

March 31, 2011

To the International Accounting Standards Board

The Japanese Bankers Association

Comments on the IASB

“Supplement to ED Financial Instruments: Amortised Cost and Impairment”

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 “Supplement to ED”.

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

1. General comments

We appreciate the fact that this supplement to the exposure draft is a proposal to converge the deliberations by both the IASB and FASB.

However, we believe that the "common" model, by attempting to simultaneously satisfy the objective of both Boards, lacks logical consistency -- the objective of allowances is unclear, is not consistent with risk management practices of financial institutions, and it imposes significant operational difficulty. What emerges from this is a lack of consistency with the objective of financial statements, which is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions. We discuss these issues in further detail in our comments on Questions 3 and 5.

In our comments dated December 6, 2010, we proposed the "Lifetime-allocation approach" as an alternative that would solve the problems raised by allocation of expected credit losses over the remaining life (see attached Appendix 1). This proposal was based on the temporary decisions made by the Board (IASB). We believe that this is the best approach because it takes a "forward-looking" perspective, is consistent with risk management practices of financial institutions, and maintains the usefulness of financial reports, including allowance level information. We request the Board to re-examine our proposal.

As discussed above, we believe it will be difficult to accept the "common" model proposed, and our comments on some of the questions have been formulated so as to compare the proposed "common" model with the our alternative proposal, or to highlight the issues that will be encountered in case the proposed model is introduced.

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

Question 1

Do you believe the approach for recognition of impairment described in this supplementary document deals with this weakness (ie delayed recognition of expected credit losses)? If not, how do you believe the proposed model should be revised and why?

(Response outline)

The approach for recognition of impairment described in the Supplement appears to deal with the weakness in the current IAS 39 of delayed recognition of expected credit losses, but as detailed in our responses to Questions 3 and 5, it has problems of its own.

Question 2

Is the impairment model proposed in the supplementary document at least as operational for closed portfolios and other instruments as it is for open portfolios? Why or why not?

Although the supplementary document seeks views on whether the proposed approach is suitable for open portfolios, the boards welcome any comments on its suitability for single assets and closed portfolios and also comments on how important it is to have a single impairment approach for all relevant financial assets.

(Response outline)

We cannot support the "common" model proposed in the Supplement, but we do believe it is necessary in principle to use the same impairment approach for both open portfolios and closed portfolios. We also believe that further outreach and careful deliberation should be conducted regarding the amortized cost measurement approach and the impairment approach for securities in the amortized cost category under IFRS 9 (for example, bonds).

(Reasons)

Applying the effective interest rate approach proposed in the exposure draft of November 2009 (referred to simply as the "effective interest rate approach" hereinafter) to closed portfolios and the impairment model proposed in the Supplement to open portfolios would lead to differences in impairment approaches and purposes.

There are differences between the effective interest rate approach and the impairment model in the Supplement in terms of both how they are calculated and whether or not it allows "decoupling", which will lead to differences in the measurements of amortized cost and the amount of recognised interest income depending upon whether the reporting entity manages a particular financial asset using "open portfolio" or "closed portfolio."

In addition, within a single entity, it is possible that securities are normally managed in "closed portfolio", while loans are managed in "open portfolio". In such cases, securities and loans involving the same debtor, which are basically of the same nature, would have measured using different impairment approaches, which would lead to differences in the measurements of amortized cost and the amount of recognised interest income.

The simultaneous employment of two different approaches is logically inconsistent, obfuscates the purposes of allowances and potentially increases the complexity of accounting standards. This harms the comparability of financial reporting among entities, and we therefore believe that further outreach and careful deliberation should be conducted to determine practical feasibility.

Question 3

Do you agree that for financial assets in the 'good book' it is appropriate to recognise the impairment allowance using the approach described above? Why or why not?

(Response outline)

We do not agree.

(Reasons)

1. Floor

The "common" model proposed in the Supplement requires the establishment of a floor, but such floor is not logically consistent with the idea of determining impairment allowance based on the allocation of expected credit losses over the life of the asset. We therefore see no rationale for the concept of a floor.

