July 5, 2013

To the International Accounting Standards Board:
(cc: The Financial Accounting Standards Board)

Japanese Bankers Association

Comments on IASB's Exposure Draft "Financial Instruments: Expected Credit Losses"

We, the Japanese Bankers Association ("JBA"), 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 Exposure Draft "Financial Instruments: Expected Credit Losses" published by the International Accounting Standards Board ("IASB").

We believe that the following comments will contribute to your further discussions on this issue.

1. General comments

The IASB's continuous effort and focus on the discussion of the expected credit loss model is highly appreciated. We support the proposed model in that it classifies financial instruments into those for which credit risk is low (Stage 1) and not low (Stages 2 and 3) and requires entities to measure a loss allowance for a Stage 1 financial asset at an amount equal to 12-month expected credit losses, on the grounds that such a model is broadly consistent with the credit risk management processes and relevant accounting treatment established in Japan.

However, the proposed approach to measure a loss allowance based on the level of deterioration in credit quality since initial recognition (the "relative approach") is not consistent with the practice of credit risk management because, among other reasons, an entity needs to track credit rating migration since initial recognition. Therefore, in finalising the standard the IASB is respectfully requested to reconsider the approach to measure the loss allowance on the basis of credit risk at the reporting date (the "absolute approach").

2. Convergence

We request that the IASB and the Financial Accounting Standards Board (FASB) establish a common model for expected credit loss. If financial institutions account for assets with similar credit risk by different ways in their financial statements, it may give rise to confusion, undermining the users' benefits.

Further, if different models were adopted by the IASB and the FASB, it will cause an undue burden on the preparers of financial statements. Therefore, we would like to again request both the Boards to reconsider, from the perspective of costs and benefits, a common expected credit loss model.

3. Comments to Exposure Draft's individual questions

| Question 1<br>(a) Do you agree that an approach that recognises a loss allowance (or provision) at an amount equal to a portion of expected credit losses initially, and lifetime expected credit losses only after significant deterioration in credit quality, will reflect:<br>(i) the economic link between the pricing of financial instruments and the credit quality at initial recognition; and<br>(ii) the effects of changes in the credit quality subsequent to initial recognition?<br>If not, why not and how do you believe the proposed model should be revised?<br>(b) Do you agree that recognising a loss allowance or provision from initial recognition at an amount equal to lifetime expected credit losses, discounted using the original effective interest rate, does not faithfully represent the underlying economics of financial instruments? If not, why not? |
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(Our comment)

(a) (b) We support the proposed approach to classify financial assets into those for which credit risk is low (Stage 1) and not low (Stages 2 and 3). However, we are not in support of the relative approach as it does not align with the practice of credit risk management, and instead strongly request the IASB to consider the adoption of the absolute approach. For details, please see our comment to Question 5.

Question 2

(a) Do you agree that recognising a loss allowance (or provision) at an amount equal to 12-month expected credit losses and at an amount equal to lifetime expected credit losses after significant deterioration in credit quality achieves an appropriate balance between the faithful representation of the underlying economics and the costs of implementation? If not, why not? What alternative would you prefer and why?

(b) Do you agree that the approach for accounting for expected credit losses proposed in this Exposure Draft achieves a better balance between the faithful representation of the underlying economics and the cost of implementation than the approaches in the 2009 ED and the SD (without the foreseeable future floor)?

(c) Do you think that recognising a loss allowance at an amount equal to the lifetime expected credit losses from initial recognition, discounted using the original effective interest rate, achieves a better balance between the faithful representation of the underlying economics and the cost of implementation than this Exposure Draft?

(Our comment)

(a) We support the IASB's proposal to recognise a loss allowance (or provision) at "an amount equal to 12-month expected credit losses" and at "an amount equal to lifetime expected credit losses" because such approaches are broadly consistent with the credit risk management practice and related accounting treatment in Japan.

However, we do not concur with the relative approach as it is inconsistent with credit risk management practices, and strongly recommend that the IASB should adopt the absolute approach. For details, please see our comment to Question 5.

