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HSBC

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30 Cannon Street
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Dear David

Exposure Draft of Proposed Amendments to:
IAS 32 'Financial Instruments: Disclosure and Presentation'; and
IAS 39 'Financial Instruments: Recognition and Measurement'

It is good to have the opportunity to comment on these important proposals in relation to financial instruments.

As you are aware I have some deep reservations about IAS 39 and these have been reinforced as we have studied the Standard and the proposed 'improvements' in detail, particularly as regards the practicalities of implementation. I have working for me at HSBC a technical accounting policy team of *5* professionals headed by a former senior executive at the UK Accounting Standards Board. Absorbing IAS 39 in terms of what it says and how it could be applied has been the principal application of their time over the last few months. Given over 500 pages of Standard and Guidance Notes, neither they nor I have any confidence we have unearthed all the consequences. I do not believe this makes a good accounting standard. When I think that the next task will be to train staff in 81 countries in numerous languages, I am truly fearful that the burden is wholly unreasonable against what are only theoretical benefits.

I am aware that the incoming IAS on Financial Instruments is intended as an interim measure pending the outcome of further study. However, this should not reduce all efforts to avoid proposals which are unworkable and will result in commitment of huge systems and human effort to effect provision of information that is not proven to be more useful to users of accounts than what they have currently. It is really doubtful whether the final product, i.e. the primary financial statements of banks, will, if prepared under the new proposals, result in reporting that is sufficiently more transparent so as to justify the considerable expense and risk management change that implementation of these proposals will entail.

I honestly believe that there are aspects of these proposals which will require major changes to bank systems to implement and yet other aspects which may be impossible to implement.

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Following publication of the amendments, the main areas of concern are as follows.

IAS 39

Loan loss provisioning

There is probably no subject which has been examined more by the banking industry, its regulators and its analysts, than loan loss incidence and accounting therefor. It is with some surprise that we observe that the IASB has felt sufficiently confident to publish dramatic changes to the way loan losses should be accounted for without meaningful consultation with the industry.

In a theoretical world these proposals may look visionary but in practice they are unworkable, or if ‘forced’ to work, it will be because accounts reflect a pro-forma basis of virtual reality accounting driven by modelling assumptions and will have less credibility than the well-understood judgemental basis applied today. Management will also be less able to explain the results.

Assessing impairment based on probabilities of default and using a discounted cash flow model, applying the original ‘effective interest rate’ is theoretically sound but practically idealistic. Although the banking industry is moving towards such a system for capital adequacy purposes under the new Basel framework currently being finalised, these proposals benefit from having been, considered in detail between the industry and its regulators. This consultation recognised that the data to deliver such default based capital measurement exist currently in only a few markets and within these markets cover only a subset of credits.

The language used in Appendix B to the proposed Standard betrays the assumption inherent in the IASB proposals when it refers to a rating of 'BB' The assumption is that credit is extended to pools of borrowers for whom there exist probabilities of default and loss given default data similar to that available in respect of formally rated companies. Globally the number of rated companies is very small and these are concentrated in the United States. Credit for non-rated companies in the United States is also regularly securitised and so again as regards the United States there exists loss data which can be used to drive the provisioning basis the IASB is proposing.

However, outside the United States, except for a very small pool of rated companies, there is not anywhere near the same historical database of loss statistics necessary to drive the accounting model proposed. In considering the new Basel capital proposals we have estimated it could take 5 to 10 years to generate sufficient statistical data to support a reliable basis for loss prediction using modelled probabilities of default and loss given default, as opposed to the current judgemental approach. Our regulators are on public record noting that virtually no bank has the loss data history to justify measuring its capital on this basis currently. If banking regulators do not think the data is good enough for what is a private measurement basis how can it be sound to base external reporting on a similar framework? It is also worth noting we do not think we will come up with very different accounting numbers using default data but we' would agree that once the necessary time series data are in place, the 'default' basis is a more intellectually robust basis of articulating provisioning numbers.

Deployment of discounted cash flow as a primary measurement basis is a fundamental revision to accounting for banks and will have major systems implications and require data input significantly in excess of that currently collected. It will also require forward-looking judgements to be made which are currently unsupported by reliable data (i.e. probabilities of default and loss given default). I question therefore whether implementation of IAS *39* will result in more reliable information on credit impairment than that produced under current provisioning methods.