The proposed "common" model also requires two different calculations, but even focusing on just the time-proportional amount of expected credit losses (Paragraph 2 (a) (i)), there is a lack of consistency with risk management practices of financial institutions and there are heavy operational burdens imposed for compliance (for details on these two problems, see the response to Question 12). Performing the two different calculations required by the proposed model is even less consistent with risk management practices of financial institutions than the calculation of time-proportional amounts of expected credit losses and imposes greater operational burdens (for details, see the responses to Questions 4, 5 and 12). What emerges from this is a lack of consistency with the objective of financial statements, which is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions.

2. Foreseeable future period

The definition of "foreseeable future period" and the way it should be determined are unclear.

The foreseeable future period is required to be a best estimate by an entity. There will be significant differences in the amount of provision from entity to entity for the same credit, which will potentially undermine comparability.

It is also difficult from both operational and conceptual standpoint to distinguish between expected credit losses for the foreseeable future period (Paragraph 2 (a) (ii)) and expected credit losses for the remaining life of the asset in the time-proportional amount of expected credit losses (Paragraph 2 (a) (i); Life time EL). Future expectations would include both those that are foreseeable and those that are not, and we question the significance of "unforeseeable future" expectations in the calculation of impairment allowances.

In addition, the greater the entity's ability to forecast is, the longer the foreseeable future period will become, and therefore, the larger the amount of allowance will be. This could potentially provide a disincentive to enhancement of forecasting capabilities.

As already submitted in our comments of December 6, 2010, we propose the "Lifetime-allocation approach" as an impairment model that resolves these problems and ensures sufficient allowance levels for expected credit losses, based on our historical experiences.

Question 4

Would the proposed approach to determining the impairment allowance on a time-proportional basis be operational? Why or why not?

(Response outline)

In our opinion, the proposed approach (the common model) is not operational.

(Reasons)

The proposed approach employs a weighted average age in the calculation of allowances. This calculation requires the retention of historical repayment data, etc. from the time of the origination of a loan credit to the measurement date, and doing so is not operational.

Question 5

Would the proposed approach provide information that is useful for decision-making? If not, how would you modify the proposal?

(Response outline)

The proposed approach (the common model) does not provide information that is useful for decision-making.

(Reasons)

The proposed approach (common model) utilizes allocation of expected credit loss that is inconsistent with risk management practices of financial institutions.

The requirement to establish a floor for impairment allowances is logically inconsistent with the principle of determining impairment allowances by allocating expected credit losses over the life of the asset and obscures the concept of impairment allowance itself. The utility of chronological comparisons within an entity will also be lost according to whether or not the floor has been hit.

Question 6

Is the requirement to differentiate between the two groups (ie ‘good book’ and ‘bad book’) for the purpose of determining the impairment allowance clearly described? If not, how could it be described more clearly?

(Response outline)

The fundamental concept of differentiating between the two groups is clearly described as classification based on the purposes of internal credit risk management.

However, the examples provided include some in which treatment will differ from jurisdiction to jurisdiction, making blanket statements difficult. We therefore believe there needs to be clear statement that, regardless of the events described in B3, substance should be considered reflecting the underlying principles in the standards.

Question 7

Is the requirement to differentiate between the two groups (ie ‘good book’ and ‘bad book’) for the purpose of determining the impairment allowance operational and/or auditable? If not, how could it be made more operational and/or auditable?

(Response outline)

The differentiation between the two groups is operational. However, we would reiterate the reservations expressed in the response to Question 6 above.

Question 8

Do you agree with the proposed requirement to differentiate between the two groups (ie 'good book' and 'bad book') for the purpose of determining the impairment allowance? If not, what requirement would you propose and why?

(Response outline)

We support the proposed differentiation of the two groups.

(Reasons)

We think it is important to differentiate between the "good book" and the "bad book" based on the degree of uncertainty about the collectability, and to ensure the appropriate level of allowances.

Question 9

(a) Do you agree with the proposal to require a floor for the impairment allowance related to the 'good book'? Why or why not?

(Response outline)

We do not agree.

(Reasons)

See the response to Question 3.