(b) Although the cost of implementation is considered to be lower under this Exposure Draft than the 2009 ED and the SD (without the foreseeable future floor), we do not support the approach proposed by the Exposure Draft as explained above in our response to question 2(a).

(c) It is considered unlikely that such an approach achieves a better balance than this Exposure Draft.

Question 3

(a) Do you agree with the proposed scope of this Exposure Draft? If not, why not?

(b) Do you agree that, for financial assets that are mandatorily measured at FVOCI in accordance with the Classification and Measurement ED, the accounting for expected credit losses should be as proposed in this Exposure Draft? Why or why not?

(Our comment)

In principle we agree with the proposed scope of this Exposure Draft however we would like to request that the IASB give due consideration to whether to apply the expected credit loss model to all debt securities. For example, the IASB may allow an exemption for highly-rated government bonds (e.g. those rated AA or above by an external rating agency).

(Basis)

- In applying the expected credit loss model to debt securities for example, it is necessary to consider specific methods to reflect credit losses on highly-rated government bonds, giving rise to increased operational complexity compared to current practices. Therefore, a careful consideration of this matter is requested taking into account costs and benefits.

Question 4

Is measuring the loss allowance (or a provision) at an amount equal to 12-month expected credit losses operational? If not, why not and how do you believe the portion recognised from initial recognition should be determined?

(Our comment)

It is considered that such measurement is operational.

Question 5

(a) Do you agree with the proposed requirement to recognise a loss allowance (or a provision) at an amount equal to lifetime expected credit losses on the basis of a significant increase in credit risk since initial recognition? If not, why not and what alternative would you prefer?

(b) Do the proposals provide sufficient guidance on when to recognise lifetime expected credit losses? If not, what additional guidance would you suggest?

(c) Do you agree that the assessment of when to recognise lifetime expected credit losses should consider only changes in the probability of a default occurring, rather than changes in expected credit losses (or credit loss given default ('LGD'))? If not, why not and what would you prefer?

(d) Do you agree with the proposed operational simplifications, and do they contribute to an appropriate balance between faithful representation and the cost of implementation?

(e) Do you agree with the proposal that the model shall allow the re-establishment of a loss allowance (or a provision) at an amount equal to 12-month expected credit losses if the criteria for the recognition of lifetime expected credit losses are no longer met? If not, why not, and what would you prefer?

(Our comment)

(a) We do not support the proposed requirement to recognise a loss allowance (or a provision) at an amount equal to lifetime expected credit losses on the basis of a significant increase in credit risk since initial recognition, which is an approach based on the level of deterioration in credit quality since initial recognition (the "relative approach").

(b) It is considered that the proposals do not provide sufficient guidance.

(c) In general we agree with the proposal. However, it would be more practical if an EL-based assessment including LGD could be applied to portfolios where the impact is immaterial.

(d) We are not in a position to comment on this question as we do not support the approach referred to in Question 5(a).

(e) We agree with the proposal.

(Basis)

(a) Basis for our disagreement

- Where the relative approach is adopted and a loss allowance (or a provision) is recognised at an amount equal to 12-month expected credit losses or at an amount equal to lifetime expected credit losses (i.e. Stage 1 or Stage 2), if the credit risk on a financial instrument was high at initial recognition and has not increased since this time, a loss allowance for such an instrument is recognised only at an amount equal to 12-month expected credit losses. On the other hand, if the credit risk on a financial instrument has increased since initial recognition, it becomes subject to the recognition of lifetime expected credit losses even if the absolute credit risk level is lower than the instrument in the former case. This significantly differs from current practices which determine the provision rate based on the level of credit risk at the time of measurement.
- The proposed relative approach requires the monitoring of "a significant increase in the credit risk since initial recognition." Therefore, banks need to track the credit rating migration by the system from initial recognition. When the expected cash flow (ECF) model was discussed, it was concluded that, if the tracking of rating migration is required, the model was operationally difficult to apply to open portfolios. This Exposure Draft faces the same issue.
- As an alternative, we prefer the absolute approach which recognises the loss allowance at an amount equal to lifetime expected credit losses when a financial instrument that is not impaired has reached a certain level of credit risk. By excluding the requirement to identify the deterioration in credit quality since initial recognition, consistency with

current credit risk management practice will be maintained as well as banks will be released from rating migration tracking burdens thereby reducing the cost of implementation as compared the relative approach. In addition to such an operational advantage, the absolute approach is in line with credit risk management practices carried out by financial institutions and thus is capable of providing more useful loss allowance information to investors.

