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Mr. Steve Ong
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Dear Steve,

IASB Supplement to Exposure Draft on Financial Instruments: Impairment ("Supplement")

I refer to your letter to our Mr. Mark Dickens dated 1 February 2011 on the above which has been passed to me for my attention.

We have completed our review of the Supplement and our views are set out below.

General

The Supplement proposes a revised approach for an impairment model for financial assets in open portfolios. The original Exposure Draft proposed that entities should recognise interest revenue, less initial expected credit losses, over the life of a financial asset by adjusting the effective interest rate used to calculate interest revenue. The Supplement now proposes to exclude credit losses when determining the effective interest rate. Impairment losses are now proposed to be presented as a separate line from interest revenue.

The Supplement also introduces a new proposal for its expected loss model. All financial assets such as loan portfolios are to be categorised into two groups, namely a "good book" and "bad book", for the purpose of determining impairment allowances. For the "good book", that is, assets for which it is regarded as appropriate to recognise expected credit losses over a time period, expected credit losses would be recognised using a "time-proportional" approach. For the "bad book", the entire amount of expected losses would be recognised immediately.

As mentioned in our letter to you dated 7 June 2010 regarding "IASB Exposure Draft on Financial Instruments: Amortised Cost and Impairment", we believe that adoption of an expected loss model is appropriate as it is an application of the fundamental concept of

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prudence. Unfortunately the concept has been downplayed in current accounting literature. We expressed concerns that the original Exposure Draft proposal of incorporating expected losses in the determination of amortised cost would substantially change the meaning of "amortised cost" and would create a new hybrid meaning of amortised cost. We are pleased that the Supplement has acknowledged this concern and now proposes a revised approach which decouples and excludes expected credit losses in determining the effective interest rate and thus interest revenue.

We also had concerns in the original Exposure Draft which proposed that credit losses would be shown as a reduction of gross interest revenue. We commented that losses of loan principal will normally be substantially larger than the losses on the related interest and a loss of principal will result in negative interest returns. We are therefore pleased that the Supplement now proposes a revised approach to present impairment losses separate from interest revenue.

Although the changes to the original proposals introduce some improvements, we still have concerns on the revised proposals in the Supplement and these are discussed below.

Need to consider a comprehensive and principle-based impairment model

The Supplement only addresses impairment in the context of open portfolios. Paragraph IN20 of the Supplement states that the IASB has not yet redeliberated on the following matters:

"(a) the credit impairment requirements for financial assets that are not part of open portfolios or are evaluated individually, other problem loans, purchased loans, short-term trade receivables and any issues specific to investments in debt securities (in particular, whether there should be a single impairment model or whether there is sufficient justification for several different impairment models).

(b) methods for measuring credit losses. This topic relates to different aspects of measurement, e.g. whether to use discounted or undiscounted amounts and whether the credit loss estimate should be an expected value.

(c) .... the proposed disclosure requirements related to stress testing, origination and maturity (vintage information) and the credit quality of financial assets.

(d) the proposed definitions of 'write-off' and, ..., 'non-performing'.

(e) the objective of amortised cost measurement and how the impairment model relates to that measurement.

(f) interest revenue recognition."

We believe the above are important and inter-related matters that should be considered together as a whole in order to develop a comprehensive and principle-based standard on impairment. In particular, the meaning of "non-performing" is essential to an impairment model as we believe it is a key criteria in determining impairment allowances. The definition of "non-performing" included in the original exposure draft was *"The status of a financial asset that is more than 90 days past due or is considered uncollectible"*. Separate consideration and consultation on these other aspects at a later stage adds to the fragmentation of the deliberation process, may lead to inconsistencies, and the issues will not be properly considered in their full context.

Basic principles

Paragraphs IN8 to IN13 of the Supplement explains that the IASB and the FASB have different objectives for making impairment allowances. The IASB's objective stresses the need to reflect the relationship between the pricing of financial assets and expected losses whereas the FASB's objective is to ensure that allowances for credit losses are adequate to cover expected losses before they finally occur.

We are very concerned that the objective of making impairment allowances has not been clearly established. We believe it is useful to refer to IAS 36 which provides some guidance on what is meant by "impairment". That standard defines an impairment loss as *"the amount by which the carrying amount of an asset or a cash-generating unit exceeds its recoverable amount"*. The meaning of impairment under IAS 16 has a similar meaning. We believe that this meaning clearly describes the ultimate purpose for impairment allowances and is relevant in considering the carrying value of financial instruments. We believe that both the IASB and FASB, in adopting an expected loss model, are applying the "prudence concept" as mentioned above. The FASB's proposed approach is to make full impairment allowances immediately once expected losses are identified whereas the IASB's time-proportional approach spreads the expected loss over the remaining future contracted life of the loan.

We believe that the FASB approach is more appropriate as it will reflect the objective of the prudence concept that assets should not be overstated. If the loan impairment estimate assessment process was thorough and it had been determined (based on past historical experience and current information and expectations) that losses are expected to arise, it is most likely that the losses will eventuate. Deferring the recognition of losses would not be prudent. We believe the FASB approach will address the criticism of the current "incurred loss model" that provisions for losses are being made "too-little-too-late".