Question 9

(c) If you agree with a proposed minimum allowance amount, do you further agree that it should be determined on the basis of losses expected to occur within the foreseeable future (and no less than twelve months)? Why or why not? If you disagree, how would you prefer the minimum allowance to be determined and why?

(Response outline)

We do not agree.

(Reasons)

See the response to Question 3.

Question 10

Do you believe that the floor will typically be equal to or higher than the amount calculated in accordance with paragraph 2(a)(i)? Please provide data and/or reasons to support your response, including details of particular portfolios for which you believe this will be the case.

(Response outline)

There is no single approach to determine whether the floor will be equivalent or higher to the amount calculated in Paragraph 2 (a) (i).

(Reasons)

The definition of "foreseeable future period" is ambiguous, making comparison impossible. Furthermore, these two calculation methods are totally different and we cannot understand the significance of comparing the two results.

Question 11

The boards are seeking comment with respect to the flexibility related to using discounted amounts. Specifically, on the following issues:

- (a) Do you agree with the flexibility permitted to use either a discounted or undiscounted estimate when applying the approach described in paragraph B8(a)? Why or why not?
- (b) Do you agree with permitting flexibility in the selection of a discount rate when using a discounted expected loss amount? Why or why not?

(Response outline)

We agree with flexibility in the decision to use undiscounted or discounted estimates and in the selection of discount rates.

(Reasons)

We understand the concept of discounting, but believe there is potential for excessive complexity in actual application and would therefore prefer the introduction of discount calculations to continue to be treated as an option.

Question 12

Would you prefer the IASB approach for open portfolios of financial assets measured at amortised cost to the common proposal in this document? Why or why not? If you would not prefer this specific IASB approach, do you prefer the general concept of the IASB approach (ie to recognise expected credit losses over the life of the assets)? Why or why not?

(Response outline)

We agree with the allocation of expected credit losses over the remaining life of the asset.

However, we also believe that there are issues in the time-proportional amount of expected credit losses proposed by the IASB (Paragraph 2 (a) (i)).

We have proposed the "lifetime-allocation approach" as an impairment model that addresses these issues.

(Reasons)

The allocation proportionate to the age of the loan, as seen in the time-proportional amounts of expected credit losses (Paragraph 2 (a) (i)), raises the following issues.

➤ Consistency with risk management

Even were the expected credit losses the same, the concept of time proportional allocations over the term is inconsistent with the concept of "forward-looking" risk management because it will lead to the provision of different allowances depending on the number of years elapsed since the origination of the loan. We believe it is more appropriate for expected credit losses to be recognised in conjunction with future interest income.

➤ Accounting issues

The allowance derived from the time-proportional amount of expected credit losses proposed by the IASB is presumably the allocation of allowances corresponding to past income from the estimate of expected credit losses for future period with uncertainty. However, this will cause current profit/loss to reflect other conditions than the current or future economic situations, and such current profit/loss is doubtful in its utility in financial reporting.

➤ Practical burdens

The time-proportional amount of expected credit losses proposed by the IASB require the retention of historical balance data as of the origination date and thereafter to calculate the weighted average age of the portfolio. Current financial institution practice, both for financial reporting and risk management, does not use either the origination date or subsequent date balance history. Financial institutions will therefore incur new operational burdens in order to retain this data. Even if they are able to do so, they will also be forced to modify their systems to calculate weighted average ages at each reporting date.

Question 13

Would you prefer the FASB approach for assets in the scope of this document to the common proposal in this document? Why or why not? If you would not prefer this specific FASB approach, do you prefer the general concept of this FASB approach (ie to recognise currently credit losses expected to occur in the foreseeable future)? Why or why not?

(Response outline)

We do not prefer the FASB approach.

(Reasons)

The definition of "foreseeable future" in the FASB approach is ambiguous, and we do not believe it is appropriate.

If the "foreseeable future" exceeds 1 year, there will be no correspondence between the calculation period for interest income and allowance, and allocation of cost will be necessary.

Question 14Z

Do you agree that the determination of the effective interest rate should be separate from the consideration of expected losses, as opposed to the original IASB proposal, which incorporated expected credit losses in the calculation of the effective interest rate? Why or why not?