- If the relative approach is to be adopted, its operational difficulties can be considerably mitigated by adopting the following approaches. In addition to a considerably limited example described in the Exposure Draft (i.e. the external credit rating of 'investment grade'), the definition of Stage 1 "having low credit quality (level)", which is an exception to the case of "a significant increase in the credit risk", should be allowed to include "those with no creditworthiness issues when assessed by a financial institution's own internal rating process and therefore to which a new loan would be issued in the ordinary course of business."

(b) Additional guidance

- If the relative approach is to be adopted, additional guidance will be required in respect of a broader definition of "having low credit quality" which is described in the above paragraph (a), financial assets that are credit-impaired at initial recognition and a simplified approach applied to immaterial and low-impact financial assets on which contractual cash flows have been modified. Further, specific guidance on how to apply the proposals under this Exposure Draft to open portfolios as well as how to estimate lifetime expected credit losses is also necessary.

  The guidance on the treatment of loan commitments is also considered as necessary. Please see our comment to Question 9.

Question 6

(a) Do you agree that there are circumstances when interest revenue calculated on a net carrying amount (amortised cost) rather than on a gross carrying amount can provide more useful information? If not, why not, and what would you prefer?

(b) Do you agree with the proposal to change how interest revenue is calculated for assets that have objective evidence of impairment subsequent to initial recognition? Why or why not? If not, for what population of assets should the interest revenue calculation change?

(c) Do you agree with the proposal that the interest revenue approach shall be symmetrical (ie that the calculation can revert back to a calculation on the gross carrying amount)? Why or why not? If not, what approach would you prefer?

(Our comment)

(a) (b) (c) While these proposals are reasonable from a theoretical perspective, the accounting treatment of nonaccrual should also be permitted.

(Basis)

- In Japan, it is a common accounting practice to suspend interest accruals for those receivables for which interest payments have not been made for a sustained period of time after the due date as well as bankrupt and quasi-bankrupt receivables. Such treatment is the result of seeking practical efficiency (i.e. to manage external legal claims (interest-bearing receivables) and at the same time to suspend interest accruals for such claims for financial accounting purposes) and that interest revenue from financial assets having objective evidence of impairment should not be recognised.
  Therefore, the IASB is respectfully requested to note that there may be a case (region) where interest revenue calculated under this Exposure Draft may not contribute to the provision of useful information and thus nonaccrual accounting should be allowed.
- Further, this issue should also be looked at from a practical perspective. Some receivables/portfolios such as small-lot receivables including mortgages and credit card receivables, though having objective evidence of impairment, are aggregated to compute expected credit losses collectively. It would cause a significant burden in practice to allot expected credit losses of such receivables/portfolios to each asset, calculate the net carrying amount on an asset-by-asset basis and compute interest revenue by multiplying effective interest rates on an asset-by-asset basis. To solve this issue, the nonaccrual accounting may be adopted as a practical expedient.

Question 7

(a) Do you agree with the proposed disclosure requirements? Why or why not? If not, what changes do you recommend and why?

(b) Do you foresee any specific operational challenges when implementing the proposed disclosure requirements? If so, please explain.

(c) What other disclosures do you believe would provide useful information (whether in addition to, or instead of, the proposed disclosures) and why?

(Our comment)

We support the proposed disclosure requirements in that comparison and qualitative disclosure required under the SD can cover quantitative disclosure, but disagree with some requirements. In addition, paragraph 32 which allows cross-reference to other statements (e.g. a risk report) is not considered to be practical.

