September 30, 2010

To the Financial Accounting Standards Board,

Japanese Bankers Association

**Comments on FASB exposure draft "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)" (referred to as "the FASB ED" hereinafter)**

The Japanese Bankers Association is an organization for banks and bank holding companies operating in Japan. It represents the Japanese banking industry.

The Association is pleased to provide for your review its comments on the FASB ED currently under consideration by the Board.

We hope that the comments below will assist the Board and the International Accounting Standards Board in your further deliberation of this topic and related issues.

## 1. General comments

We are opposed to the proposed measurement method because measuring all financial instruments at fair value will not enable accurate presentation of the real status of bank's operations on the financial statements, nor will it provide useful information. In addition, we believe that reclassification subsequent to initial recognition should be allowed under certain conditions, which the FASB ED proposes not to allow.

With respect to the treatment of equity instruments, we note that there are cases in which equity instruments are held not for the purpose of earning capital gains but for the purpose of facilitating operations and expanding the business profit of an entity. We, therefore, believe that there should be an option of reflecting the changes in fair value in other comprehensive income (OCI).

As another general comment, in light of the steps currently being taken towards convergence, we think that further consideration should be given to the perspective of consistency with International Financial Reporting Standards, which will have an impact on many preparers and users of financial statements around the world.

Below are comments on specific points.

## 2. Comments on specific points

(1) Measurement principles (Question 8, Question 13)

We are opposed to the principle of measuring all financial instruments at fair value. There are cases in which the purpose of holding a financial asset or liability, or the characteristic of the financial instrument itself makes it appropriate to use the amortized cost as the measurement attribute. We believe that the principle should be to use a mixed measurement attribute model like IFRS. In addition, we do not think presentation of one balance sheet line item at both amortized cost and fair value would necessarily be useful because it may serve as a factor for confusion among investors.

*(Reasons)*

○ There are cases in which the purpose of holding a financial asset or liability, or the characteristic of the financial instrument itself makes it appropriate to use the amortized cost as the measurement attribute. One example would be loans and securities instruments that an entity intends to hold, or is forced to hold, for the medium and long-term. Reflecting changes in the fair value of these financial instruments to net assets each term would fail to present faithfully the real status of banking operations on the financial statements, and it would not provide useful information. Expanding the scope of fair value measurement would also potentially exacerbate procyclicality.

○ Furthermore, fair values are not measured for all financial instruments for the purpose of internal management such as risk management. Disclosure of figures measured with an approach that is not used in internal management will be inconsistent with the principle of reporting financial and investment activities of a financial statement preparer. As a result, financial statement users will find it difficult to understand financial statements that are inconsistent with the management methods of a financial statement preparer, and such statements will not provide useful information.

○ There are some financial instruments for which it is difficult to calculate fair value, and mechanically valuing these financial instruments at fair value will raise model risks because of differences in the models used by individual financial statement preparers, which will in turn raise material questions regarding the reliability and comparability of financial statements.

(2) Reclassification (Question 16)

We think that reclassification from the initial classification should be allowed in subsequent measurements under certain conditions.

*(Reasons)*

○ As discussed in (1) above, the measurement attributes should be based on the purpose of holding a financial asset or liability and the characteristic of the financial instrument. When there is a change in the purpose of holding, reclassification should be allowed in order to reflect that change and present information more accurately on financial statements. The prohibition against reclassification would potentially fail to appropriately present the real status of an entity on the financial statements.

(3) OCI option

With respect to the measurement of equity instruments not held for trading, there should be an option of recognizing the changes in fair value in OCI.

*(Reasons)*

○ There are cases in which equity instruments are held not for the purpose of earning capital gains but for the purpose of facilitating operations and expanding the business profit of an entity. If in such cases the equity instruments were measured at fair value and the change in their fair value were recognized in profit or loss, the entity's performance would become more volatile than necessary and would fail to reflect at the real status of an entity, and thus the resulting financial statements would not provide useful information.

○ Among equity instruments there are many equities that do not have market prices, and fair values for equities that cannot be reliably measured do not provide useful information.

(4) Core deposit liabilities (Question 17, Question 31)

We are opposed to remeasurement of core deposit liabilities at present value. Deposit liabilities should be measured at amortized cost.

