but this must not be confused with the vital objective of reflecting the impact of changes in economic conditions on the financial performance and position of an entity's financial statements as they occur. In this regard there are known areas of difficulty in IFRSs, for example fair value measurement in illiquid markets, and the recognition of impairment losses in available-for-sale ('AFS') financial asset portfolios. We would temper this, however, with the observation that in general IFRSs aim to provide objective information about the effect of changes in economic conditions as these occur, for example the incurred loss model of impairment in financial instruments measured at amortised cost. Fair value measurement for derivative contracts and assets held for trading highlighted the deterioration in financial markets for structured assets earlier than might otherwise have been the case under previous accounting frameworks.

Transparent disclosure in financial statements is a key factor in maintaining market confidence. While improvements have been made to disclosure requirements in IFRS, most notably through IFRS 7, *'Financial Instruments: Disclosures'*, with further improvements in progress, the

disclosure requirements within IFRS as a whole have been designed in a piecemeal fashion, and lack overall coherence. When combined with other statutory and regulatory disclosure requirements this can result in financial reports of daunting length and complexity. There is a need to assess the framework of disclosure requirements as a whole to establish a principle-based approach which aims to provide useful information in a format that is readily accessible and understandable.

Question 2

If prudential regulators were to require 'through-the-cycle' or 'dynamic' loan provisions that differ from the current IFRS or US GAAP requirements, how should general purpose financial statements best reflect the difference: (1) recognition in profit or loss (earnings); (2) recognition in other comprehensive income; (3) appropriation of equity outside of comprehensive income; (4) footnote disclosure only; (5) some other means; or (6) not at all? Please explain how your answer would promote transparency for investors and other resource providers.

HSBC believes that it is crucial for market confidence that the users of published accounts receive transparent information about losses which have been incurred at the balance sheet date, and fair value measurements that reflect conditions at the balance sheet date. If additional reserves or buffers for future expected losses are considered necessary, these should be included in regulatory capital measurements, where such reserves are consistent with the financial stability objective of capital adequacy. The incurred loss information in financial statements could be supplemented by appropriate disclosure of capital reserves and requirements as well as the existing risk management disclosures about risk exposures at the balance sheet date under IFRS7.

If it is decided to incorporate information on expectations of future losses in the primary financial statements, such information should be clearly segregated and treated as a separate reserve in equity so that the transparency of information to investors is not compromised. However, it not clear why a reserve movement would convey significantly different, or indeed superior, information to capital and risk disclosures, including the impact on capital of such a reserve. There is nothing to stop regulators requiring bonuses, dividends, share buy-backs and other corporate actions to be determined with reference to such a reserve without requiring that reserve to be recorded in the primary financial statements. Furthermore, such a reserve would presumably represent just one aspect of a bank's capital adequacy requirements, and would raise further questions about the precise amount of headroom that a bank has available in order to understand the significance of the reserve. If this route is taken HSBC would like to understand how this proposal would interrelate with the countercyclical capital requirements that regulators propose to introduce, to ensure that requirements are not effectively duplicated, reducing the banks' capacities to lend.

Question 3

Some FCAG members have indicated that they believe issues surrounding accounting for off-balance items such as securitizations and other structured entities have been far more contributory to the financial crisis than issues surrounding fair value (including mark-to-market) accounting. Do you agree, and how can we best improve IFRS and US GAAP in that area?

HSBC disagrees with the statement that accounting issues surrounding off-balance sheet items has been far more contributory to the financial crisis than fair value measurement issues, and does not find the question to be worded in a particularly helpful way for a debate, as there are significant issues with both areas of accounting and it is necessary to consider all areas that could be improved in the light of the crisis.

In terms of IFRSs, HSBC believes that the main issue regarding securitisations and structured entities is the lack of a comprehensive risk-focused disclosure requirement. Attempts are currently being made to address this gap with the publication of ED10. HSBC's view is that the consolidation principles within IFRS are essentially sound and the urgent priority is to address the disclosure requirements. In US GAAP, however, we believe that the current consolidation rules lack a clear grounding in principles, and permit many securitisations to remain off-balance sheet compared with the treatment under IFRSs. We know from our contact with institutional investors that these issues are confusing to the investor community, and convergence towards a common principles-based consolidation standard should be regarded as a priority.

In response to the question as stated, HSBC believes that the issue of fair value measurement in illiquid or closed markets is probably of greater significance, as this has been a difficult issue to resolve across many financial markets and in both IFRSs and US GAAP.

Question 4

Most constituents agree that the current mixed attributes model for accounting and reporting of financial instruments under IFRS and US GAAP is overly complex and otherwise suboptimal. Some constituents (mainly investors) support reporting all financial instruments at fair value. Others support a refined mixed attributes model. Which approach do you support and why? If you support a refined mixed attributes model, what should that look like, and why, and do you view that as an interim step toward full fair value or as an end goal? Whichever approach you support, what improvements, if any, to fair value accounting do you believe are essential prerequisites to your end goal?