(Response outline)

We agree that there should be a separation from expected losses.

(Reasons)

From a practical standpoint, the internal management systems are separate from the systems that manage interest income and are based on the concept that losses on loan assets (including expected losses and actual losses) are losses with respect to principal (charge-offs) as at the reporting date, which forms the basis for credit risk management and determinations of profitability. To incorporate the latter into the former, whether an allowance is calculated individually for each asset or on the basis of portfolio, would require substantial upgrades to the systems used to manage interest income. There would also be cost incurred for the development of systems to provide estimates based on cash flow, operational burdens from the increase in data retention, and additional cost to ensure appropriate internal control (because of the difficulty of specific calculations). We therefore believe that it will be difficult to comply with the initial

IASB proposal of incorporating expected credit losses into the calculation of the effective interest rate.

Question 15Z

Should all loan commitments that are not accounted for at fair value through profit or loss (whether within the scope of IAS 39 and IFRS 9 or IAS 37) be subject to the impairment requirements proposed in the supplementary document? Why or why not?

(Response outline)

We oppose the impairment requirements proposed in the Supplement, but we believe that the same impairment provisioning should be applied to both loan commitments and loans. On the other hand, we believe that a careful, cautious deliberation should be given to "amortized cost and impairment" requirements that have a high degree of affinity with both loan commitments and loans.

(Reasons)

Loan commitments are subject to the same methods of risk management as loans, so it is appropriate to apply the same impairment model.

On the other hand, from an accounting perspective, loans are recognized as assets, but the undrawn loan amounts of loan commitments are not. The conceptual framework, including the definition of "exposure," will therefore need to be reworked for both the effective interest rate approach proposed in the exposure draft of November 2009 and the impairment model proposed in the Supplement, before they can be applied to the undrawn loan amounts of loan commitments. We think that there will be practical difficulties with the approach of defining exposure as the undrawn loan amount multiplied by the pull-through rate as defined as a percentage of the loan commitments resulting in loan originations.

As described above, loan commitments are given the same risk management as loan based on certain assumptions, but from an accounting perspective it will be difficult for them to be matched against loans without some reworking of the conceptual framework. In light of this, we think that there needs to be greater outreach and further deliberation on the application of impairment to loan commitments, including the question of whether the current concept of IAS 37 *Provisions, Contingent liabilities and Contingent assets* will be retained.

Question 16Z

Would the proposed requirements be operational if applied to loan commitments and financial guarantee contracts? Why or why not?

(Response outline)

We are opposed to the impairment requirements proposed in the Supplement, but we believe the same impairment approach should be applied to financial guarantee transactions and loans. On the other hand, the accounting treatment of financial guarantee contracts is still uncertain, and it is difficult at this time to make a firm determination about the operational feasibility of the proposed requirements. For application of the proposed impairment requirements to loan commitments and their operability, see our response to Question 15 Z above.

(Reasons)

From the perspective of consistency with risk management, we believe that the same impairment approach as loans should be applied to all financial guarantee transactions whose primary risk is credit risk and for which banks use the same risk management as loans. With respect to the accounting treatment of financial guarantee transactions, as noted in our comments on the IASB "Insurance Contracts" exposure draft submitted on November 30 of last year (see attached Appendix 2), from the perspective of consistency with risk management, we advocate the application of IAS 39 treatment, with the exclusion from "insurance contracts" of all financial guarantee transactions whose primary risk is credit risk and for which banks use the same risk management as loans.

Question 17Z

Do you agree with the proposed presentation requirements? If not, what presentation would you prefer instead and why?

(Response outline)

We agree with the proposed presentation requirements.

Question 18Z

(a) Do you agree with the proposed disclosure requirements? If not, which disclosure requirements do you disagree with and why?

(Response outline)

We do not agree with the proposed "common" model, and are therefore unable to agree with disclosure related to this model.

Even if the proposed "common" model were to be applied, we would disagree with the proposed disclosure requirements.

(Reasons)

Banks already engage in considerable disclosure under the Basel capital framework, and requirements should be consistent with those rules. Any additional information to be disclosed should be qualitative rather than quantitative in its nature.

