April 30, 2013

To the Financial Accounting Standards Board:

Japanese Bankers Association

Comments on the FASB's Proposed Accounting Standards Update "Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities"

We, the Japanese Bankers Association, are an organization that represents the banking industry in Japan, and our members comprise banks and bank holding companies operating in Japan.

We would like to express our gratitude for this opportunity to comment on the Proposed Accounting Standards Update "Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities" published by the Financial Accounting Standards Board ("FASB") ("FASB Exposure Draft").

We respectfully expect that the following comments will contribute to your further discussion to develop the accounting standards for this issue.

(Overall comments)

1. The Proposed Accounting Standards Update "Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities – Financial Instruments (Topic 825) and Derivatives and Hedging (Topic 815)" published by the FASB in May 2010 requires all financial instruments to be measured at fair value. We had expressed our dissenting view on the grounds that such a treatment may not properly present banking practice, and therefore may not provide users with useful information.
2. The FASB Exposure Draft sets out that financial assets shall be classified into one of the following three categories on the basis of contractual cash flow characteristics of the instrument and the business model: those measured at fair value with all changes in fair value recognized in net income (FV-NI), those measured at fair value with qualifying changes in fair value recognized in other comprehensive income (FV-OCI), or those measured at amortized cost. In this FASB Exposure Draft, our concern noted in the preceding paragraph has been resolved, and hence we support the approaches taken in this FASB Exposure Draft.
3. The FASB Exposure Draft proposes a practicability exception for measuring equity investments without readily determinable fair values. We agree with this proposed treatment.
4. Equity instruments, however, may be held for the purposes of enhancing business relationships and increasing an entity's business profit, rather than earning capital gains. Given such a business strategy, we consider that an option to recognize changes in fair value in other comprehensive income (OCI) should be allowed for such equity instruments, similar to the treatment taken by IFRS 9.

5. Lastly, the FASB Exposure Draft has generally achieved convergence with the Exposure Draft “Classification and Measurement: Limited Amendments to IFRS 9” published by the International Accounting Standards Board (“IASB”) in November 2012. It is understood that the FASB and the IASB will continue their joint discussions with the aim of finalizing the both standards, and we fully support such efforts. We would like to note that, given such joint efforts, we have submitted a letter to the IASB with comments similar to those provided herein.

(Specific comments)

(Q4: Principle associated with the contractual cash flow characteristics assessment)

6. It is our concern that the definition of interest under the Exposure Draft is not proper, and accordingly financial assets with contractual cash flows that should be considered solely payments of principal and interest may not be appropriately identified.

7. Contractual interest on a financial instrument in general encompasses various elements including consideration for the time value of money and the credit risk, consideration for liquidity risk, funding cost reflecting own credit risk and administrative expenses.

8. 825-10-25-18 states that “Interest is consideration for the time value of money and for the credit risk associated with the principal amount outstanding during a particular period of time, which may include a premium for liquidity risk”. While, 825-10-55-16 sets out that “If the contractual cash flows include payments that are unrelated to principal, the time value of money, and the credit risk, the contractual cash flows do not represent solely payments of principal and interest”. We are concerned over an excessively strict interpretation of these requirements.

9. In particular, we are concerned that (i) many ordinary financial assets without leverage will need to be assessed as to whether they include payments that are unrelated to principal, the time value of money and the credit risk, resulting in increased workload in practice, and that (ii) such general financial instruments encompassing a variety of elements as set out in paragraph 7 of this document may be classified as FV-NI.

10. As discussed above, it is technically difficult to consider interest on a general financial instrument based only on the time value of money and the credit risk. Therefore, paragraphs 825-10-25-18 and 825-10-55-16 need to be reconsidered.

11. 825-10-55-19 defines the benchmark instrument as a contract of the same credit quality and with the same contractual terms, except for the contractual term under evaluation. According to this definition, the benchmark instrument can be interpreted as also encompassing a variety of elements set out in paragraph 7 of this comment letter. In this respect, paragraph 825-10-55-19 is consistent with our view expressed in the above paragraphs.

(Q7: Modified economic relationship between principal and consideration for the time value of money and the credit risk)

12. We agree that even if the economic relationship between principal and consideration for the time value of money and the credit risk is modified due to an interest rate mismatch feature or leverage, a financial asset with such a modified economic relationship could be considered to contain cash flows that are solely payments of principal and interest, and thereby still satisfy the contractual cash flow characteristics assessment.

