June 29, 2010

To the International Accounting Standards Board,

Japanese Bankers Association

International Accounting Standards Board (IASB) Exposure Draft
Opinion on "Financial Instruments: Amortised Cost and Impairment"

The Japanese Bankers Association is an organization for banks and bank holding companies operating in Japan. It represents the Japanese banking industry.

The Association is pleased to provide for your deliberation its comments on the exposure draft published by the Board (IASB).

It is hoped that the comments below will assist you in your review.

1. General comments

Our understanding is that the model proposed in the exposure draft attempts to address the problems, such as delays in loss recognition found in the incurred loss model under IAS No. 39.

However, we are concerned that the proposed model lacks consistency with the concepts of credit risk management employed by financial institutions, will not benefit users of financial reports, and will pose significant practical difficulties in adapting to its measurement approaches. We discuss these problems in greater detail in our comments on Question 4 (a). We wish to see the Board (IASB) reconsiders alternative approaches to solve the problems in the IAS No. 39's incurred loss model in light of the issues discussed in our comments.

As noted above, we believe that the proposed model will be difficult to adopt, but our comments other than those in response to Question 4 (a) are based on the assumption that it is introduced as proposed and discuss the problems that we envision are likely to happen.

2. Comments on individual "Questions" in the exposure draft

Question 2

Do you believe that the objective of amortised cost set out in the exposure draft is appropriate for that measurement category? If not, why? What objective would you propose and why?

(Response outline)

We believe that measurement categories need to be reconsidered.

(Reasons)

① The objective of amortized cost to provide information about effective return is not appropriate for credits of which the holding purpose is not to earn interest revenue (for example, accounts receivable).

② Further, in the view of the measurement objective of amortized cost to allocate interest revenue or interest expense over the expected life of the financial instrument we believe applying the effective interest rate to credits with extremely short-term contractual periods (for example, less than 1 year) is of little significance and does not meet the objective of amortized cost to provide information about effective return.

Question 3

Do you agree with the way that the exposure draft is drafted, which emphasizes measurement principles accompanied by application guidance but which does not include implementation guidance or illustrative examples? If not, why?

How would you prefer the standard to be drafted instead, and why?

(Response outline)

We believe that implementation guidance and illustrative examples are necessary.

(Reasons)

Only with the proposed measurement principles and application guidance, the estimate of cash flows will include a large number of elements that are at the discretion of management, which will make it difficult to ensure the objectivity and reliability of the accounting figures used to measure profit/loss for the reporting period. It is also highly likely that comparability among enterprises cannot be achieved.

Further, the exposure draft is unclear on the treatment of revolving loans, loans with derivatives embedded and securitized instruments. As it currently stands, it might be impossible to prepare financial statements. We therefore believe that additional guidance and illustrative examples are necessary for clarification.

Question 4(a)

Do you agree with the measurement principles set out in the exposure draft? If not, which of the measurement principles do you disagree with and why?

(Response outline 1)

Among the measurement principles, we do not agree with the principle of maintaining the initially measured effective interest rate (constant interest rate) as an input of amortized cost.

(Reason 1)

Under the model proposed in the exposure draft, the effective interest rate calculated at the initial recognition is kept constant and applied to the subsequent measurement of amortized cost, which requires that the effective interest rate be estimated either for each individual asset or for each closed portfolio of assets which are grouped by asset characteristics (type of asset, vintage, transaction period, geographical location, security interest, early redemption rate, etc.) and whose components are fixed.

Measuring credit risk for individual assets or closed portfolios on the basis of initially measured information is not consistent with the actual practice of credit risk management at financial institutions. At the foundation of credit risk management is the detailed assessment of credit risk of each borrower or deal as at the financial statement date, not the management of expected loss of individual portfolios categorized by vintage. Therefore, disclosure of the figures measured with an approach that is inconsistent with credit risk management practice in the financial institution may in turn be inconsistent with the principle of reporting financial activities and investment activities by the financial statement preparer. In addition, for financial statement users, financial statements that are inconsistent with the management approach used by the preparer are difficult to understand and presumably do not provide useful information.

(Response outline 2)

Among the measurement principles, we disagree with the approach where the initial expected loss is recognized through the effective interest rate because it is not the only approach that could be taken in the light of the background that drove the development of the proposed model and it poses practical difficulties.

(Reason 2)

Whether expected loss is included a priori in the effective interest rate is presumably merely a difference in the methodology of recognition of the expected loss. In other words, as long as future credit losses are forecasted and recognized appropriately, there are no constraints on the method, and in actual practice, current accounting standards allow a number of different approaches to the recognition of costs for, for example, fixed assets.