*(Reasons)*

○ Remeasurement of core deposit liabilities at present value would add a new measurement attribute and increase the complexity of financial instrument accounting standards, which is against the stated purpose to improve accounting standards.

○ In the proposed definition, it would be difficult to apply a consistent method to the measurement of the present value of core deposit liabilities, and the results could significantly change the present value of core deposit liabilities depending upon the management judgment. This would only impair the reliability and comparability of financial statements. This proposal would not be feasible because, for example, the result of estimation of the all-in cost-to-service rate of core deposits would differ significantly depending on the scope of cost estimation (payroll expenses, facilities maintenance expenses, upkeep expenses, etc.) as well as the method of allocation of branch office rent to deposit operations.

○ The proposed measurement method is not based on the management practice employed by financial institutions and will therefore not reflect the real status of financial statement preparers.

(5) Credit impairment (Question 40, Question 47)

For financial assets that are valued on a portfolio basis, the outlook period of losses should be appropriate to the nature of the financial assets and business rather than immediately recognizing entire expected losses over the term to maturity upon initial recognition of a financial asset.

*(Reasons)*

○ The scope of financial instruments subject to impairment is decided without considering the business model of holding the instruments for the purpose of collecting contractual cash flow. That is, the immediate recognition of entire expected losses over the term to maturity upon initial recognition of a financial asset is inconsistent with the expected profit corresponding to expected loss that is recognized over the term to maturity. If the proposed model is adopted, upon origination entities would be forced to post large allowance covering entire expected loss over the term to maturity, which would potentially make it difficult to provide new credit even to sound borrowers. We urge reconsideration of the outlook period so that the standard is rational and consistent with business models (for example, an outlook period of 1 year for credits that do not have problems in collection of repayment, depending upon the credit risk of the financial asset).

○ This will amplify procyclicality.

The immediate recognition of entire expected losses over the term to maturity will increase volatility of earnings resulting from changes in estimate and therefore potentially amplify procyclicality.

(6) Interest income (Questions 48 and 49)

We are opposed to the approach proposed for calculating interest income by multiplying the amortized cost, net of any allowance for credit losses, by the effective interest rate.

*(Reasons)*

○ Current financial practice is to manage interest income and expected losses separately. Recognizing interest income reflecting expected losses is inconsistent with financial institution’s risk management and would be difficult for users to understand.

○ It is explained that the proposed approach deals with overstatements of initial interest in earlier years, but the rationale and theoretical justification are unclear. If future expected losses are estimated and provisioned as allowance (regardless of the outlook period), the issue of overstatement would not appear to emerge on a net basis. This measure would result in an unnecessarily large understatement of interest income that would fail to present accurately the real status of the business.

(7) Hedge accounting (Questions 61)

1 Ineffectiveness should not be recognized in under-hedging situation in cash flow hedges.

2 The de-designation of hedge relationship should be allowed as with the current standard.

*(Reasons)*

○ In the case of derivatives used as hedging instruments for expected transactions, the FASB ED requires recognition of profit or loss that do not exist at that point in time, which would reduce the usefulness of net income.

Unless entities are allowed to de-designate hedge relationship, financial statements will fail to present accurately the status of hedging operations, which would be inconsistent with the principle of reporting the financial and investment activities of a financial statement preparer.

(8) Hybrid financial instruments (Question 25)

Bifurcation should be allowed for hybrid financial instruments.

*(Reasons)*

- ○ If bifurcation is not allowed, there will be a mismatch between the entity's risk management and accounting treatment, and it will potentially produce financial statements that fail to accurately present the real status of an enterprise.

  For example, if an entity executes an offsetting transaction for the embedded derivative in the market in order to manage risk, the proposed approach would result in accounting mismatch that would fail to present accurately the entity's risk management on the financial statements.

(9) Timing of application

We would seek accommodations in the timing of application for foreign entities when their home countries are planning to adopt IFRS.

*(Reasons)*

- ○ Japan plans to reach a decision on the mandatory adoption of IFRS in 2012, and the first IFRS reporting period will be 2015 or 2016 if the mandatory adoption is decided. If there is divergence between US GAAP and IFRS, the effective date of the proposed revisions could result in excessive costs for Japanese entities that adopt US GAAP because they would be required to temporarily prepare the financial statements in accordance with the revised standards during the run-up to IFRS adoption.