HONG KONG MONETARY AUTHORITY
香港金融管理局

Circulars

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Impact of the New Hong Kong Accounting Standards – Regulatory Reserve (To HKICPA)

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29 July 2005

Mr Stephen Chan
Executive Director
Hong Kong Institute of Certified Public Accountants
4th Floor Tower Two
Lippo Centre
89 Queensway
Hong Kong

Dear Mr Chan,

Impact of the New Hong Kong Accounting Standards - Regulatory Reserve

On 11 July 2005, the HKMA circulated a Guidance Note on interim financial disclosures by locally incorporated AIs in accordance with module FD-2 of the Supervisory Policy Manual and by overseas incorporated AIs in accordance with module FD-3. Since then, some AIs have expressed their concern over the disclosure requirement relating to the Regulatory Reserve (RR). These concerns centre on the potential for misinterpretation of the RR by users of financial statements. Thus, the HKMA considers it appropriate to clarify to the industry and other interested parties its purpose in requiring AIs to maintain a RR.

As explained in Mr Topping's letter of 12 December 2004, and our subsequent Guidance Note of 12 April 2005 on the impact of the new Hong Kong Accounting Standards (HKAS) on regulatory reporting, the new HKAS opens up a conceptual gap between "accounting provisions" and "regulatory provisions". The new accounting standards adopt a primarily backward-looking "incurred loss" approach to provisioning. This broadly means that provisions for impairment must be based on loss experience and only recognised after the event on which the loss experience is based has occurred. By contrast, both sound policy and the Banking Ordinance require us to take in addition a forward-looking view of provisions. Thus we also expect AIs to provide conservatively against losses which, based on historical experience, are likely to occur at some point in the future, but may not yet be evident.

One practical consequence of the conceptual difference between the accounting and regulatory approaches to provisioning has been the disappearance of the concept of a

general provision. This has created the potential for substantial write-backs of provisions without a corresponding improvement in AIs' asset quality.

The HKMA does not consider such write-backs to be consistent with prudent banking practice, as any changes in provisioning levels should be explicitly linked to changes in asset quality.

Thus the HKMA's primary objective in requiring a RR has been to ensure that the accounting changes, in and of themselves, do not result in a reduction to the overall level of provisions held by AIs. In other words, the RR is a supervisory tool to bridge the gap between the accounting and regulatory concepts of provisioning and neutralise the effect of accounting changes on banks' provisioning levels. The only effect of the RR for capital adequacy purposes is to transfer a portion of reserves from tier 1 capital and to redesignate them as tier 2.

In discussing with individual AIs the level of RR, we have been guided by the principle that it should broadly correspond to the difference between the former general provision and the collective impairment allowance, which we have accepted carries some features of a general provision under HKAS 39, taking into account any other relevant changes, such as an AI's asset quality, and credit risk management practices, in the interim.

Given that the concept of expected loss will remain important in the Basel II Framework, over the longer term one objective of this policy is to create incentives for AIs to adopt more sophisticated approaches to setting provisions. As credit risk models become more widely used and more sophisticated, and thus better predictors of actual losses, we would expect the RR to gradually come to form a less significant component in each AI's approach to provisioning.

I trust this explanation will help clarify the way in which the RR ought to be interpreted. In requiring AIs to set aside a RR we have not departed significantly from our previous policy. The RR should not be seen as an extra buffer for credit risk, over and above our existing capital requirements. Nor, given its method of calculation, can it be considered to be a proxy for the HKMA's supervisory assessment of a particular AI.

If there are additional questions regarding the issues in this clarification, please contact either me at 2878-8045 or Ms Theresa Kwan at 2878-1093.

I am writing in similar terms to the Hong Kong Association of Banks and the DTC Association.

Yours sincerely,

Michael Taylor
Head, Banking Policy

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