(Basis)

- While the Exposure Draft requires an entity to provide a reconciliation of the opening balance to the closing balance for financial assets in order to disclose the "amounts arising from expected credit losses," it is considered significantly difficult in practice to create such a reconciliation that results in the presentation of financial assets on a gross basis. Under the IASB's past financial statement presentation project, many financial statement users and other related parties pointed out the difficulty of gross-based presentation of each account on the statement of cash flows when using a direct method.[1] The IASB is respectfully requested to take into account the comments made in relation to the above-mentioned project in assessing the necessity of this disclosure requirement. In the meantime, we sought the opinion of analysts who are financial statement users regarding the effectiveness of substantially presenting financial assets on a gross basis. They responded that such information was unnecessary.

  If this reconciliation requirement is retained in the final standard, we would like to request the IASB to give due regard to the following points. Banks do not obtain information to categorise "newly originated or purchased financial assets" and "repayment" because certain debt financial instruments are frequently rolled over after a short period of time. To collect such information would require significant system development. Further, this information is likely to result in a considerably large numbers, which is unlikely to be useful information for decision making purposes. Therefore, the Exposure Draft should be amended to allow a net-based disclosure of "newly originated or purchased financial assets" and "repayment."
- In paragraph 38, the Exposure Draft gives a description of the disclosure requirements related to the modification of terms. However, the required information, such as the re-default rate, is not recorded under current credit risk management practices and thus will necessitate systems modification among other things.

  Further, such information is required to be disclosed subsequent to the modification on an ongoing basis and therefore a degree of data tracking will be required and thus increasing burdens in practice, while providing little benefit. Given this, the IASB is respectfully requested to give thorough consideration to this disclosure requirement.
- Since banks are subject to significant disclosure requirements under the Basel regulatory capital framework, we basically support the approach for permitting cross-reference from such disclosures. However, given (1) disclosures under the Basel capital

[1]http://www.ifrs.org/Meetings/MeetingDocs/IASB/2010/December/6th/WG-AP3-Statement-FSP-Final.pdf

requirements are not subject to audit, (2) the timing of such disclosures is later than the financial statements and for other reasons, it is difficult to put into practice such cross-reference. Therefore, instead of cross-referencing, it is requested that the IASB allows those entities disclosing their risks under other regulatory frameworks such as the Basel capital requirements to integrate its risk disclosure (e.g. into disclosure under the Basel capital requirements) and not require any particular disclosure in the financial statements.

Question 8

Do you agree with the proposed treatment of financial assets on which contractual cash flows are modified, and do you believe that it provides useful information? If not, why not and what alternative would you prefer?

(Our comment)

We basically support the proposed treatment of financial assets on which contractual cash flows are modified. Nonetheless, a simplified method should be allowed in accordance with the size and materiality of such portfolios.

(Basis)

- Discounting the modified contractual cash flows to the present value at the financial asset's original effective interest rate would create a significant burden. Therefore, from the perspective of costs and benefits, where reasonable depending on the size and materiality of the portfolio, a simplified method which has similar effects as the method to discount to present value should be allowed especially in calculating a modified carrying amount of open portfolios

Question 9

(a) Do you agree with the proposals on the application of the general model to loan commitment and financial guarantee contracts? Why or why not? If not, what approach would you prefer?

(b) Do you foresee any significant operational challenges that may arise from the proposal to present expected credit losses on financial guarantee contracts or loan commitments as a provision in the statement of financial position? If yes, please explain.

(Our comment)

We agree with the proposals on the application of the general model to loan commitment and financial guarantee contracts, but consider it necessary to carefully discuss the calculation method of provisions for loan commitment and financial guarantee contracts.

(Basis)

- The same approach to calculate impairment allowances for loans should also be taken for loan commitments because the same risk management approach for loans is applied to loan commitment and financial guarantee contracts.
- On the other hand, from an accounting perspective loans and financial guarantee contracts[2] are recognised as assets at the year-end whereas the undrawn portion of loan commitments is not. The Exposure Draft does not provide specific guidance (e.g. a method to estimate the draw-down rate) on the recognition of provisions for off balance sheet assets such as loan commitments and therefore it is considerably difficult to put it into practice at present. The IASB is respectfully requested to specify detailed methods such as permitting the application of Basel-based drawn-down rate in light of consistency with credit risk management practices and allowing flexible operation in accordance with loss probability or business practices across jurisdictions.
- The IASB proposes that the remaining life of a loan commitment and financial guarantee contract should be the remaining contractual period, or shorter period, over which it is exposed to credit risk, which is considered to be reasonable. Some argue that expected credit losses should be calculated over a longer period than the legal period based on business practice (a substantial period[3]), but such a view is not in line with the proposal to calculate expected credit losses on financial assets such as loans over the remaining contractual period. Further, if the substantial period is applied, there is a concern that it may be difficult to maintain objectivity and may undermine comparability.