The current proposal requires detailed disclosure by credit risk rating, but this is difficult in practice because the greater the amount of detail disclosed on rating systems and segments, the greater the burden for disclosure from enhancement in risk management that result in more detailed definitions of ratings and segments. Below is our opinion regarding the individual disclosure requirements.

- Disclosure of the basis of calculation of expected credit losses for individual credit risk ratings should be kept to a minimum. Credit risk management is a source of competitiveness for banks, and disclosure of the basis for calculating credit losses for individual credit risk ratings (PDs, LGDs, etc.) is tantamount to disclosing the entity's confidential, proprietary financial information. We do not, therefore, think that detailed disclosure is appropriate.

With respect to the basis for calculating expected credit losses for individual credit risk ratings, Basel II requires the disclosure of examples for individual credit risk ratings with a certain degree of grouping. We believe that these regulatory disclosure requirements indicate the level of information required to understand the status of the bank's risk management. Therefore, the disclosure of quantitative information in summary form will fully satisfy the initial purpose of providing investors with information that is useful in investment decisions.

- We also believe that disclosure should not be required for watchlists. The definition of "watchlist" is unclear, and in addition, watchlists are confidential corporate information, and their disclosure could exacerbate reputational risk for entities on the list, which would potentially amplify procyclicality.
- We think there is little utility in disclosing the results of back testing.

If back testing results are not appropriate, the estimation approaches are modified to reflect the actual results, which results in changes to allowances for the most recent term. There is therefore little utility in disclosing back testing results for the previous estimation approach.

In addition, the proposed model, when the time-proportional amount of expected credit losses (Paragraph 2 (a) (i)) is used, allocates expected credit losses over the life of the asset, making comparisons against actual results difficult.

We would note that other standards (IAS 37, etc.) do not require the disclosure of after-the-fact verifications of the appropriateness of allowance amounts, and believe that the appropriateness should be verified in an external audit.

- The quantitative information described above raises the requirements for capabilities of auditors and could result in an increase in audit hours.

- We think it is excessive to require disclosure of results for the previous 5 years because this exceeds the disclosure period for financial statements, including comparable years. It is not practical to analyze subsequent changes in the quality of portfolios from a mere list of historical numbers, and we believe that this information has little benefit and is unnecessary. If it were to be disclosed, we think it would be appropriate for annotations to cover two terms, which would correspond with normal disclosure in financial statements.

Question 19Z

Do you agree with the proposal to transfer an amount of the related allowance reflecting the age of the financial asset when transferring financial assets between the two groups? Why or why not? If not, would you instead prefer to transfer all or none of the expected credit loss of the financial asset?

(Response outline)

We do not agree with the proposal to transfer the amount of related allowance reflecting the age of the asset.

(Reasons)

We do not agree with the use of weighted average age in the allocation of expected credit losses. (See responses to Questions 3, 4, 5 and 12).

Even if this model were to be applied and the amount of related allowance reflecting the age of the financial asset were transferred and disclosed, the amount would not necessarily be consistent with the financial reporting figures, which would be calculated to reflect the floor and the weighted average for the open portfolio as a whole. This information would therefore have little beneficial use.

December 6, 2010

To the International Accounting Standards Board,

Japanese Bankers Association

Alternative Proposal for “Financial Instruments: Amortised Cost and Impairment”

1 Preface

This paper proposes the “Lifetime-allocation approach” prepared by the Japanese Bankers Association (the “Association”) as an alternative to be considered in the discussion of impairment models taking place at the International Accounting Standards Board (the “Board”).

The Association would like to express its appreciation to the Board for the ongoing, intensive discussions since the publication of the “Financial Instruments: Amortised Cost and Impairment” exposure draft (ED) last November on alternative impairment models to replace the expected cash flow approach (“ECF model”), and also for the sincere manner in which the Board has dealt with discussions held at the Expert Advisory Panel (EAP) and comments received from around the world. We would particularly like to express our strong support for the tentative decisions reached by the Board on “application to open portfolios” and “non-integration of interest revenue and expected losses (‘decoupling’)”. These steps will significantly mitigate operational issues for us as financial statement preparers.

