November 30, 2010

To the International Accounting Standards Board;

The Japanese Bankers Association

Comments on the IASB Exposure Draft *"Insurance Contracts"*

The Japanese Bankers Association is an organization that represents the banking industry in Japan; its members comprise banks and bank holding companies operating in Japan. The Association submits the following comments on the Exposure Draft, *"Insurance Contracts" (the "ED").*

We hope that the comments below will assist the Board in its further deliberation.

1. General comments

The ED requires the same accounting treatment for financial guarantee contracts as insurance contracts. We understand that the intent behind this is to eliminate the complexity created by the existence of different accounting treatments for the same transaction resulting from both IAS 39 and IFRS 4 stipulating accounting treatments for financial guarantees. However, we request reconsideration from the perspective of cost-benefits. The application of the proposed accounting treatment for insurance contracts to financial guarantee contracts whose primary risk is credit risk would be inconsistent with the concepts of risk management employed by financial institutions, as well as with the accounting treatments for other financial instruments such as loans. We question whether this will contribute to the interests of the users of financial statements. For example, we propose that the measurement approach in the current IAS 39, for which no particular problems have been identified, be allowed as a simplified method. In light of these requests, we believe that, from the perspective of consistency with risk management, all financial guarantee contracts whose primary risk is credit risk and for which banks use the same risk management as loans can be excluded from the ED. Specifically, we believe that explicitly adding credit risk to the definition of financial risk will enable the exclusion of financial guarantees performed by banks from insurance contracts.

We also note that as at the end of March 2010, Japanese banks had financial guarantees to provide credit enhancement totaling approximately 17 trillion yen (Note).Given their size, if the simplified method proposed above is not allowed, we would encourage the Board to be cognizant of the need for careful, cautious study and field testing.

Similarly, we propose the Board to rethink accounting treatment for reinsurance, because the proposal is inconsistent with risk management and economic substance. We discuss these problems in greater detail in our comments on Question 16 (b).

(Note) Total principal value for 120 banks: 6 city banks, 64 regional banks, 42 members of the Second Association of Regional Banks, 6 trust banks and 2 other banks.

2. Comments on Question 11 (c)

Comment:	We propose that enterprises that do not engage in insurance business be allowed to use a simplified accounting treatment for financial guarantee contracts. If simplified accounting treatment is not allowed, we request careful, cautious study and field testing.

(Reasons)

(1) The measurement approach proposed in the ED is inconsistent with internal controls (risk management) over financial guarantee contracts and contrary to the principle that the financial statement preparer reports the status of its financing and investing activities.

One significant, concrete difference between internal control (risk management) and the measurement approach proposed in the ED is that the measurement approach proposed in the ED requires the deduction of a "risk adjustment" from the guarantee fee to be collected from the customer (inflow) to calculate a residual margin, with the residual margin recognized as earnings over the term of the contract. In the financial guarantee contracts handled by banks, the "risk adjustment" as defined in the ED is generally managed in a manner similar to unexpected loss. Banks do not have the practice to explicitly collect such unexpected losses from customers, so in some situations, the proposed treatment would force recognition of losses not intended by management as "residual margin."

In addition, banks do not compare the guarantee fee collected from the customer (inflow) against the "risk adjustment" (unexpected loss) in their internal control (risk management).

Therefore, inconsistencies arise with the risk management practiced by the financial statement preparer when the measurement approach proposed in the ED is applied to those financial guarantee contracts. This is counter to the principle that the financial statement preparer reports the status of its financing and investing activities.

(2) Financial guarantee contracts hold credit risk commensurate to loans, and requiring a measurement approach that is inconsistent with loans would potentially impair the clarity of financial statements.

Loans and financial guarantee contracts involve credit risk of the same nature; the only difference is the inflow and outflow of cash. Therefore, for credit risk management purposes, loans and financial guarantee contracts are managed by banks in the same manner.

By contrast, the measurement approach proposed in the ED is significantly different from the measurement approach for loans in that the risk adjustment is deducted from the guarantee fee to be collected from the customer (inflow) to calculate a residual margin. If financial guarantee contracts are required to be measured by the measurement approach inconsistent with that used for loans which involve the same credit risk as financial guarantee contracts, it would makes financial statements more difficult to understand and raises the potential for intentional distortion of financial statements by management.

Additionally, there are cases in which collateral of the financial guarantee contract is collected together with the loan, and significant differences between the measurement approaches for financial guarantee contracts and loans will raise the potential for intentional distortion of financial statements in the choice of how to allocate the value of the collateral to the financial guarantee contract or the loan.

