June 17, 2010

To The International Accounting Standards Board:

Japanese Bankers Association

Opinion on IFRS 9

The Japanese Bankers Association is an organization that represents the banking industry in Japan; its members consist of banks and bank holding companies doing business in Japan.

The Association submits the following request to the International Accounting Standards Board ("IASB") to consider the accounting treatment for 15-year floating-rate Japanese Government Bonds ("JGBs")" under IFRS 9 issued by the IASB.

1. IFRS 9: Request for classification of 15-year floating-rate JGBs into financial assets measured at "amortized cost"

[Summary]

- 15-year floating-rate JGBs are similar in nature to the example detailed in IFRS 9 (Appendix B Instrument B - pages 24 and 25) of a constant maturity bond with a five-year term that pays a variable rate which is reset periodically but always reflects a five-year maturity. The analysis contained within the appendix of IFRS 9 indicates that this scenario does not result in contractual cash flows that represent payments of principal and interest on the principal amount outstanding and thus the instrument would not be measured at amortized cost.
- Japanese financial institutions hold these JGBs as investment instruments to mitigate the risk arising from fixed interest rates. In addition, we believe that these should be treated as financial instruments measured at the amortized cost in terms of the business model.

(1) Outline of 15-year floating-rate JGBs

✧ Background of the issuance

➢ These bonds were issued in 2000 at the time when interest rates were expected to rise and there was strong demand among institutional investors for floating-rate instruments, in order to facilitate marketability of JGBs and stabilize interest burdens in terms of the government bond management policy.

✓ The design of the instrument is similar to the "TEC10 OAT" floating-rate bonds once issued in France.

✧ The coupon rate of 15-year floating-rate JGBs is expressed as "Reference Interest Rate (the 'RIR') minus an α factor" where,

➢ The RIR is the contract rate in the most recent auction for 10-year fixed rate JGBs. It is reset to market yields every 6 months;

➢ The "α" is determined once at the time of the issuance from the bids and not subject to change until maturity (i.e., "α" is fixed from the issuance);

➢ The conditions of the issuance require the coupon rate (the 'RIR' minus α) to be no less than 0% (i.e. there is a floor of 0%);

➢ The "α" is determined at the time of the JGB issuance so that the cumulative expected value of the coupons of short-term floating-rate instruments for 15 years matches the cumulative expected value of interests on the JGB. In actual practice, α is also determined by prevailing market rates at the time of auction and by considering supply and demand factors.

✧ Coupon payments:

- Coupons are paid twice a year and the coupon rate would be changed or adjusted at the time of coupon payment.

(Reference) Market size and description of 15 year floating-rate JGBs:

- The notional outstanding 15-year floating-rate JGB in issuance at the end of December 2009 was approximately 40 trillion yen (out of a total outstanding notional of Japanese government bonds (fixed interest + floating interest) of approximately 600 trillion yen (4.5 trillion pounds));
- Volatility per annum of market value: 2.87% (calculated from market values at the end of each of December 2002 to 2009);
- Main investors: Deposit-taking financial institutions (commercial banks, financial institutions for agriculture, forestry and fisheries).

(2) Requests (draft)

✧ Under IFRS 9, 15-year floating-rate JGBs may need to be classified as "fair value through profit and loss." We believe that these instruments should be classified as financial instruments measured at amortized cost for the reasons outlined below.

✧ We also request that in the next revision of IFRS 9, IASB should provide additional guidance on "interest rates" or specific interpretation guidelines.

- The product nature of 15-year floating-rate JGBs as financial instruments
  - ✓ The RIR of the coupon rate at the time when the 15-year floating-rate JGB is issued is based on a yield on 10 year products, but the "minus α" clause adjusts it for coupon rate to be equivalent to short-term interest. This interest rate at the time of the issuance, therefore, is considered to satisfy the condition for the time value of money.
  - ✓ We believe that the interest rate which satisfies this condition at the time of the issuance is considered to continue to satisfy it if the component of this rate is not reset. This is because the α factor within the coupons of the 15-year floating–rate JGB is considered to have the same property as the interest rate of a fixed-rate bond which satisfies the condition no matter how much the market rate changes after the issuance.
  - ✓ The 15-year floating-rate JGB in question is also a <u>simple financial instrument</u> that refers to the market interest rates for a single 10-year fixed-rate bond and is adjusted by - α. <u>It differs significantly from a financial instrument that embedded derivatives seeking a unusual leverage on interest rates.</u>
  - ✓ In addition, coupon rates cannot become negative and fluctuations in market interest rates will not cause the holder to not recover the principal. These JGBs are not similar to bonds which do not meet the condition for the “time value of money” from issuance, such as a bond whose coupon rate is determined as "10 year interest minus 2 year interest," or the reverse floater.
  - ✓ In addition, this JGB is not structured by financial institutions, but by the Ministry of Finance Japan, the issuer of the bonds, and the Ministry structures JGBs to reflect prevailing market interest rates at the time of the issuance and the issuer periodically pays the interest initially be determined by itself at the time of the issuance.
  - ✓ From the perspective described above, even if the formal conditions for "interest" are not always satisfied, the application of amortized cost should be allowed for a financial

