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%

☐ 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

	Incurred 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
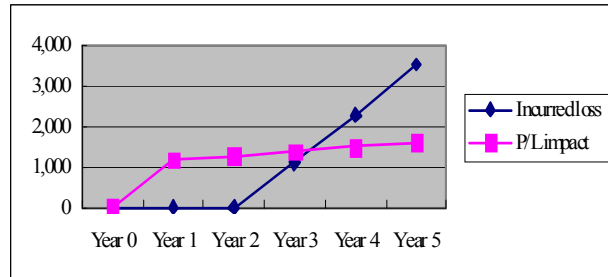
Lifetime-allocation approach

	Incurred 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
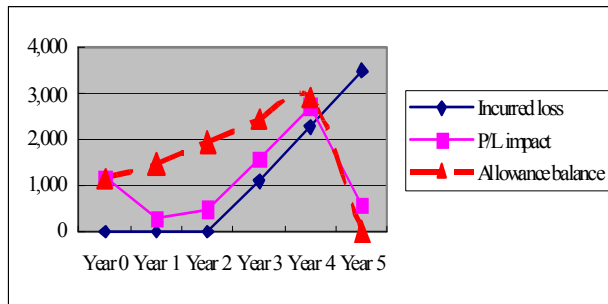
Time proportionate approach

	Incurred 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