HSBC believes strongly in the mixed measurement model for financial instruments because it provides the most relevant and reliable information for investors and other users of financial statements. HSBC disagrees that a single fair value measurement basis for all financial instruments ('full fair value measurement') would provide relevant and reliable information. One of the key lessons from the financial crisis is that when markets become inactive or characterised by distressed transactions, it becomes very difficult and judgemental to measure fair values reliably. HSBC believes that fair value measurement remains appropriate for derivative contracts and financial instruments managed at fair value, including trading instruments, despite the judgemental difficulties involved in fair value measurement when markets become stressed or inactive. However, we believe that it has become very clear that a theoretical extension of the fair value measurement model to financial instruments which by their nature are not actively traded in financial markets is fundamentally flawed. Taken to extremes, fair value measurement for all financial instruments on an exit price basis would result in financial statements for banks and other financial institutions being prepared on a break-up basis without regard to the longer-term value of business activities. Not only would this approach fail the test of providing relevant and reliable information to investors on many business activities, it would also introduce an

unjustified bias towards pro-cyclical volatility.

The proponents of full fair value measurement often claim that this will reduce complexity in accounting for financial instruments. In our response to the IASB Discussion Paper, *'Reducing the Complexity in Reporting Financial Instruments'* in September 2008, we gave our view that it is unrealistic to assume that the issues and concerns associated with a general requirement for fair value measurement can be resolved such that the outcome would be less complicated and more relevant and reliable than the current mixed measurement approach. Accordingly, HSBC does not support any intermediate approaches that are designed as steps towards full fair value measurement, whether presented under the heading of 'reducing complexity' or otherwise.

HSBC has recommended refinements to the current mixed measurement model in the past. We do not believe that the existing mixed measurement model is a major source of complexity, and a reduction in the number of categories would bring only limited benefits. We believe that the AFS category has an important role to play in distinguishing holdings of quoted investments that are held for a different economic purpose from financial assets in the held for trading category. If a decision is taken to remove the AFS category in order to reduce the number of categories, we believe that it is crucially important to extend the use of the amortised cost measurement basis as applied to loans and receivables to quoted investments, perhaps with some qualifying requirement based on the risk characteristics of the instrument. Fair values for financial instruments measured at amortised cost would continue to be a required disclosure.

HSBC has commented in the past that the current requirements under IAS39 for recognising impairment losses on AFS debt securities significantly overstate the impairment losses that are likely to be realised where financial institutions have the intent and ability to hold the securities for the long-term. In our opinion, a more appropriate basis of measurement of impairment of AFS debt securities is to record only the amount that reflects the present value of the expected shortfall in estimated future cash flows, with the balance of the fall in fair value recorded in equity. The expected shortfall in future cash flows is determined by examining the current status of the cash flows underlying the securities, based on actual levels of factors such as delinquency, default and recovery, and applying assumptions regarding the probable outcome of these factors to arrive at the expected shortfall in future cash flows. This would be consistent with the current impairment requirements for held-to-maturity investments and loans and receivables under IAS 39. Again, institutional investors have provided feedback to HSBC that this is an area of accounting that they would like to see changed.

Question 5

What criteria should accounting standard-setters consider in balancing the need for resolving an 'emergency issue' on a timely basis and the need for active engagement from constituents through due process to help ensure high quality standards that are broadly accepted?

HSBC believes that an orderly due process is of the utmost importance. We agree that there is a need, as part of this due process, for a fast-track emergency procedure, however this should be used sparingly for those issues which meet appropriate criteria for an urgent response. If urgent issues are identified and handled appropriately we believe that preparers and users of financial statements will understand the need for a rapid response to consultation and will respond

positively. There have been examples recently of attempts to rush through 'urgent' changes that did not appear to reflect accurately the feedback from the preceding consultation process, as well as examples of errors in amendments that required subsequent correction. This can place an intense burden on preparers of accounts if such changes are being rushed in order to bring them into effect for an imminent reporting season. The challenges of data collection in complex financial institutions (and other types of entity) are such that urgent changes need to meet a practicability test in order to avoid the potential embarrassment that is caused when proposals are simply impossible to deliver in the time frame, for example the recent IASB proposal to amend IAS39 with respect to disclosures about debt instruments.

Question 6
Are there financial crisis-related issues that the IASB or the FASB have indicated they will be addressing that you believe are better addressed in combination with, or alternatively by, other organizations? If so, which issues and why, and which organizations?

In general, it is absolutely vital that the IASB and FASB co-ordinate their activities in the interests of international convergence towards high quality accounting standards. Given the global nature and complexity of the crisis, the co-ordination of the accounting standards boards with international regulatory standard setters through the Financial Stability Forum is also of critical importance. The key areas on which co-ordination is necessary include the dialogue on the response to perceived pro-cyclical tendencies in regulatory capital and accounting treatments, and the need for a comprehensive disclosure framework focused on the needs of investors and other users of financial statements.

In particular, as noted in the answer to question 2, HSBC believes that if additional reserves or buffers for future expected losses are considered necessary these should be included in regulatory capital measurements, where such reserves are consistent with the financial stability objective of capital adequacy. Accordingly, this matter should be dealt with by banking regulators in an internationally co-ordinated manner to ensure that a level competitive market is maintained.

Question 7
Is there any other input that you'd like to convey to the FCAG?

HSBC is a strong advocate of full and open international discussion on accounting and regulatory matters including the serious issues that the crisis has highlighted. We would be pleased to take part in further discussions on the issues discussed above, and would support appropriate field work to ensure that changes meet the intended objectives.

Yours faithfully
Douglas J Flint
Group Finance Director