The IASB's proposed approach represents acknowledgement that losses are expected to eventuate but prefers deferral of recognition of such losses. The IASB position is based on the premise that there is a relationship between the pricing of financial assets and expected credit losses. Although this may be true, we believe that once a loan has been

made, the matching of possible future cash inflow streams with the possible timing of credit losses has less relevance. Instead, prudence should be the primary consideration. Identification of expected losses means that cash inflows will not be forthcoming - not only cash inflows of anticipated interest income which were intended to contribute to profits but more importantly the non return of loan principal. Losses of loan principal represent permanent cash outflows by the reporting entity. If the estimate of expected losses has been reasonably determined the losses will be inevitable. Deferral of the losses overstates the reporting entity's financial position. In its deliberations, the IASB should consider the following question. If deferral and amortisation of impairment losses is permitted for financial assets, should similar treatment be allowed for impairment losses of assets covered under IAS 36 and IAS 16?

Paragraph 3 of the Supplement describes "bad book" loans as having the following feature:

> *"It is no longer appropriate to recognise expected credit losses over a time period if the collectibility of a financial asset, or group of financial assets, becomes so uncertain that the entity's credit risk management objective changes for that asset or group thereof from receiving the regular payments from the debtor to recovery of all or a portion of the financial asset."*

Making impairment allowances for the "good book" and "bad book" loans recognise the fact that past experience has shown that a certain percentage of all loans will become bad debts and therefore there is a need to make a provision for the non-recovery of debts. The only difference between the treatment of "good book" and the "bad book" loans is the timing of recognition of the expected losses.

We believe that the proposed impairment allowances for the "bad book" loans essentially represent "impairment allowances for specific doubtful debts" or even possibly "bad debts" as the "bad book" loans, as mentioned in paragraph 3 of the Supplement, are those where "collectibility has become so uncertain". We would add that the proposed "bad book" impairment allowance in effect is akin to applying the "incurred loss model" for the "bad book" loan category.

Paragraph 4 of the Supplement requires that an entity shall update all estimates of expected credit losses, at a minimum, at the time an entity prepares its annual or interim financial statements. We agree with this.

The Supplement further states that for "good book" loans the allowance should be the higher of:

(i) the time-proportional amount, which is proposed to be computed as follows:

$$\left[\text{Expected credit losses over the full life of the loan portfolio} \times \frac{\text{weighted average current age of the loan portfolio}}{\text{weighted average full life of the loan portfolio}}\right]; \text{ and}$$

(ii) the floor, which are the credit losses expected to occur within the foreseeable future (i.e. a period of at least twelve months after the reporting period end date).

The Supplement focuses on how expected losses on the "good book" loans should be recognised over the remaining life of the relevant loans i.e. to spread the loss. We believe the proposed approach as set out in the examples in the Supplement is unduly complex, will be operationally problematic and costly to implement.

We believe the proposals on the allocation of losses to future periods will give rise to operational difficulties since an entity will have to maintain multiple sets of data to meet the proposed requirements, including: -

(a) data on the contracted and actual cash flows;
(b) amortised cost data for the principal amount of the financial asset;
(c) data to support expected credit loss estimates;
(d) amortised cost data for the time-proportional amount of impairment allowances, and changes thereto; and
(e) keeping track of transfers between the "good book" and "bad book" loan portfolios and related impairment allowances.

As suggested in our earlier letter to you dated 7 June 2010, we believe that the IASB should reconsider the use of amortised cost for the measurement of financial assets which has the effect of spreading expected interest returns using a constant "effective interest rate" over the life of the loan. We believe the use of contracted amounts is more appropriate as it will reflect the actual cash inflows and outflows and the obligations of the lender and borrower.

We believe that a simpler approach for making impairment allowances would be to estimate total expected losses on all contracted amounts of loans outstanding at the reporting date. The impairment allowances can be determined as a simple percentage of all outstanding loans at the reporting date. The percentage could be different depending on the nature of the major classes of loans and their specific characteristics or loss experience.

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If this approach is adopted, the IASB should require disclosure of the percentage used to enhance comparability between reporting entities. Readers of financial statements can then make their own assessment of whether the percentage adopted is reasonable or needs adjustment for the purpose of making their investment decision.

We believe that this alternative approach achieves the objective of addressing the current criticism that impairment losses are made "too-little- too-late". As the "bad book" loans or financial assets contribute to the overall loss experience on all loans, they will form part of the percentage so determined. If the loss experience becomes worse or is expected to become worse, it would be appropriate to increase the percentage impairment allowance.

It appears from paragraph IE9 on page 30 of the Supplement that the loan and related interest due for both the "good book" and "bad book" loans are required to be accrued and built up until the end of the contracted term of the loans. That is, there will be a build up of receivables and impairment allowances. We do not agree with this approach. We believe that once a receivable is regarded as a bad, accrual of interest income should cease.

We hope that the above comments are helpful.

Yours sincerely,
For and on behalf of
The Stock Exchange of Hong Kong Limited

Colin Chau
Senior Vice President
Listing Division

CC/KYS/el

c.c. Mr. Mark Dickens JP – Head of Listing