To be specific, in order to perform the required calculations, the following data is required for <u>each loan asset</u>:

(i) the contractual interest rate;
(ii) the internal rate of return on origination, net of expected losses;
(iii) the expected future cash flows, at each reporting date, taking into account the expected default date, the expected losses and recoverable amount of any collateral or other recoveries; and
(iv) the timing of these recoveries.

Only item (i) is currently held within underlying loan systems. We expect to build items (ii) to (iv) once we know the new Basel capital requirements but we would stress we will not, and will not be required to, collect this data for all loan pools as our regulators accept the data would be unreliable in smaller markets and thus will accept a simpler basis of capital measurement to be applied.

I do not believe that it is reasonable for the IASB, independently, to stipulate a basis of measurement which relies on massive databases which do not currently exist, and thus I do not believe the proposed accounting can be implemented except on a very broad brush 'guesstimate' basis: this is not an improvement in accounting worthy of the time and cost involved in implementation.

Effective interest method

Paragraph 10 provides guidance on how to calculate the effective interest rate' to be used when calculating the amount of a financial instrument to be recognised initially and to account for income subsequently. The 'effective interest rate' computation incorporates all fees paid or received between parties to the contract as adjustments to yield, through recognising these fees within the 'effective interest rate' calculations. For banking entities this would include, for example, loan origination fees. Whilst we do not disagree with the deferral and amortisation of these fees through the profit and loss account, we do not believe it is appropriate for fees to be accounted for as interest when they are not. To do so mixes income received for services and income received for the extension of credit and liquidity. Analysis of performance within the banking industry looks differently at revenues generated from interest margin and those from fees and under the IASB proposals there would be contamination of those accounting ratios traditionally used by analysts to assess performance such as margins, spreads and yields. Only fees that are in substance interest should be accounted for as such.

Financial Assets and Financial Liabilities

We agree that a financial asset or financial liability should on initial recognition be measured at cost, which is the fair value of the consideration given. This should be simple to apply yet we believe there is scope for misinterpretation arising from the wording of paragraph 67. .This paragraph seems to require a comparison of the arms' length transaction value against the fair value of a comparable reference asset to determine whether "the consideration is for something other than the financial instrument".

If this interpretation is correct we disagree with this requirement as we believe that financial assets and liabilities should be measured at amortised cost. Cost is defined in IAS 16 'Property, plant and equipment' as 'the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction' and this definition should be consistent across all accounting standards. There should be no requirement to analyse into components the fair value of the actual consideration, except in demonstrably 'off market' transactions, to deduce that a separate asset or cost, liability or profit has also been created. The potential for abuse is limited - for example if a loan is advanced at a rate significantly below the market rate, such that it is below the bank's cost of funds and its credit spread for such a borrower, this is a matter which should be dealt with by the asset impairment provisions. Conversely one could interpret paragraph 67 as allowing an immediate profit to be recognised on the origination of low cost deposits or high yielding assets such as credit card receivables. I doubt such a move to full fair value is intended by this paragraph but it could be so interpreted. Perhaps the potential for misunderstanding could be remedied by adding the word 'clearly' to the second sentence of paragraph 67 so that it reads "..or part of the consideration is clearly for something other than the financial instrument."

Financial guarantee contracts

Financial guarantee contracts are scoped out of IAS 39 after initial recognition. At the date of inception the standard requires a financial guarantee contract (and letters of credit) to be recognised as a liability in the balance sheet. The liability will initially be measured at cost and, thereafter, in accordance with IAS 37 'Provisions, contingent liabilities and contingent assets" at the amount an entity would rationally be expected to pay to settle the obligation or transfer it to a third party. The significance of this departure from current GAAP under which financial guarantee contracts are reported as memorandum items and are not recognised as a liability of the guarantor unless the customer has defaulted (or is expected to default) on payments due to a third party should not be underestimated. Under current control processes and accounting systems, contingent risks such as financial guarantees are treated as giving rise to a liability only when impairment is identified and measurable. There is no data held to assess how much would have to be paid to transfer the contingent risk to third parties and there is no market for such risk transfers except in a very small subset of externally rated companies. With millions of financial guarantees issued I believe the practical implications of this proposal are substantial with the cost of creating a system to address this accounting massively outweighing any benefits. In reality guarantees and letters of credit are no different from a credit risk perspective from originated loans and should be accounted in the same way, that is, on an accruals and impairment basis.

