December 28, 2018

International Accounting Standards Board

Japanese Bankers Association

Comments on the Discussion Paper
Financial Instruments with Characteristics of Equity
issued by the International Accounting Standards Board ("IASB")

We, the Japanese Bankers Association ("JBA"), are an organization representative of Japan's banking industry whose members consist of banks and bank holding companies operating in Japan.

We would like to express our gratitude for this opportunity to comment on the Discussion Paper ("DP") *Financial Instruments with Characteristics of Equity* issued by the International Accounting Standards Board ("IASB").

Our comments discussed below are mainly provided from the holders' perspectives. We however think that IAS 32 has effects not only on the issuers' accounting treatments but also on the holders' accounting treatments, and our comments would also facilitate your future discussion on IFRS 9. We therefore respectfully expect that the following comments will contribute to your further discussion.

Question 1

Paragraphs 1.23–1.37 describe the challenges identified and provide an explanation of their causes.

(a) Do you agree with this description of the challenges and their causes? Why or why not? Do you think there are other factors contributing to the challenges?

(b) Do you agree that the challenges identified are important to users of financial statements and are pervasive enough to require standard-setting activity? Why or why not?

(Our comments)

- IAS 32 sets out the accounting treatments of issuers of financial instruments, and unlike US GAAP, the distinction between liabilities and equity in IAS 32 is interrelated with the accounting treatments of holders to distinguish debt

instruments from equity instruments. It means the distinction between liabilities and equity in IAS 32 has effects not only on the issuers' accounting treatments but also on the holders' accounting treatments.

- Since the proposals in the DP retain the interrelation noted above, alike current IAS 32, the issues due to some logical inconsistency from the holders' viewpoint have not been solved by the proposals, requiring presentation of holders that does not appropriately reflect the substance. Specifically, Japanese banks' investment trusts which consist of listed stocks are classified as debt instruments. The classification is inconsistent with the substance of their holding.
- Given the above, we would like to request the IASB to consider developing a standard that allows holders to classify investment trusts discussed above as equity instruments.
- One of the potential solutions is not to apply the condition of paragraph 16(a)(i) of IAS 32 (equivalent to timing feature in the DP) for the liabilities and equity classification of the holders of investment trusts specified above.
  Another similar solution would be to eliminate paragraph BC5.21 of IFRS 9 (i.e. "The Board noted that in particular circumstances a puttable instrument (…) is classified as equity. However, the Board noted that such instruments do not meet the definition of an equity instrument."), and allow the holders to classify puttable instruments as equity instruments.

(Rationale, etc.)

<u>1. Rationale of our comments:</u>

(1) Grounds in IAS 32 for classifying investment trusts consisting of listed stocks as debt instruments:

- Under IAS 32, investment trusts are classified as debt instruments based on the feature described in paragraph 16(a)(i) "an obligation to deliver cash or another financial asset."
- More specifically, an investment trust contract includes a clause pertaining to a cancellation call and/or exchange call. If cancellation is called for, assets under management are sold and returned to investors in cash or other forms. If exchange is called for, invested instruments are delivered to investors in exchange. Therefore, each of the cancellation call and the exchange call is deemed as "an obligation to deliver cash or another financial asset" stated above, resulting in the classification of these investment trusts as debt instruments.

- However, the type of investment trusts assumed in our discussion does not have a maturity (i.e. perpetual) and any discretion over dividend payments. Therefore, the cancellation call and/or the exchange call is only the base that prevents such instrument trusts from being classified as equity instruments.
- Even if the preferred approach specified in paragraph 2.36 of the DP is applied, these investment trusts are still classified as debt instruments based on the timing feature, which is the same treatment as shown in the current IAS 32.

(2) Reason why the classification as debt instruments does not reflect the substance:

① Difference in accounting treatments depending on the forms of holding:

- If investment trusts are consolidated based on IFRS 10 "Consolidated Financial Statements," the listed stocks comprising the investment trusts are classified as equity instruments.
- On the other hand, if they are held in the form of investment trusts, they are classified as debt instruments as discussed in paragraph 1(1).
- The IASB does not provide clear explanation about this difference in classification as debt instruments or equity instruments depending on whether investment trusts are consolidated or not. Accordingly, in considering the classification of investment trusts, it would be appropriate to take into account the classification of those financial instruments comprising such investment trusts.