Nonetheless, we are concerned that the “Partial Catch-up approach” (or now called the “Time-proportionate approach”) being discussed by the Board as an alternative proposal is inconsistent with “credit risk management practices” of financial institutions. The Association would therefore like to present the Lifetime-allocation approach, which was developed respecting the tentative decisions of the Board as at the end of November, while also maintaining consistency with credit risk management practices. We believe that by maintaining consistency between expected losses and reserve amounts, this approach, although some issues remain further described below, will provide information with comparability and usefulness for both financial institutions and for financial information users around the world.

We strongly request the Board to consider our proposal as one approach, both in its own Board discussions and in joint meetings with the FASB.

2 Alternative proposal

We recognize that the Board has expended a great deal of work, effort and study on the Time-proportionate approach as an alternative for the ECF model. Although this model may result in presentations that are appropriate from the standpoint of recognizing interest revenue taking into account expected losses, it generates catch-up adjustments looking back to the time of origination of the loan when accounting for changes in future expectations. This may potentially lead to undermine the benefit of current profit/loss on the following two points.

First, it may result in financial reporting that is inconsistent with risk management practices of financial institutions. Second, it generates retrospective adjustments to historical reserve amounts which are not directly related to current or future economic conditions.

The Lifetime-allocation approach estimates expected losses each period and allocates reserves in a “forward-looking” manner through the life of the portfolio. Key points in the Board discussion of the ECF model alternatives were the meaning of reserve amount in B/S presentations and rationality of current profit/loss. We believe that this approach is more consistent with practices of financial institutions (risk management from forward-looking perspectives) and the objectives of loan loss reserve provisioning (allowances against future losses).

1) Outline of the Lifetime-allocation approach

(1) Loans, etc. are divided into credits that are being repaid as per the original terms of the contract (Good-Book) and credits for which some form of impairment is recognized (Bad-Book). Different reserve calculation methods are applied to each category. For the Good-Book, the assumption is that credits can be evaluated in aggregate. Expected losses (EL over the lifetime) are calculated for each portfolio, allocated across the average life of the portfolio and such amount is provisioned as reserves.

The calculated reserves are reevaluated each period according to the conditions of the portfolio. Reserves are rebalanced (reserves from the previous term are not carried forward to the next period).

(2) For the Bad-Book, the lifetime expected loss is provisioned as reserves. The DCF approach could conceivably be used for calculation, but for practical convenience, institutions may choose to calculate in aggregate, using adjusted historical defaults rates, or to calculate on the basis of collateral values.

The reserves calculated for the Bad-Book are reevaluated each period according to the conditions of the portfolio. Reserves are rebalanced (reserves from the previous term are not carried forward to the next period).

2) Rationale

(1) Reserves against the Good-Book should be allocated across the average life of the portfolio after estimating lifetime expected loss for the portfolio at the end of each period.

a Issues in the Time- proportionate approach

We can support the Time-proportionate approach currently being discussed by the Board since it allocates expected losses across the life of the portfolio. On the other hand, it employs weighted average age against lifetime, which raises the following issues.

➤ Consistency with risk management

The concept of time proportionate allocation is inconsistent with the concept of forward looking risk management practices. Even if future expected losses are the same, the amount of reserves will differ depending on the number of years that have elapsed since the initial loan origination. We believe it is more appropriate for

expected losses to be recognized in a manner that corresponds with future interest incomes.

➤ Operational issues

The Time-proportionate approach mitigates the operational difficulties because it eliminates the need to calculate EIR including expected loss and to retain initial EIR data, both of which are required by the ECF model. However, the approach requires origination dates and historical balance data to be retained in order to calculate weighted average age of the portfolio. Current practices of financial institutions, both for financial reporting and risk management purposes, do not use either the origination dates or the subsequent historical balance records. Financial institutions will therefore incur new operational challenges in order to retain this data. Even if they are able to do so, they will need to significantly invest in their systems to calculate weighted average ages each reporting period.

b Alternative proposal (Lifetime-allocation approach)

We propose the Lifetime-allocation approach described below as a way to address these issues, at the same time respecting the tentative decisions of the Board to estimate expected losses over the life of the portfolio.