Recognition/derecognition rules

We do not believe that in all cases the 'continuing involvement' approach proposed in IAS 39 results in an accounting treatment reflecting the true economics of a transaction. In our view, linked presentation, as permitted under current UK GAAP, better reflects those transfers not qualifying for total derecognition. In addition, we have concerns that some pass-through arrangements will not meet the conditions for derecognition owing to the length of the settlement period, i.e. the time taken to transfer cash received to the transferee. There is no guidance as to what the draft standard means by 'without material delay' in paragraph 4 1(c). On a more practical note it is deeply unsatisfactory for banks to have to change the accounting for their structured finance transactions to fall in line with requirements that will almost certainly change shortly after 2005 implementation. We therefore believe that the Board should work towards a final set of proposals for 2005 adoption.

Prohibition of reversal of impairment losses on available-for-sale assets

Paragraph 119 of IAS 39 states that impairment losses recognised in the profit and loss account on available-for-sale assets shall not be reversed through the profit and loss account as long as the instrument is recognised. This proposal is inconsistent with the reversal of impairments on intangibles, tangible fixed assets and inventories. Furthermore there is no corresponding paragraph for originated loans and, hence, we understand (and agree that) reversals of bad debt provisions on originated loans could continue to be credited to the profit and loss account. This illustrates the illogical treatment proposed for impairment of available-for-sale assets and paragraph 119 should be deleted.

Insurance

In spite of all endeavours, practitioners are finding it difficult to agree where the line is drawn between instruments falling within the Insurance Draft Statement of Principles and IAS 39. As drafted, many believe that insurance-linked savings products would be brought into the scope of IAS 39 without proper consideration. We believe such products should be exempted from IAS 39 until the IASB's insurance project finalises a definition of insurance contracts to be used across all IFRSs.

Prohibition of transfers out of the trading book

We believe that prohibition of redesignation of financial instruments initially designated as 'held for trading' as instruments measured at cost is unnecessary and restrictive without corresponding benefit. Prohibition would cause entities to sell instruments held at fair value in the market and purchase similar instruments that are intended to be held to maturity. Of course this is possible, but when accounting rules force entities to undertake transactions that have no purpose other than to effect compliance with a theoretical model of how business should be done and in the process incur transaction costs and expose the organisation to counterparty settlement risk unnecessarily, when redesignation of the instrument would achieve the same effect, then we should stand back and question whether an accounting rule is overstepping its role. Clearly any permitted redesignation needs to take place within a framework which prevents loss or profit deferral but there are already effective rules in place to prevent this.

Fair value measurement - large holdings

It is standard policy in the financial industry to apply both a liquidity adjustment and a credit risk adjustment when calculating the fair value of large holdings of financial instruments; ‘fair value’ models where used also incorporate these elements to reflect the ‘true’ net realisable value of financial instruments. These adjustments are based on appropriately documented and approved internal policies. We believe it would be imprudent and misleading to investors to record an asset on the basis of a quoted ‘price’ which is wholly unrepresentative of the size or position being valued where such an amount could not be realised. I would draw your attention to the Capital Markets’ section of the Financial Times of 16th October 2002 which, when commenting on the extreme nervousness in current markets, noted “Dealers say they are finding it harder to trade large quantities of corporate bonds”. A *$5* million to $10 million sale is now considered “a big trade” in the investment grade market. The opportunity for abuse in this area is clear and it would do discredit to the IASB should the company’s defence be that the over-valuation of the financial instrument was mandated by IAS 39.

Loans and receivables originated by the entity

Under IAS 39 as currently proposed, a loan cannot be classified as originated where it is quoted in an active market. We are unclear as to what happens where an originated loan subsequently becomes quoted in an active market. Should the loan be reclassified out of the originated loan category?

Loan commitments

We are pleased that loan commitments that cannot be settled net in cash or by some other financial instrument and are not designated as held for trading are scoped out of IAS 39. However, the standard goes on to state that an entity that has a past practice of selling assets resulting from its loan commitments shortly after origination must apply IAS 39 to all of its loan commitments. How should this rule be applied? Does it mean habitually, in a majority of cases, regularly, or at any time? We are concerned by the fact that selling some assets resulting from loan commitments shortly after origination will contaminate all loan commitments and bring them within IAS 39's scope. We believe that the most appropriate accounting treatment is that, only where the intention is for the asset to be disposed of, the loan commitment should be marked to market.