(3) Applying the measurement approach proposed in the ED to financial guarantee contracts will require adjustments to systems, which entail an increase in costs. In light of the points raised in 1 and 2 above, we do not believe that the benefits will justify the costs.

(4) The initial assumption on the measurement of impairment of financial assets in the IASB exposure draft on Financial Instruments: Amortised Cost and Impairment was a closed portfolio, but after analyzing the comments to that exposure draft a provisional agreement was reached to switch to a model that could be applied to open portfolios because of the practical difficulties entailed. The ED assumes a closed portfolio[1] but bank risk management uses open portfolios for financial guarantee contracts as well. Similar practical difficulties are expected, and they will lead to substantial system costs. We therefore advocate that careful analysis be conducted through field test in finalizing the standard setting process.

(Proposals/requests)

We have described the difficulties in applying the measurement approach proposed in the ED to financial guarantee contracts. We propose the Board allow a simplified measurement approach to be applied to financial guarantee contracts by enterprises that do not engage in the insurance business.

The simplified measurement approach proposed in the ED is not acceptable because: 1) it can only be applied to short-term contracts, and 2) conducting "disadvantageous contract test" is in itself inconsistent with risk management. We therefore propose the recognition of other simplified measurement approaches, for example, the measurement approach found in the current IAS 39 for which specific problems are not identified.

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[1] Paragraph 53 states, "If fewer contracts are in force at the end of a period than was expected at the beginning of the period, the amount of the residual margin recognised in profit or loss during the period shall include an adjustment to eliminate from the residual margin at the end of the reporting period the portion relating to contracts that are no longer in force. If more contracts are in force at the end of a period than was expected at the beginning of the period, the insurer shall not increase the residual margin." The wording "an adjustment to eliminate from the residual margin...the portion relating to contracts that are no longer in force" indicates that a closed portfolio is assumed.

In light of these requests, we believe that, from the perspective of consistency with risk management, all financial guarantee transactions whose primary risk is credit risk and for which banks use the same risk management as loans should be excluded from the ED. As a specific method for accomplishing this, we propose the following revisions to the ED. The definition of "financial risk" found in Appendix A only includes the risk of changes in credit rating or credit index, with no explicit mention of credit risk. The explicit inclusion of credit risk in financial risk would mean that credit risk was no longer included in insurance risk, which is defined as risk other than financial risk. Insurance contracts are contracts that accept significant insurance risk, and as a result all financial guarantee transactions in which banks underwrite credit risk would be excluded from the ED, which would enable the current measurement approach found in IAS 39 to continue to be applied. In conjunction with this, B18 (f) includes performance bonds and bid bonds as examples of insurance contracts, but from the perspective of banks, these financial guarantee transactions are financial guarantee transactions whose primary risk is credit risk and should therefore be deleted.

If these recommendations are not taken, we underscore the need for careful, cautious study and field testing. Absent that, it may be impossible for the standard to be applied outside of insurance companies.

3. Comments on Question 16 (b)

Comment:	We propose reconsideration of the definition and accounting treatment of reinsurance (counter-guarantees) as applied to financial guarantee contracts.

(Reasons)

(1) There are cases in which the reinsurance measurement approach proposed in the ED needs to be applied to the loans held by banks because third-party guarantees are provided to the banks.

For example, consider the situation where a bank (cedent) enters into a financial guarantee contract with Company A, for which Company A's parent company, Company B, provides a guarantee.

In this case, the bank does not view the guarantee contract with Company A and the guarantee contract with Company B, A’s parent, as 2 separate transactions for risk management purposes. In managing the credit risk of Company A, the bank instead considers A’s credit risk is secured by Company B.

(2) By contrast, the ED defines the insurance contract with Company B as "reinsurance" which is recognized as assets and it requires the guarantee to Company A be treated as a separate financial guarantee without considering the guarantee taken by Company B. Banks often do not pay guarantee fees when receiving third-party guarantees against loans held by the bank.

Turning back to the example in (1) above, there is no payment of a premium, so the bank's expected future cash outflow from the reinsurance is zero, while there is, for calculation purposes, an expected future cash inflow that is posted to profit [either immediately or prorated over the term].

Because of this, banks perform risk management and measurement comprehensively for all credits to the same borrower, including loans and financial guarantees. By contrast, the IFRS proposes to treat third-party guarantees as cash inflows from a loan in measuring impairment of a loan while it is treated as a separate reinsurance transaction in case of a financial guarantee. As a result, different accounting treatments are applied to the transactions with the same economic substance managed in the same manner, leading to inconsistencies with risk management and economic substance.