October 10, 2014

To: The International Accounting Standards Board

Japanese Bankers Association

Comment on the International Accounting Standards Board (IASB)'s Discussion Paper
"Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging"

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 took this opportunity to gather and compile comments on Discussion Paper *"Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging"* (the "Discussion Paper") issued by the IASB.

We respectfully expect that the following comments will contribute to your further discussion on this issue.

1. General Comments

We would like to express our gratitude for the discussions being made on the accounting model to reflect in entity's financial statements the actual risk management dynamically performed.

However, the concept of the Portfolio Revaluation Approach (PRA) proposed in the Discussion Paper is believed to be inconsistent with Japanese commercial banks' actual management operation, including risk and profit/loss management.

Given the nature of Japanese commercial banks' customer transactions (e.g. loans and deposits), these transactions should be measured at amortised cost. However, they would be measured at fair value if the PRA is applied on the basis that they are subject to the interest rate risk management under ALM. As a result, gains or losses will arise from those customer transactions that are intentionally unhedged. If the PRA is applied to Japanese commercial banks, the following issues will be raised.

- This is inconsistent with interest rate risk management under ALM conducted by Japanese commercial banks, which focuses on the management of net interest income (NII) measured at amortised cost.

- As a result, this may undermine the usefulness of accounting information due to recognition of profit or loss in financial statements not intended by management, or increased volatility in profit or loss.

Consequently, we do not support the mandatory application of the PRA and would recommend that the PRA application should be optional. Even if the PRA application is made optional, the scope of the PRA application should be focused on risk mitigation and be restricted to the extent risk mitigation has an effect on (the sub-portfolio approach).

2. Comments on "questions" included in the Discussion Paper

Question 15

(a) Do you think that the PRA should be applied to all managed portfolios included in an entity's dynamic risk management (ie a scope focused on dynamic risk management) or should it be restricted to circumstances in which an entity has undertaken risk mitigation through hedging (ie a scope focused on risk mitigation)? Why or why not? If you do not agree with either of these alternatives, what do you suggest, and why?

(b) Please provide comments on the usefulness of the information that would result from the application of the PRA under each scope alternative. Do you think that a combination of the PRA limited to risk mitigation and the hedge accounting requirements in IFRS 9 would provide a faithful representation of dynamic risk management? Why or why not?

(c) Please provide comments on the operational feasibility of applying the PRA for each of the scope alternatives. In the case of a scope focused on risk mitigation, how could the need for frequent changes to the identified hedged sub-portfolio and/or proportion be accommodated?

(d) Would the answers provided in questions (a)–(c) change when considering risks other than interest rate risk (for example, commodity price risk, FX risk)? If yes, how would those answers change, and why? If not, why not?

(Reply to Question 15 (a))

The scope of the PRA application should be focused on risk mitigation and be restricted to the extent risk mitigation has an effect on (the sub-portfolio approach). Further, in the case of applying the PRA, the parallel application of IFRS 9 should be permitted.

(Reasons)

- Japanese commercial banks' ALM focuses on NII management where risk of fluctuation in future cash flows arising from changes in interest rates for the purpose of maximising profits arising from assets/liabilities measured at amortised cost is hedged. (In addition, they manage risk of fluctuation in fair value for the purpose of future cash flow management.) Commercial banks have a number of small customer transactions where early termination and prepayment occurs actively and frequently, and thus these cannot be completely hedged. Further, some are unhedged intentionally with a view to maximising future cash flows.

- If the PRA is applied to all managed portfolios, transactions unhedged will be measured at fair value, which may give rise to gains or losses unintended by management and increase volatility in profit or loss. This treatment is inconsistent with Japanese commercial banks' actual management operation, including Japanese commercial banks' risk and profit/loss management. The scope of the PRA application should be focused on risk mitigation and be restricted to the extent risk mitigation has an effect on (the sub-portfolio approach).
- Since the proportional approach does not align with the existing management methods, it is considered difficult to apply for a practical perspective.
- Depending on hedged items/hedging instruments, the application of general hedge accounting may be more suitable than the PRA application. It would be more aligned with Japanese commercial banks' risk management practices to apply both the general hedge accounting and the PRA ("parallel application"), compared to the case where only either of them is allowed to be applied. Therefore, parallel application should be allowed.

  E.g.: The PRA is more suitable for core demand deposits while the general hedge accounting is more suitable for large fixed interest rate loans.

  - As previously mentioned, it is difficult to apply the PRA to customer transactions (excluding core demand deposits). Applying the general hedge accounting instead will be more consistent with Japanese commercial banks' risk management activities from the perspective of cash flow management.
  - Core demand deposits and pipeline transactions are not qualified for hedged items for the general hedge accounting purpose, but would be qualified for hedged items under the PRA. Therefore, the PRA should be applied to core demand deposits and pipeline transactions.
- Where both the PRA and the general hedging are applicable (parallel application), and several risks exist in the same product and are managed on a risk-by-risk basis; useful accounting information could be provided by determining whether to apply the general hedge accounting or the PRA on a risk-by-risk basis.