Manipulation of earnings

Failure to allow principle-based hedging rules is opening up avenues for unintended or engineered earnings anomalies. For example, where an entity has a fixed rate asset classified as 'available-for-sale', funded by a fixed rate liability, an opportunity for manipulation of earnings exists. Under the proposals, the liability may be designated as 'held for trading' and, hence, marked to market through the profit and loss account. As the asset will be marked to market through equity, changes in fair value of the liability will not be offset and, hence, profits could be manufactured in a rising interest rate environment. As interest rates currently are at their lowest levels globally for some time this opens up dangerous possibilities.

Other concerns

In spite of the fact that IAS 39 has been amended, the following concerns that have been brought to the Board's attention on many previous occasions still remain and need proper debate and consideration if this standard is ever to be acceptable.

It is of great concern that an accounting standard should change the way in which the banking industry manages risk. IAS 39 will have this effect primarily because of its requirement that all derivatives are marked to market and its onerous rules concerning hedge accounting and internal contracts. Experience in the US is that FAS 133 "Accounting for derivative instruments and hedging activities" radically changed the use of derivatives for hedges because of the complexities of the accounting rules and resulted in greater use of on-balance sheet risk management strategies with no incremental economic benefit. We therefore urge you to reconsider the heavily rules-orientated approach of IAS 39 on hedging and to enter into discussions with banks and corporates to produce a simplified principles-based approach that does not introduce artificial definitions such as fair value and cash flow interest rate risk.

IAS 39 does not allow on-balance sheet financial assets or liabilities to be designated as hedging instruments except in respect of a structural foreign investment. The reason given is that on-balance sheet items can be measured at fair value or amortised cost and permitting their designation as hedging instruments, with the one exception noted, would create measurement inconsistencies. We do not accept the logic behind the restriction on hedging by instruments other than derivatives and believe that on-balance sheet hedging should be recognised albeit without permitting an entity to reflect the revaluation of its own credit risk.

Under IAS 39, purchased loans cannot be accounted for as originated loans and must be classified as held-to-maturity, available-for-sale or trading. As a result, purchased loans cannot be assimilated into the acquirer's mainstream originated loan book even though the intention is to manage them in the same way. We disagree with this restriction as there are many instances where loan assets are acquired with no intention of subsequent disposal. For example, where we have on a number of occasions purchased complete portfolios from vendor institutions exiting a country or a line of business.

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IAS 32

Offset rules

In order for a financial asset and a financial liability to be offset in the balance sheet. IAS 32 requires that there be an intention to settle net or to realise the asset and liability simultaneously. The rules are contrary to both UK GAAP and US GAAP and to bank reporting practice. These do not require an entity to have the intention to settle net, only to have the ability to insist on net settlement, in order for outstanding balances with the same counterparty to be reported net. In addition, IAS 32's offset rules fail to recognise master netting arrangements and do not reflect the way in which banks settle financial transactions and thus will almost certainly necessitate widespread systems changes. It is regrettable that consultation in what is not a contentious area was not pursued more actively. We do not believe that current practice is either open to abuse or likely to mislead users of accounts in any way and there is therefore no reason why existing practice should be changed.

Disclosures

Simply put, the disclosures required by IAS 32 are disjointed and lack a logical structure. The Board should take advantage of the work being carried out on IAS 30 'Disclosures in the Financial Statements of Banks and Similar Financial Institutions' to produce a coherent, single disclosure standard that will gain acceptance.

Finally, on a practical note regarding implementation of IASs 32 and 39 we believe it would be of considerable help if there should be a dispensation from producing comparative figures of any description in relation to financial instruments recognition and disclosure. This would considerably ease the burden of implementation particularly for the banking industry. There is precedent for this in the US where there was a similar dispensation on first time application of FAS 133. For companies in Europe this would mean that the application of IAS 39 would be with effect from 1 January 2005 without comparative data for 2003 and 2004.

The issues explained above are of such importance that any amendments made in relation to them would, in our view, necessitate re-exposure.

I am always available to discuss any of the issues mentioned above and any aspect of the financial instrument project in general.

Yours sincerely

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