instrument that satisfies the requirements for "interest" in its product design at the time of the issuance and has no speculative component.

- Mismatch of accounting treatments in the business model
  - ✓ Japanese banks have structurally surplus deposits and as such are essentially forced to invest in the JGBs to earn interest.
  - ✓ 15-Year floating-rate JGBs have different maturities from other types of JGBs and are the only JGBs with floating rates. They are therefore a financial instrument that institutions need to hold from the perspective of ALM and also to diversify their sources of interest income.
  - ✓ In other words, Japanese banks have the business model in which they invests in JGBs as part of their portfolios to earn interest income, and those investments include an asset mix of both the JGBs with fixed rates and the JGBs with floating rates. If the ruling is to classify only 15-year floating-rate JGBs into fair value through profit and loss, there will be a mismatch in accounting treatment in the business model, and this accounting standard will have a significant impact on the investment decisions of financial institutions.
  - ✓ For JGBs, there is an extremely high likelihood that the principal will be redeemed at par, but by virtue of their design of coupon, fluctuations in unrealized gains and losses would be required to be recorded in profit and loss at every financial statement date. This could potentially result in the provision of financial information that would mislead the investment decisions of investors.

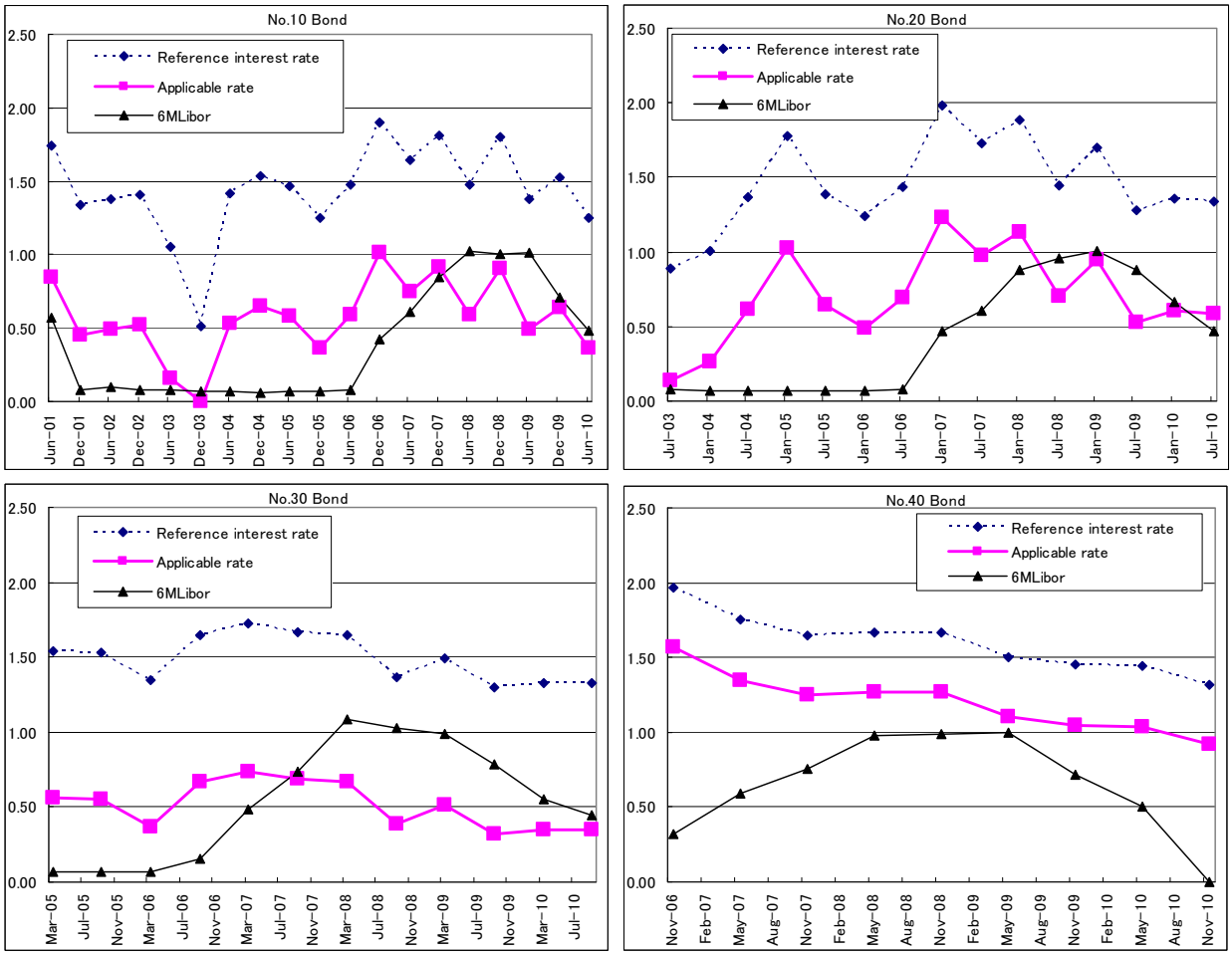
Reference 1: Actual applicable rates

The current auction mechanism started with the Issue No. 8 in June 2000. Actual applicable rates for every 10 issuance are as follows.

No. 10 bond (issued December 2000) α = 0.89			No. 20 bond (issued January 2003) α = 0.75			No. 30 bond (issued September 2004) α = 0.98			No. 40 bond (issued May 2006) α = 0.40		