  E.g.: Applying the general hedge accounting to interest rate risk hedge and the PRA to FX risk hedge

(Reply to Question 15 (b))

Fair value varies depending on various elements, and thus does not provide useful information.

(Reason)

- Market trends, such as interest rates and foreign exchanges, and recognition of realized gain/loss give rise to fluctuations in fair value of the derivative designated as a hedging instrument. In addition, fair value of the hedged item demonstrates a similar fluctuation. Therefore, disclosure of fluctuations in fair value arising from the PRA application would not represent the actual hedging activity, and hence the usefulness of accounting information would not be enhanced.

Question 16 (a) Do you think that the application of the PRA should be mandatory if the scope of application of the PRA were focused on dynamic risk management? Why or why not? (b) Do you think that the application of the PRA should be mandatory If the scope of the application of the PRA were focused on risk mitigation? Why or why not?

(Reply to Question 16 (a) & (b))

We do not support the mandatory application of the PRA.

(Reasons)

- If the PRA is applied, all customer transactions (e.g. loans and deposits) subject to interest risk management under ALM would be measured at fair value. As a result, gains or losses will arise from those transactions that are intentionally unhedged.
- Management does not expect such gains or losses to arise. Further, the above treatment is inconsistent with Japanese commercial banks' actual management operation and may increase volatility in profit or loss, undermining the usefulness of accounting information. Therefore, the IASB should avoid mandatory application and adopt optional application of the PRA.

Question 7 If a bottom layer or a proportion approach is taken for dynamic risk management purposes, do you think that it should be permitted or required within the PRA? Why or why not? If yes, how would you suggest overcoming the conceptual and operational difficulties identified? Please explain your reasons.

(Reply to Question 7)

The bottom layer approach should be allowed under the PRA application.

(Reasons)

- Commercial banks have a number of small customer transactions where early termination and prepayment occurs actively and frequently. Therefore, the bottom layer approach is taken under current ALM practice by Japanese commercial banks. Under this approach, hedging activities are undertaken by designating a certain interest rate risk layer, which excludes those portfolios comprised of transactions which are expected to be terminated early or prepaid in light of customer behavior. Except for those large transactions where hedging activities are undertaken on an individual basis, hedging transactions which take into account changes arising from customer behaviour, as described in the DP, are not undertaken for open portfolios.
- Hedging transactions based on the proportions approach, instead of the bottom layer approach, entail following issues and involves complicated treatment in practice.
  - They would require day-to-day management of a significant amount of customer data, necessitating systems development to enable such management.
  - Execution/cancellation of hedging transactions would be needed on a daily basis, giving rise to unnecessary transaction costs. In addition, as full hedging is difficult in practice, the ineffective portion unintended by management is likely to incur as profit or loss.

Question 9
(a) Do you think that core demand deposits should be included in the managed portfolio on a behaviouralised basis when applying the PRA if that is how an entity would consider them for dynamic risk management purposes? Why or why not?
(b) Do you think that guidance would be necessary for entities to determine the behaviouralised profile of core demand deposits? Why or why not?

(Reply to Question 9 (a))

We agree that core demand deposits should be accounted for under dynamic risk management.

(Reasons)

- For interest rate risk management purposes, commercial banks generally recognise core demand deposits as a fixed interest rate exposure in line with their own internal rules. Therefore, core demand deposits should be included in the relevant portfolio.
- However, if the PRA is applied to core demand deposits, the outstanding balance of core

demand deposits will change as a result of measuring these deposits at fair value. It is hence necessary to discuss and clarify the relation with the definition of liabilities under the conceptual framework currently being discussed.

(Reply to Question 9 (b))
Guidance is not necessary.

(Reason)

- We do not support the establishment of uniform criteria since core demand deposits relate to the concept of market risk and differ in the duration and the setting logic depending on each bank's financial position.

Question 12
(a) Do you think that transfer pricing transactions would provide a good representation of the managed risk in the managed portfolio for the purposes of applying the PRA? To what extent do you think that the risk transferred to ALM via transfer pricing is representative of the risk that exists in the managed portfolio (see paragraphs 4.2.23–4.2.24)?
(b) If the managed risk is a funding rate and is represented via transfer pricing transactions, which of the approaches discussed in paragraph 4.2.21 do you think provides the most faithful representation of dynamic risk management? If you consider none of the approaches to be appropriate, what alternatives do you suggest? In your answer please consider both representational faithfulness and operational feasibility.
(c) Do you think restrictions are required on the eligibility of the indexes and spreads that can be used in transfer pricing as a basis for applying the PRA? Why or why not? If not, what changes do you recommend, and why?
(d) If transfer pricing were to be used as a practical expedient, how would you resolve the issues identified in paragraphs 4.3.1–4.3.4 concerning ongoing linkage?