② Unclear explanation as to why the distinction between liabilities and equity varies depending on "cancellation call and/or exchange call" or "sales in the markets:"

- Like listed stocks, exchange traded funds (ETFs) and listed real estate investment trusts (REITs) are listed on stock exchanges. These financial instruments are also classified as debt instruments due to the reason previously described in paragraph 1(1). On the other hand, listed stocks are classified as equity instruments because they are not entitled to the cancellation call and/or the exchange call, although they can be sold in the markets through stock exchanges.
- Theoretically, economic effects arising from the "cancellation call and/or exchange call" and the "sales in the markets" are the same. It is therefore considered unreasonable that the distinction between equity instruments and debt instruments for the holders varies only based on the difference in the way of conversion into cash.

  Indeed, for the issuers, the cancellation call or the exchange call could be an important element for the distinction between liability and equity as the issuers

have an unconditional payment obligation once the holders select cancellation or exchange. On the other hand, for the holders, the cancellation call or the exchange call is only one of the options of the holders. Accordingly, it would not be appropriate that the cancellation call or the exchange call is a key factor for determining the classification of financial assets from the holder's perspectives.

③ Inconsistency with US GAAP:

- Under US GAAP, investment trusts comprising of listed stocks are deemed as equity securities and thus are treated in the same way as common stocks. This classification gives rise to the difference in accounting treatments between US GAAP and IFRS in terms of the liabilities and equity classification. However, the reason for this difference is unclear.

2. Significant impacts that may arise if our comments are not addressed:

- The classification of financial assets either to an equity instrument or debt instrument has a significant impact on the scope of application of other comprehensive income (OCI) option under IFRS 9.
- The OCI option is applicable to equity instruments that are held for the purposes other than trading. Major applicable instruments are those stocks held for the purposes other than trading.
- In some cases, due to the circumstances specific to Japan, Japanese banks hold investment trusts for the purposes other than short-term sale or trading. If the OCI option cannot be applied to investment trusts, period-end valuation gains/losses will be recognized in profit or loss (P&L). Increased volatility in P&L will make it difficult for Japanese banks to hold investment trusts, which could lead to a decline in prices across the entire stock markets. Essentially, recognizing period-end valuation gains/losses in P&L would not appropriately represent operating results in the situation where investment trusts are not held for gaining short-term profit.

3. Solutions to be considered:

- A potential solution would be not to apply the condition of paragraph 16(a)(i) of IAS 32 (distinction based on timing feature in the DP) for the liabilities and equity classification of the holders of investment trusts comprised of listed stocks. Another similar solution would be to eliminate paragraph BC5.21 of IFRS 9 (i.e. "The Board noted that in particular circumstances a puttable instrument (…) is classified as equity. However, the Board noted that such instruments do not meet

the definition of an equity instrument.”), and allow the holders to classify puttable instruments as an equity instruments.

Question 4

The Board’s preliminary view is that the puttable exception would be required under the Board’s preferred approach. Do you agree? Why, or why not?

(Our comments)

- We agree to the Board's preliminarily view.

(Rationale)

- If the IASB’s preferred approach is applied in the way as it is proposed in the DP, puttable instruments will meet the definition of a debt instruments defined as noted in paragraph 3.32. It is our concern that, due to this definition, investment trusts held by Japanese banks referred to in the above would be deemed as debt instruments.
- In this view, we agree to retain the puttable exception. Furthermore, we would like to request the IASB to consider elimination of paragraph BC5.21 of IFRS 9 (i.e. “The Board noted that in particular circumstances a puttable instrument (…) is classified as equity. However, the Board noted that such instruments do not meet the definition of an equity instrument.”), to allow the holders to classify puttable instruments as equity instruments.

Question 7

Do you agree with the Board’s preliminary views stated in paragraphs 6.53–6.54? Why, or why not?

The Board also considered whether or not it should require separation of embedded derivatives from the host contract for the purposes of the presentation requirements as discussed in paragraphs 6.37–6.41. Which alternative in paragraph 6.38 do you think strikes the right balance between the benefits of providing useful information and the costs of application, and why?

(Our comment)

- It would be easier for users to understand the presentation resulting from accounting treatment if non-recycling OCI items specified in paragraph 6.53(b) are treated as equity instruments.

(Rationale)

- It would be easier for users to understand the presentation resulting from accounting treatment if such instruments specified in items (i) to (iii) of the paragraph 6.53(b) are treated as equity instruments and then the income and expenses arising from them are separately presented in the statement of changes in shareholders' equity, rather than presented in OCI, without recycling.