Hong Kong Institute of
Certified Public Accountants
香港會計師公會

By email < sywfung@hkma.gov.hk > and by post

17 February 2012

Our Ref.: C/RIF, M81820

Ms. Meena Datwani
Chief Executive Officer
Hong Kong Deposit Protection Board
78/F., Two International Finance Centre
8 Finance Street
Central, Hong Kong

Dear Ms. Datwani,

Guidance Note on Contingent Liabilities Estimations

Thank you for your letter dated 20 December 2011 inviting comments from the Hong Kong Institute of Certified Public Accountants ("Institute") on the above-referenced guidance.

It is noted that section 27(4)(c) of the Deposit Protection Scheme ("DPS") Ordinance gives the Hong Kong Deposit Protection Board ("DPB") the power to determine the value of contingent liabilities of depositors, by making an estimate that is reasonable and appropriate in the circumstances of the case where there is uncertainty as to the value of the contingent liabilities; the time to ascertain the value would unduly delay compensation payments; or the calculation would not be cost-effective.

We support the DPB's initiative to develop the transparent guidance to enable the industry and the public, in particular depositors, to have a clear understanding of the conditions, principles and approaches to be adopted by the DPB in estimating the value of certain contingent liabilities of depositors, arising from derivatives and trade finance transactions.

We have no objection to the general principles of estimation as proposed. As regards the detailed approaches, we should like to offer the following comments for your further consideration.

Paragraph 16 of the draft guidance indicates that a fair market value approach will be adopted to estimate the valuation of contingent liabilities arising from derivatives.

Fair value assumes an orderly transaction between knowledgeable willing buyers and sellers in an arm's length transaction. However, some may query, if a bank has failed, which would be the trigger for activation of the deposit protection scheme, whether the fair value approach should still apply. In accounting terms, the going concern assumption would no longer apply to the bank's assets and liabilities and, under these circumstances, the value placed on the assets and liabilities for accounting purposes would be distressed values. An insolvent company's assets and liabilities should normally be measured on a break-up basis.

On the other hand, we understand that the intention of the legislation is to estimate the “contractual” or actual liabilities of depositors when a bank fails rather than the value of the bank's assets per se. This distinction may need to be explained more fully in the guidance note.

Paragraph 17 states that when the trade price of a derivative product at the specified date "is not available", the price at a date very close to the DPS trigger date will be applied. However, where "no active market" exists for the derivative product, the approaches set out in paragraphs 19 and 20 of the guidance note will be adopted.

We think the difference between these two scenarios needs to be made clearer. If the market is closed on the specified date, then clearly the trade price will not be available. However, what if the market as a whole is inactive on the specified day due to, e.g., external uncertainties, or if, for some reason, trading in the particular product concerned is at a very low volume on that day? How will these situations be defined and treated. If, for example, "no active market" is intended to refer only to situations of little or no trading in the product for a prolonged period, this should be stated. On the other hand, if it is the case that, where trading in a relevant derivative is "inactive" (even though a price may be "available") on the specified date and a more representative price can be found on a day close to the DPS trigger date, then the latter price will be used, the guidance notes should also make this clear.

Paragraph 19 has picked up the disclosure requirements in HKFRS 7 *Financial Instruments: Disclosures* with regard to the hierarchy of fair valuation and paragraph 20 discusses the implications of that hierarchy with regard to the relative difficulty in valuing different categories of derivatives. However, these disclosures in financial statements merely reflect the underlying valuation methodology applied to the derivatives in banks' accounts and are not necessarily appropriate for determining the valuation methodology to be used to estimate the value of contingent liabilities arising from derivative products in the situation envisaged in the guidance note. If the guidance note is simply suggesting that the valuation approach adopted should aim to be consistent with the classification disclosed in the financial statements, we would recommend that it be clarified that the inclusion of these paragraphs is for a consistency check only rather than specific instructions on how to value.

Paragraph 20 states that where the fair value hierarchy is not available, the DPB will ask the failed Scheme member to classify the derivatives in accordance with the fair value measurement principles. Where a failed bank has not previously been required to apply HKFRS 7 (or the international standard in which it is based), it may not be used to carrying out such classifications. As such, it may be questionable whether the management would be in a position to provide reliable information and whether the DPB should rely on the failed Scheme member to provide it. Under such circumstances, the DPB should consider adopting the proposal in paragraph 21, i.e., use independent parties and valuation specialists, or obtaining advice from the liquidator (or provisional liquidator) on the valuation or valuation approaches.

In addition, it is not clear from the guidance note when "the latest fair value hierarchy maintained by the failed Scheme member" (i.e., internal management information) may be used to classify derivatives, as opposed to the one disclosed in the financial statements of the bank, and whether the former should be accorded same level of reliance as the latter.

In relation to the fair value hierarchy set out in paragraphs 19 and 20, which has been drawn from paragraph 27A of HKFRS 7, we consider that it would be also appropriate to draw reference from paragraphs 72 to 90 and paragraphs B35 and B36 of HKFRS 13 *Fair Value Measurement* (applicable when another HKFRS requires or permits fair value measurements or disclosures about fair value measurements). This is because the relevant provisions in HKFRS 7 will be deleted upon the implementation of HKFRS 13, which will be effective for annual periods beginning on or after 1 January 2013.

Paragraph 20(c) states that a prudent approach for depositors who hold derivatives classified as Level 3, is for payment to these depositors "to be withheld pending the determination of a reasonable range of value, or more advice is obtained from the liquidator (or provisional liquidator) on the valuation or valuation approaches". Given that the main purpose of the guidance on estimations is to speed up the payment process, any undue delays would seem to defeat the object. Under the circumstances, we would suggest that the guidance note make it clear that every effort should to avoid delays in the valuation process, even where Level 3 derivatives are involved. The DPB may also wish to consider, where possible, making partial initial payments to affected depositors where this would clearly not be imprudent.

Drafting comments

We suggest that the last two sentences of paragraph 11 (5th last line of the paragraph) be revised to read as "For some derivatives, inputs to these methods are values from observable markets … There are also derivatives the fair value of which ~~may be~~ are valuated based on unobservable inputs … ."

The main verb appears to have been missed out in final sentence of paragraph 20(c).

We hope that the above comments are helpful. If you have any questions on this submission or wish to discuss it further, please feel free to contact me (on 2287 7084 or email <peter@hkicpa.org.hk>).

Yours sincerely,

Peter Tisman
Director, Specialist Practices

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