Question 10

(a) Do you agree with the proposed simplified approach for trade receivables and lease receivables? Why or why not? If not, what changes do you recommend and why?

(b) Do you agree with the proposed amendments to the measurement on initial recognition of trade receivables with no significant financing component? If not, why not and what would you propose instead?

(Our comment)

[2] Under JGAAP, financial guarantee contracts are recognised on the balance sheet.
[3] Behavioral life

(a) (b) We agree with both the proposals.

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| Question 11<br>Do you agree with the proposals for financial assets that are credit-impaired on initial recognition? Why or why not? If not, what approach would you prefer? |

(Our comment)

We disagree with the proposals for financial assets that are credit-impaired on initial recognition.

(Basis)

- Applying an accounting treatment to financial assets that have objective evidence of impairment on initial recognition that is different from that for other financial assets is inconsistent with credit risk management practices. Further, if the initial expected credit loss on a financial instrument is reflected in the effective interest rate in some cases and is not reflected in other cases, depending on whether such a financial instrument has objective evidence of impairment on initial recognition, such a difference may confuse the financial statement users and further complicate the practices for the financial statement preparers. Therefore, the benefits of this proposal do not outweigh its costs.

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| Question 12<br>(a) What lead time would you require to implement the proposed requirements? Please explain the assumptions that you have used in making this assessment. As a consequence, what do you believe is an appropriate mandatory effective date for IFRS 9? Please explain.<br>(b) Do you agree with the proposed transition requirements? Why or why not? If not, what changes do you recommend and why?<br>(c) Do you agree with the proposed relief from restating comparative information on transition? If not, why? |

(Our comment)

(a) A longer lead time than generally granted would be required given multiple standards will be implemented at the same time.

(b)(c) We agree with these proposals and also request that IFRS 1 be amended so that the proposed transition requirements, etc. can be applied to first-time adopters.

(Basis)

(a) Lead time

- Financial statements prepared by financial institutions mostly consist of financial instruments information. Therefore, for them, adopting IFRS 9 (Classification and Measurement, Impairment, Hedge Accounting) requires not only a considerable change to accounting practices but also their management accounting and risk management are likely to be considerably affected. Given this, a lead time longer than what is generally provided by the IASB (i.e. 18 – 24 months) is necessary.

- The establishment of forward-looking methodology and systems development to comply with impairment-related requirements under this Exposure Draft would require at least 3 years after the finalisation of the standard. Further, the IASB should take into account that those banks that do not apply the Basel's Advanced Internal Ratings-based Approach would need a reasonable period of time for data accumulation to calculate PD or LGD[4] for expected credit losses estimation purposes.
- A challenge in practice is that as Japan's current accounting standards do not require the computation of the effective interest rate, this proposal, when finalised, will require the systems development for effective interest rate management purposes, which will need a reasonable period of lead time.

(b) (c) First-time adopters

- To secure a level playing field for first-time adopters, the IASB is respectfully requested to allow them to apply the proposed transition requirements and the proposed relief from restating comparative information on transition.

| Question 13<br>Do you agree with the IASB's assessment of the effects of the proposals? Why or why not? |
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(Our comment)

We disagree with aspects of the IASB's assessment of the effects of the proposals. Our particular concern is the description in paragraph BC200: "two loans to the same entity could have different loss allowances when they are originated at different times," because this is not in line with current credit risk management practices. As mentioned in our comment to Question 5, we request IASB to give consideration to application of the absolute approach.

[4] Under the Advanced Internal Ratings-based Approach, LGD should be estimated based on data covering at least seven years. Therefore, those banks which have not calculated LGD in the past will need to accumulate relevant data for 7 years.