13. If a financial asset may be assessed as not satisfying the contractual cash flow characteristics assessment for any modification to the above economic relationship even when that the modification is not significant, actual economic conditions are not appropriately reflected in the financial statements.

(Q8: Guidance on assessing a modified economic relationship)

14. We do not consider the proposed application guidance to be sufficient nor operationally practicable.

(Comparison with the benchmark cash flows)

15. We acknowledge that paragraph 825-10-55-19 of the Exposure Draft stipulates that "An entity need not make a detailed assessment if it is clear with little or no analysis that the cash flows of the financial asset under assessment could or could not be more than insignificantly different from the cash flows of the benchmark instrument". However, comparing contractual cash flows with the benchmark cash flows on an asset-by-asset basis in all cases of assessing a modified economic relationship, would in practice entail significant workload, and we thus consider it operationally impractical. We therefore request that the proposed guidance specify that a quantitative comparison with the benchmark cash flows is not a mandatory procedure.

(Clarification of the comparison method with the benchmark cash flows)

16. The proposed guidance does not provide specific guidance on how to compare contractual cash flows with the benchmark cash flows (e.g. whether an entity should compare aggregated cash flows over the contractual term or cash flows over each interest payment period, to assess if the modification results in not significant difference from the benchmark cash flows).
17. The contractual cash flow characteristics assessment relates only to those business models in which assets are managed "to collect contractual cash flows" or "both to collect contractual cash flows and to sell". It should be noted that under these business models, financial assets are held over a long-term period (contractual term) to collect contractual cash flows. Accordingly, we consider that comparing aggregated cash flows over the entire contractual term is more consistent with such business models and results in providing more relevant information, than comparing cash flows over each

interest payment period.

(Q9: Applying the contractual cash flow characteristics assessment to securitized instruments)

18. In applying the contractual cash flow characteristics assessment to securitized instruments, the proposed guidance will cause significant workload. Therefore, the introduction of a simplified method is recommended.

19. Paragraphs 825-10-55-26 and 825-10-55-64 to 55-69 provide guidance on the application of the contractual cash flow characteristics assessment to securitized instruments, requiring entities to look through in detail to the underlying pool of instruments. However, assessing individual securitized instruments in accordance with the proposed guidance would in practice require significant workload and is thus operationally impracticable.
20. Taking this into account, we would like to recommend the introduction of the following simplified methods.
    (a) Regarding the most senior tranche, an entity is exempted from applying the contractual cash flow characteristics assessment set forth under the above guidance provided that the entity itself confirms, by reference to Loan-to-Value (LTV) or other thresholds, upon structuring that the underlying asset would generate sufficient cash flows.
    (b) Tranches that have a lower yield than the average yield of the underlying assets should be deemed as satisfying the contractual cash flow characteristics assessment.

(Q10: Principle associated with the business model assessment)

21. We basically agree with the principle associated with the business model assessment. However, it is considered necessary to redefine the scope of debt instruments classified as FV-OCI.

22. Japanese banks hold debt instruments (securities) for various purposes, ranging from collecting principal and interest payments through holding such instruments, meeting liquidity needs and managing interest rate risk. Therefore, as compared to IFRS 9 (issued in 2010) which adopts the two-category approach (amortized cost and FV-NI), the three-category approach (amortized cost, FV-OCI and FV-NI) would make for a more appropriate reflection of actual economic conditions in the financial statements based on the business models of respective entities, and provide more relevant information.

(Scope of debt instruments classified as FV-OCI)

23. The scope of financial assets to be measured at FV-OCI should not be limited to those

debt instruments with the eligible contractual cash flow characteristics (i.e. qualifying debt instruments), held within a business model in which assets are managed both to collect contractual cash flows and to sell. Rather, the scope should also include those debt instruments that do not satisfy the contractual cash flow characteristics assessment (i.e. non-qualifying debt instruments), held within a business model in which assets are managed to collect contractual cash flows.

24. We support the idea of presenting fair value on the statement of financial position for non-qualifying debt instruments held within a business model in which assets are managed to collect contractual cash flows. However, we consider the recognition of changes in fair value in profit or loss which represents the results of operations of the entity may not be consistent with the business model.

25. Under a business model in which assets are managed to collect contractual cash flows, it is assumed that assets are managed and their performance is evaluated based on amortized cost rather than based on changes in fair value. If such changes in fair value, which are not managed by an entity, are included in profit or loss, we do not consider that the financial statements exactly reflect the entity's economic conditions and provide highly relevant information to the users of the financial statements.