Reserves against the Good-Book are provisioned by calculating the lifetime expected loss of each portfolio at the end of each period and allocating them to the average life of the portfolio. The required reserves are recalculated each period according to the conditions of the portfolio (reserves are not carried forward from the previous term).

For credits with terms of less than 1 year, the full value of the lifetime expected loss is recognized.

c Alternative proposal issues and concepts

○ *Day 1 losses*

The biggest difference with the Time-proportionate approach is recognition of Day 1 losses.

On this point, the Time-proportionate approach recognizes lower reserves at the time of origination, which raises concern that financial reporting may not accurately reflect the risk of the portfolio. If there is uncertainty of timing of loss when expected future losses are estimated, it is appropriate to prepare for potential losses by initially provisioning a certain degree of reserves. This will help ensuring financial soundness and will also lead to financial reporting for investors that is consistent with actual practices of financial institutions. In an open portfolio, we do not consider this a critical issue because the coexistence of origination and recovery equalize the P/L impact. There may be cases in which this does not happen, for example, during periods in which there is increase in new lending. In such situations, we consider that there is greater need to recognize a certain degree of reserves in advance compared to ordinary times when there are established track records.

There are also discussions on recognizing the entire lifetime expected loss immediately. On this point, the Association does not believe that would be

appropriate for the Good-Book. The Good-Book consists of credits which repayment is being made as stipulated in the original contract, and unlike credits for which impairment has been recognized, financial institutions can expect these credits to accrue interest income across the life of the portfolio. The cost recognized by partially reducing interest income can be considered as the cost from future expected losses allocated to the period. From the perspective of matching earning and cost, it is reasonable to recognize expected losses across the average life as reserves against the Good-Book. We think it practical from an operational standpoint to use accounting period of 1 year for loss allocation (therefore, for credits with less than 1 year, the entire amount of expected loss is recognized). Reserves must be recalculated each period on the basis of expected losses for the portfolio. This means that earning and cost will match at the end of the annual reporting period because loss forecast for the year are recognized as reserves matching the interest income earned during the year.

- *Timing of reserve provisioning*

There may be concerns that the Lifetime-allocation approach will result in delays in reserve provisioning compared to the Time-proportionate approach. However, this is an issue of perspective and is not a general statement. As shown in the attached examples, at the time of origination, reserves will be recognized earlier than with the Time-proportionate approach.

The Lifetime-allocation approach posts a certain degree of reserves in advance even for the Good-Book, which addresses the issue of recognizing reserves “too late” as in the current incurred loss model. Also for the Good Book, this approach appropriately addresses the “too little” issue by recognizing reserves upfront and calculating the proportionate average amount of lifetime expected losses in case where credit risk is relatively low at origination and gradually increases over time.

For special cases in which historical data clearly indicates that large portion of defaults in the portfolio occurs during early years, there is room to consider making adjustments to the expected loss allocation ratios based on notional loss curves.

(2) Practical expedients should be allowed for reserves against the Bad-Book

We would like to comment on this point because of its importance in actual banking practice.

Unlike the Good-Book, impairment is recognized for credits in the Bad-Book, where there is clear impairment of value as of the reporting date. It is therefore reasonable to use DCF and similar methods to calculate reserves.

Nonetheless, in terms of actual financial institution practice, there is enormous burden incurred to calculate reserves based on DCF method for all credits in the Bad-Book and practical expedients should be allowed. For example, reserves could be provisioned on the basis of adjusted historical defaults rates or on the basis of collateral valuations.