Interest payment period	Reference interest rate	Applicable rate	Interest payment period	Reference interest rate	Applicable rate	Interest payment period	Reference interest rate	Applicable rate	Interest payment period	Reference interest rate	Applicable rate
2001/6/20	1.74	0.85									
2001/12/20	1.34	0.45									
2002/6/20	1.38	0.49									
2002/12/20	1.41	0.52									
2003/6/20	1.05	0.16									
2003/12/20	0.51	0.00	2003/7/20	0.89	0.14						
2004/6/20	1.42	0.53	2004/1/20	1.01	0.26						
2004/12/20	1.54	0.65	2004/7/20	1.37	0.62						
2005/6/20	1.47	0.58	2005/1/20	1.78	1.03	2005/3/20	1.54	0.56			
2005/12/20	1.25	0.36	2005/7/20	1.39	0.64	2005/9/20	1.53	0.55			
2006/6/20	1.48	0.59	2006/1/20	1.24	0.49	2006/3/20	1.35	0.37			
2006/12/20	1.90	1.01	2006/7/20	1.44	0.69	2006/9/20	1.65	0.67	2006/11/20	1.97	1.57
2007/6/20	1.64	0.75	2007/1/20	1.98	1.23	2007/3/20	1.72	0.74	2007/5/20	1.75	1.35
2007/12/20	1.81	0.92	2007/7/20	1.73	0.98	2007/9/20	1.67	0.69	2007/11/20	1.65	1.25
2008/6/20	1.48	0.59	2008/1/20	1.88	1.13	2008/3/20	1.65	0.67	2008/5/20	1.67	1.27
2008/12/20	1.80	0.91	2008/7/20	1.45	0.70	2008/9/20	1.37	0.39	2008/11/20	1.67	1.27
2009/6/20	1.38	0.49	2009/1/20	1.70	0.95	2009/3/20	1.49	0.51	2009/5/20	1.50	1.10
2009/12/20	1.53	0.64	2009/7/20	1.28	0.53	2009/9/20	1.30	0.32	2009/11/20	1.45	1.05
2010/6/20	1.25	0.36	2010/1/20	1.36	0.61	2010/3/20	1.33	0.35	2010/5/20	1.44	1.04
			2010/7/20	1.34	0.59	2010/9/20	1.33	0.35	2010/11/20	1.32	0.92

(Extracted from Ministry of Finance web page)

（Reference 2:Comparison between actual applicable rates and short-term interest rates (6 m Libor)



As can be seen from the graph above, the applicable rates for 15-year floating-rate JGBs are roughly the same as short-term interest rates (6 m Libor). The applicable rate for the government bond will in principle trend the same as a 10-year fixed rate JGB due to the method by which it is determined, but the "α" set at the time the government bond is issued will cause the applicable rate for the 15-year floating-rate JGB to be roughly the same as the short-term interest rate (6 m Libor).