(Reply to Questions 12 (a) to (d))
In practice, there is no other way than transfer pricing. It is however difficult to establish uniform rules on transfer pricing.

(Reasons)

- Typically, commercial banks use the transfer price rate to transfer interest rate risk to the ALM unit. Accordingly, for the application of the PRA, the transfer price rate is considered to be the most appropriate to distinguish between business units and the

ALM unit.

- However, it is difficult to implement uniform rules since banks establish the transfer price rates from a comprehensive perspective taking into account their financial position and business strategies.

Question 19 (a) If an entity uses internal derivatives as part of its dynamic risk management, the DP considers whether they should be eligible for inclusion in the application of the PRA. This would lead to a gross presentation of internal derivatives in the statement of comprehensive income. Do you think that a gross presentation enhances the usefulness of information provided on an entity's dynamic risk management and trading activities? Why or why not? (b) Do you think that the described treatment of internal derivatives enhances the operational feasibility of the PRA? Why or why not? (c) Do you think that additional conditions should be required in order for internal derivatives to be included in the application of the PRA? If yes, which ones, and why?

(Reply to Question 19 (a))

A gross presentation in the statement of comprehensive income should be carefully considered.

(Reasons)

- If internal derivatives are presented on a gross basis in financial statements, the same transactions will be recorded multiple times. This may not necessarily represent an entity's financial position authentically, undermining the usefulness of accounting information.
- On the other hand, if internal derivatives are presented on a net basis by offsetting the same transaction, it will not be easy to determine what risks an entity retains within the PRA.

Question 20 (a) Do you think that each of the four identified themes would provide useful information on dynamic risk management? For each theme, please explain the reasons for your views. (b) If you think that an identified theme would not provide useful information, please identify that theme and explain why. (c) What additional disclosures, if any, do you think would result in useful information about an entity's dynamic risk management? Please explain why you think these disclosures would be useful.

(Reply to Question 20 (a))

Disclosure about core demand deposits should be considered deliberately.

(Reason)

- Disclosure items of core demand deposits may include the commercially confidential matters. Such disclosure should be discussed with due care.

Question 24 (a) Do you think that it is possible to apply the PRA to the dynamic risk management of FX risk in conjunction with interest rate risk that is being dynamically managed? (b) Please provide an overview of such a dynamic risk management approach and how the PRA could be applied or the reasons why it could not.

(Reply to Question 24 (a))

Management of FX risk in open portfolios using the PRA should be allowed.

(Reason)

- Japanese commercial banks are engaged in FX transactions using macro hedging in open portfolios for foreign currency funding purposes (i.e. FX forward and currency swap transactions). If the PRA application is made "optional", the "sub-portfolio approach" is taken and the "bottom layer approach is allowed", it is likely that the PRA application to FX risk represents actual practice.

Question 26 Do you think that an approach incorporating the use of OCI in the manner described in paragraphs 9.1–9.8 should be considered? Why or why not? If you think the use of OCI should be incorporated in the PRA, how could the conceptual and practical difficulties identified with this alternative approach be overcome?

(Reply to Question 26)

Similar to the treatment in the general hedge accounting, fluctuations in fair values should be allowed to be recognized in OCI with regard to the currency basis spread and differences between spot and forward.

(Reason)

- The currency basis spread and differences between spot and forward are a component of funding costs and will, by their nature, ultimately become zero over time. The recognition in OCI, similarly to the treatment in the general hedge accounting under IFRS9, could represent the actual situation more appropriately.

[Additional issue]

It is respectfully requested to provide feedback on the following comments submitted by the JBA from the viewpoint of improving the usefulness of hedge accounting as an issue related to the application of the general hedge accounting, as we reply to Question15, although this is not the discussion on macro hedging (see the following comments extracted from "Comments on IASB's draft of forthcoming IFRS on general hedge accounting dated November 22, 2012).

- IAS 39 IG F.6.1 through F.6.3 provide the interpretation of how to apply the cash flow hedge accounting for a portfolio hedge of interest rate risk. In particular, the guidance on determining hedge ineffectiveness, the approach on hedge designation, and accounting treatment on related hedge adjustments is meaningful in practice, and is applied by a number of financial institutions.
- Given this, we would like to confirm whether the accounting treatment in accordance with IAS 39 IG F.6.1-F.6.3 shall be permitted under the new hedge accounting model.