Simulation: Comparison of ECF Model, Lifetime-allocation approach, Time-proportionate approach

Loan amount	100,000
Contractual interest rate	10%
Repayment	5 year bullet

ECF Model

	Principal	Interest	Default Rate	Expected CF	Interest Revenue based on EIR	Book amount	Provisioning amount for Principal	P/L impact
Year 0	-100,000		0%	-100,000		100,000	0	0
Year 1		10,000	0.0%	10,000.0	8,840	98,840	1,160	1,160
Year 2		10,000	0.0%	10,000.0	8,737	97,577	1,263	1,263
Year 3		10,000	1.0%	9,900.0	8,625	96,302	1,275	1,375
Year 4		10,000	2.0%	9,702.0	8,513	95,113	1,189	1,487
Year 5	100,000	10,000	3.0%	103,520.3	8,408	-0	1,003	1,592
							5,891	6,878

Initial EIR	8.84%
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Lifetime-allocation approach

	Cumulative loan loss allowance	Incurred loss for principal	Increase in loan loss allowance	Incurred loss for interest	P/L impact (incurred loss + increase in allowance)
Year 0	1,178	0	1,178		1,178
Year 1	1,473	0	295	0	295
Year 2	1,964	0	491	0	491
Year 3	2,445	1,000	482	100	1,582
Year 4	2,911	1,980	465	298	2,743
Year 5	0	2,911	-2,911	589	589
		5,891			6,878

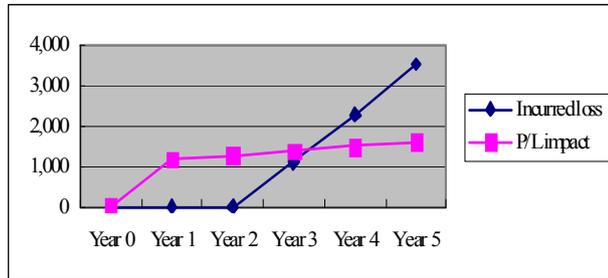
Time proportionate approach

	Cumulative loan loss allowance	Incurred loss for principal	Increase in loan loss allowance	Incurred loss for interest	P/L impact (incurred loss + increase in allowance)
Year 0	0	0	0		0
Year 1	1,178	0	1,178	0	1,178
Year 2	2,356	0	1,178	0	1,178
Year 3	2,934	1,000	578	100	1,678
Year 4	2,328	1,980	-606	298	1,672
Year 5	0	2,911	-2,328	589	1,171
		5,891			6,878

Loan amount	100,000
Contractual interest rate	10%
Repayment	5 year bullet

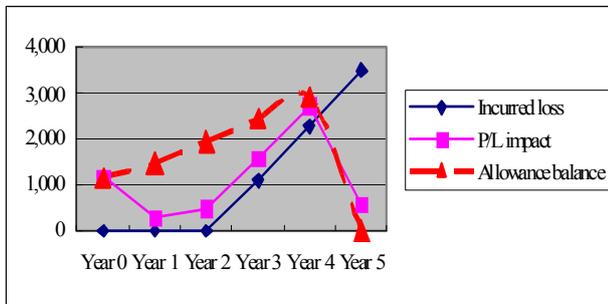
ECF Model

	Incurring loss	P/L impact
Year 0	0	0
Year 1	0	1,160
Year 2	0	1,263
Year 3	1,100	1,375
Year 4	2,278	1,487
Year 5	3,500	1,592



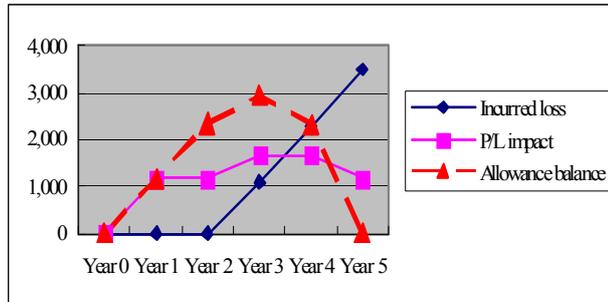
Lifetime-allocation approach

	Incurring loss	P/L impact	Allowance balance
Year 0	0	1,178	1,178
Year 1	0	295	1,473
Year 2	0	491	1,964
Year 3	1,100	1,582	2,445
Year 4	2,278	2,743	2,911
Year 5	3,500	589	0



Time proportionate approach

	Incurring loss	P/L impact	Allowance balance
Year 0	0	0	0
Year 1	0	1,178	1,178
Year 2	0	1,178	2,356
Year 3	1,100	1,678	2,934
Year 4	2,278	1,672	2,328
Year 5	3,500	1,171	0



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 make 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 portfolio¹ 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.

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.
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(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.