HSBC

Douglas J Flint CBE
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Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
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Dear Sir David

IASB Exposure Draft – Investments in Debt Instruments

We welcome the opportunity to comment on the IASB's Exposure Draft on Investments in Debt Instruments and thank the Board for enabling us to participate in this debate. While we commend the promptness of the Board's efforts to address the issues raised by participants at the public round tables held in November and December 2008 in response to the global financial crisis, we strongly disagree with the proposals as set out in the exposure draft.

At the round tables, we expressed the view that the rules for measuring impairment losses on available-for-sale ('AFS') financial assets should be changed. We gave the view that this deficiency in the measurement approach could not be remedied purely by disclosure, and that continues to be our view. However, as an interim step we believe that the disclosure of the disaggregation of impairment losses for AFS debt securities as summarised in paragraph BC4 of the exposure draft would be helpful. We would support such disclosures and it is unclear to us why the disclosures as described in paragraph BC4 were excluded from the final exposure draft.

The disclosures actually proposed by the IASB are much more extensive, and different in nature to the ones requested at the round tables. We are concerned that these disclosures significantly increase the data collection burden on preparers. It is difficult to understand why these particular disclosures are needed now, given that neither users nor preparers have requested them. It is also difficult to understand how this information will be useful or facilitate comparison of such investments within and between different entities.

We believe that the highly accelerated timetable proposed for the introduction of these requirements leaves no time for a well controlled implementation. We would find it very difficult to produce these disclosures in time for our 2008 year end financial statements to an auditable standard, and it is disappointing that the Board is proposing to require the industry to produce disclosures at such short notice which is based on data that is not readily available.

Measurement of impairment losses for available-for-sale debt securities
We believe that there is a very pressing need to review accounting for impairment of AFS debt and equity securities. Whilst the current requirements for AFS debt securities consider

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the entire fair value decline to be the impairment loss, we believe that this can 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. We believe that 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. This would be consistent with the current impairment requirements for held-to-maturity investments and loans and receivables under IAS 39.

Scope of the proposed disclosures
The term "investments in debt instruments" is not defined within IFRSs, therefore it is not clear what instruments are captured by the proposed new disclosures. The proposed Staff Position paper issued by the FASB on the same topic suggests that instruments such as loans and advances originated by financial institutions could also fall into the scope of these new disclosures.

We believe that the term "investments in debt instruments" should not be interpreted to include loans and advances made by a financial institution to a customer. These are considered to be loans, not "investments", and are debt instruments held for the collection of interest income and principal through time. Active markets do not exist for most if not all such financial instruments. Unless these assets are held for resale in a traded market, in which case they would be classified as held for trading, fair value information is irrelevant for business purposes. Accordingly, while fair values are periodically measured in accordance with IFRS 7 for the purposes of balance sheet disclosure in the financial statements, profit or loss on a fair value basis is not measured and reported on a regular basis. The proposed profit or loss disclosures on a fair value basis, if applied to loans and advances, are likely to be misleading and would be onerous to obtain.

To introduce a fair value-based profit or loss disclosure requirement for originated loans and advances on this timescale would be tantamount to requiring reporting entities to suddenly acquire the capability to carry out full fair value accounting for loans and advances. This is both unrealistic and inappropriate to these business activities. The concept of measuring all types of financial instruments using a single fair value measurement basis was discussed at length in the IASB's Discussion Paper on "Reducing Complexity in Reporting Financial Instruments" and an attempt to reintroduce this concept at this stage without appropriate due process is not acceptable.

Our responses to the Board's individual questions are attached in the Appendix and we would be pleased to discuss our comments with you in further detail if that would be helpful.

Yours sincerely

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Appendix - Questions for respondents

Question 1

The exposure draft proposes in paragraph 30A(a) to require entities to disclose the pre-tax profit or loss as though all investments in debt instruments (other than those classified as at fair value through profit or loss) had been (i) classified as at fair value through profit or loss and (ii) accounted for at amortised cost.

Do you agree with that proposal? If not, why? What would you propose instead, and why?

We disagree with the proposals in paragraph 30A(a) as the disclosures do not directly address the fundamental concerns of participants with regards to differentiating the different components of impairment losses recognised on AFS debt instruments. Whilst the proposed disclosure attempts to capture the differences in the accounting treatment of AFS debt instruments as though they were accounted for at amortised cost, we believe that clearer and more concise information would be provided to the users if the proposed disclosure was simply in line with that described in paragraph BC4.

Furthermore, it is unclear to us how the proposed disclosure would provide more useful information to the users of financial statements. The alternative profit or loss disclosures would not provide information relevant to how the financial instruments are used in the business. It is hard to understand why this information is required urgently.

The information gathering process required for this disclosure will be extremely onerous and we currently do not have the systems in place which collects all the required information. While we believe that loans and receivables originated by financial institutions should not be included within the scope of "investments in debt instruments", we would like to illustrate the difficulties with data collection and the calculation of the profit or loss amount, should the proposed disclosures be made a requirement for such instruments.

For an instrument classified within loans and receivables, the fair values and amortised cost information as at the balance sheet date is currently available. The fair values are calculated on a periodic basis for statutory disclosure purposes. However, it would not be straightforward to calculate the difference between the pre-tax profit or loss on a fair value basis, and on an amortised cost basis. To carry out such a calculation, firstly, it would be necessary to reverse those amortised cost accounting entries that are not applicable in the fair value measurement model, for example, certain fees receivable and payable and incurred loss impairment allowances. Secondly, it would be necessary to estimate the fair value movements on loans and receivables that would have been recorded had the entire portfolio been measured on a fair value basis during that period. Due to new loans, further advances, repayments, redemptions, write-offs and other adjustments to customers' accounts during the period, this is quite clearly not a case of comparing opening and closing balances. It will require significant systems input to prepare to an auditable standard. Furthermore, this

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calculation would also need to be replicated across large portfolios of individually insignificant loans. The problem would be particularly intractable for revolving credit instruments.