26. In view of the above, we respectfully recommend that those financial instruments held within a business model in which assets are managed to collect contractual cash flows and that do not satisfy the contractual cash flow characteristics assessment, should be measured at FV-OCI, thereby providing fair value information on the statement of financial position, while providing profit/loss information through the income statement in the same manner as for financial assets measured at amortized cost.

		Contractual cash flow characteristics assessment	
		Qualified	Not qualified
Business model	To manage assets to collect contractual cash flows	Amortized Cost	~~FV-NI (Residual)~~ **FV-OCI**
	To manage assets both to collect contractual cash flows and to sell	FV-OCI	FV-NI (Residual)
	Others (held for sale)	FV-NI (Residual)	FV-NI (Residual)

(Question 11: Application guidance on the business model assessment)

27. The guidance on sales which are considered consistent with the amortized cost category needs to be reconsidered.

28. The first half of 825-10-55-31 states that sales of financial assets as a result of a significant deterioration in the issuer's creditworthiness would not be inconsistent with the objective of amortized cost classification if the purpose of those sales is to maximize the collection of contractual cash flows through sales rather than through cash collection.

29. However, in the case of financial assets qualifying for amortized cost measurement, sales may be restricted until it is confirmed that a significant deterioration has actually occurred, thereby resulting in an increased loss on sale of assets.

30. While, the latter half of 825-10-55-31 notes that sales of financial assets that result from managing the credit exposure because of concentrations of credit risk would not be consistent with the objective of amortized cost classification.

31. In some cases, financial institutions may sell part of their financial assets in order to reduce credit concentration on a portfolio basis as a part of their credit risk management. Such a sale is also construed to be an activity to secure the collection of as much contractual cash flows from the entire portfolio as possible.

32. Given the above, we would expect the FASB to consider adding the following examples: (i) a case where an entity has identified a risk of credit deterioration but where there is no objective evidence that the credit quality of an asset has actually deteriorated; and (ii) a case where credit concentration is reduced on a portfolio basis for the purpose of credit risk management.

(Q 19: OCI option)

33. For the measurement of equity instruments held for purposes other than trading, there should be an option of recognizing the changes in fair value in OCI.

34. First, we support the proposed practicability exception for measuring equity investments without readily determinable fair values, on the grounds that fair value measurement for such equity instruments may give rise to undue practical difficulty, and recognizing fair value changes with uncertainty in the reliability of fair value estimation in net income may not provide useful information to users of financial statements.

35. With regard to the measurement of equity investments other than those discussed above, there should be an option of recognizing the changes in fair value in OCI for the following reasons:

    (a) Equity instruments may be held for the purposes of enhancing business relationships and increasing an entity's business profit, rather than earning capital gains. Under such a business strategy, recognizing changes in fair value of equity instruments measured at fair value in net income may give rise to an increase in the volatility of an entity's performance, not properly reflecting the actual results of the entity. Hence, financial statements may not provide useful information.

    (b) Accordingly, for equity instruments, convergence with IFRS that adopts the OCI option for fair value changes should be promoted.

(Q 21: Bifurcation of embedded features)

36. The Exposure Draft proposes "no-bifurcation approach for financial assets" and to retain "closely-related bifurcation approach for financial liabilities," which cannot be supported.

37. It is considered that the FASB should add a provision to allow both financial assets and financial liabilities to be bifurcated when embedded features are separated for management purposes.

38. Under current practice, Japanese banks manage hybrid instruments by separating embedded derivatives from the host contract, with the host contract being held for the purpose of collecting contractual cash flows and with risks inherent in the embedded derivatives being hedged in the markets as necessary.

39. If an embedded feature is separately managed as a derivative, bifurcation of such an embedded feature for accounting purposes should provide more relevant information to users of financial statements.

40. For example, if a loan with an embedded derivative is classified in its entirety to be measured at amortized cost, any changes in the fair value of the embedded derivative would not be presented in the financial statements; on the other hand those derivatives used as hedging instruments give rise to changes in fair value. As a result, matching of profit and loss is not achieved, thus actual economic conditions are not appropriately reflected in the financial statements. Further, hedge accounting may be applied in this case but is likely to be impracticable because the amount of derivatives embedded in hybrid instruments offered to customers is generally de minimis, with only slight differences in the terms and conditions of a transaction.

41. It is therefore our view that the FASB should add a provision to allow both financial assets and financial liabilities to be bifurcated when embedded features are separated for management purposes. (See the diagram below.)

(Example)