That being the case, it is not necessarily essential to include the credit loss in the initial calculation of the effective interest rate in order to solve the problem of delay in recognition of losses that became evident in the global financial crisis and drove the development of the exposure draft. We do not agree to include the expected loss in the effective interest rate because of the practical issues outlined below.

(1) Estimating the expected loss for the entire life of the asset for multiple portfolios may have limited precision, particularly with assets such as home mortgages that are extremely long-term in nature, because of their term structures, including the timing of losses and repayments. It is therefore difficult to ensure the accuracy and appropriateness of estimates. There is also significant room for management judgment in estimates, and the degree of variation in estimates will increase as the time horizon that the estimates covers becomes longer. In particular, in sectors where financial assets account for large percentages of total assets, it is highly likely that there will be material discrepancies when comparing company to company. In addition, there will be greater room for errors by financial statement preparers and intentional selection of policies by management with respect to revenue recognition.

(2) From a practical standpoint, the systems for internal management are separate from the systems that manage interest income and are based on the concept that losses on loan assets (including expected losses and incurred losses) are losses against principal (by loss rate, charge-offs) as at the financial statement date, which forms the basis for credit risk management and determinations of profitability. Whether expected losses are estimated for individual assets or calculated for segmented portfolios, the incorporation of the internal management system into the interest income system would require significant restructuring of the systems used to manage interest income, the development of systems to create estimates based on cash flow projections and an increase in the volume of data to be stored. This increases practical workloads and imposes large costs to make the changes and to provide appropriate internal controls (although quantification of workloads and costs is difficult). It will therefore be difficult for institutions to comply.

In the light of the objective, which is to respond to the problem of delays in the recognition of loss, we like to see consideration given to alternatives that are based on the idea of losses against principal (by loss rate, charge-offs) in line with actual credit risk management practice at financial institutions that is prevailing internationally.

(Response outline 3)

We do not agree with recognizing the subsequent change in estimate of the expected loss as a one-off profit/loss at the time of the change (the catch-up approach).

(Reason 3)

The proposed measurement principle allocates the initial expected loss over the life of the financial asset, but would require recognition of the effect of the entire change in estimate as losses at the time of the change. We believe it is inconsistent to allocate the initial expected loss over the life of the financial asset and to recognize it as a catch-up adjustment. The rationale for the catch-up approach is IAS No. 8 Paragraph 37, which is a provision that is consistent with the current incurred loss model (for example, changes in estimate of impaired credit), and we question whether it would provide the rationale for the catch-up approach under the expected loss model.

If the subsequent change in estimate of the expected loss were made at a time when there are signs of economic downturn, the catch-up adjustment that incorporates the downturn would be recognized as loss, which would be likely to amplify procyclicality.

Question 7(a)

Do you agree with the proposed disclosure requirements? If not, what disclosure requirement do you disagree with and why?

(Response outline)

We disagree with some of the disclosure requirements.

(Reasons)

The proposed measurement principles would require the calculation of the effective interest rate and update of the expected loss to be made at each measurement date for each of a large number of segmented portfolios (particularly for closed portfolios whose component fixed). Were disclosure to be made on the basis of the proposed disclosure requirements, there would be increased burdens on financial statement preparers, while the information provided to financial statement users would be difficult to understand and likely less useful. We would therefore like consideration to be given to simplification of the disclosure requirements, for example, by eliminating the requirement for the quantitative information in Paragraphs 17 and 18,.

With respect to information on stress tests, there will be significant differences from enterprise to enterprise in the assumptions under which information is prepared, so from the perspective of comparability we do not think it appropriate to require the disclosure of such information.

Question 8

Would a mandatory effective date of about three years after the date of issue of the IFRS allow sufficient lead-time for implementing the proposed requirements? If not, what would be an appropriate lead-time and why?

(Response outline)

We do not believe three years are sufficient lead-time.

(Reasons)

From a practical perspective, interest income is managed by systems on the basis of contractual interest rate, while expected loss is managed by a completely separate internal management system. Incorporating the latter into the former would require significant modifications to the systems used to manage interest income, and would need a much longer lead-time than three years for implementation if appropriate internal controls are to be ensured. In addition, the existing Japanese accounting standards do not require the calculation of effective interest rate irrespective of whether expected loss is included, so we would also note the need to create new systems for the management of effective interest rate.