There are perhaps less challenging data collection issues for AFS debt securities, which are already recorded at fair value, but for which amortised cost information is maintained. Here the main issues concern the timing and measurement of gains or losses on disposal of AFS securities. However, it would not be a trivial exercise to collect such information.

In addition to the complexity of the calculations required, we believe that the information would be of limited meaning to users of financial statements due to the failure of the proposals to consider related transactions, such as hedging and the impact of financial liabilities managed in conjunction with the assets in question. In respect of hedge accounting the current proposals do not take into consideration the treatment of hedge accounting or economic hedging which may have taken place during the year. For example, where cash flow hedging is applied to a debt instrument measured at amortised cost, the effective portion of the fair value movement of the hedging instrument is recognised within equity. If there is a requirement to disclose the pre-tax profit or loss on the hedged items as though they were measured at fair value through profit or loss, then it would be necessary to disclose the full fair value movement of the hedging instrument in the profit or loss in order to provide meaningful information. Where the debt instrument is hedged in a fair value hedging transaction, it is not clear from the proposed disclosures whether the profit or loss on the debt instrument stated on an amortised cost basis should include the fair value movement on the hedged risk or not. In both these examples, the profit or loss disclosures would be affected by volatility that does not reflect the risk management policies of the reporting entity.

Furthermore, we believe that the cost of maintaining two systems (one actual and a "what if" situation) simply for disclosure purposes would far outweigh the benefits of providing such information. The proposed disclosures would require certain debt instruments to be accounted for under three methods of accounting. For example, for an AFS debt security accounted for as an AFS asset, additional information would also have to be collected to represent this AFS debt security as if it were accounted for at fair value through profit or loss and at amortised cost. For a financial institution such as HSBC, which has a large number of these instruments, the cost of collecting this data would far outweigh the benefits of disclosure.

Paragraph 30A(a) is also unclear on the following points:

a) Do the proposals require disclosure of the pre-tax profit or loss *for the whole entity* adjusted for the different treatment of debt instruments; or is the disclosure of the pre-tax profit or loss only for the investments in the debt instruments under the two alternative classification assumptions?

b) Is the disclosure cumulative for the entire lives of the debt instruments or for each reporting period only?

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c) Is the pre-tax profit or loss disclosure applicable for debt instruments in existence at the closing balance sheet date or should debt instruments which have been disposed during the period also be included?

Question 2

The exposure draft proposes to require disclosing the pre-tax profit or loss amount that would have resulted under two alternative classification assumptions.

Should reconciliations be required between profit or loss and the profit or loss that would have resulted under the two scenarios? If so, why and what level of detail should be required for such reconciliations?

As we do not agree that the pre-tax profit or loss amount that would have resulted under two alternative classification assumptions should be disclosed, we believe that the requirement for a reconciliation between the two scenarios would not provide meaningful information. We believe this would be extremely costly to implement.

Question 3

The exposure draft proposes in paragraph 30A(b) to require entities to disclose for all investments in debt instruments (other than those classified as at fair value through profit or loss) a summary of the different measurement bases of these instruments that sets out (i) the measurement as in the statement of financial position, (ii) fair value and (iii) amortised cost.

Do you agree with that proposal? If not, why? What would you propose instead, and why?

We do not support this disclosure requirement as most of the information is already required by IFRS 7. This requirement would simply result in duplication of disclosures.

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Question 4

The exposure draft proposes a scope that excludes investments in debt instruments classified as at fair value through profit or loss.

Do you agree with that proposal? If not, would you propose including investments in debt instruments designated as at fair value through profit or loss or those classified as held for trading or both, and if so, why?

While we disagree with the proposed disclosures as discussed above, we agree that "investments in debt instruments" classified as at fair value through profit or loss should not be included within the scope of the disclosures.

If the proposed disclosures were to be extended to instruments in the fair value through profit or loss category, it would become necessary to set up a parallel amortised cost accounting system for these items. This is unduly onerous and would involve significant cost and effort. Furthermore, we believe such disclosures will not provide users of the financial statements with meaningful information, because it does not reflect how these instruments are managed.

Question 5

Do you agree with the proposed effective date? If not, why? What would you propose instead, and why?

For the reasons discussed above, we do not believe that the proposed effective date is appropriate. We believe that the issuance of this exposure draft has been rushed through, without full consideration of the purpose or the practical consequences of these disclosures.

While it would appear that the Board has envisaged that no additional information would need to be collected as a result of existing IFRS 7 requirements, we strongly disagree with this view. The information required to populate the proposed pre-tax profit or loss disclosures is not currently collected by our systems, nor is such data used for management purposes.

We suggest that if the proposed disclosures were to be approved, the effective date should not be backdated to apply to financial statements for the year ended 31 December 2008. Rather, the Board should allow for a reasonable implementation period (perhaps consistent with that proposed for amendments to IFRS 7 on fair value and liquidity risk disclosures), with earlier adoption permitted.

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Question 6

Are the transition requirements appropriate? If not, why? What would you propose instead, and why?

Notwithstanding our comments above, we agree that the transition requirements are appropriate, otherwise reporting entities would not be able to obtain comparative data.

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