March 27, 2013

To the International Accounting Standards Board;

Japanese Bankers Association

Comments on the IASB's Exposure Draft "Novation of Derivatives and Continuation of Hedge Accounting (Proposed amendments to IAS 39 and IFRS 9)"

We, the Japanese Bankers Association, are an organization that represents the banking industry in Japan. 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 "Novation of Derivatives and Continuation of Hedge Accounting (Proposed amendments to IAS 39 and IFRS 9)" published by the International Accounting Standards Board ("IASB").

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

Question 1

The IASB proposes to amend IAS 39 so that the novation of a hedging instrument does not cause an entity to discontinue hedge accounting if, and only if, the following conditions are met:

(i) the novation is required by laws or regulations;

(ii) the novation results in a central counterparty (sometimes called 'clearing organisation' or 'clearing agency') becoming the new counterparty to each of the parties to the novated derivative; and

(iii) the changes to the terms of the novated derivative arising from the novation of the contract to a central counterparty are limited to those that are necessary to effect the terms of the novated derivative. Such changes would be limited to those that are consistent with the terms that would have been expected if the contract had originally been entered into with the central counterparty. These

changes include changes in the collateral requirements of the novated derivative as a result of the novation; rights to offset receivables and payables balances with the central counterparty; and charges levied by the central counterparty.

Do you agree with this proposal? If not, why? What criteria would you propose instead, and why?

Question 2

The IASB proposes to address those novations arising from current changes in legislation or regulation requiring the greater use of central counterparties. To do this it has limited the scope of the proposed amendments to a novation that is *required* by such laws or regulations. Do you agree that the scope of the proposed amendment will provide relief for all novations arising from such legislation or regulations? If not, why not and how would you propose to define the scope?

(Our comments)

1. The scope of areas under discussion is insufficient and consequently the scope of the proposed amendments is not considered to be appropriate. Such scope should not be limited to a novation that is *required* by laws or regulations, or a novation involving the use of a central counterparty, but rather should include all novations of derivatives.
2. Financial institutions are engaged in hedging activities using financial instruments for the purpose of managing exposures arising from risks such as interest rate risk that may have an impact on profits or losses, and apply hedge accounting to appropriately reflect such activities in their financial statements. Regardless of whether a novation of derivatives is *required* by laws or regulations, or whether a novation involves the use of a central counterparty, the objective of applying hedge accounting does not change before or after such novation. Therefore, it should be deemed that the hedge relationship continues.
3. Further, paragraph AG113A of the Exposure Draft is added to clarify that any fair value changes of the hedging instrument that arise from a novation of the hedging instrument shall be reflected in the measurement of the novated derivative and therefore in the measurement of hedge effectiveness. This should sufficiently minimise the risk of accounting manipulation even if the scope of the proposed amendments is expanded.

(Limiting the scope to the novation that is *required* by laws or regulations)

4. In Japan, the use of central counterparties is *required* by laws or regulations only for those derivative contracts entered into after the effective date of such laws or regulations mainly for practical reasons. For those derivative contracts that existed before the effective date, the use of central counterparties is not *required* to use central counterparties.
5. On the other hand, in some cases, parties to a derivative transaction may decide to use a central counterparty for existing contracts "on a voluntary basis" for counterparty risk management purposes. If the term "*required*" used in the Exposure Draft is strictly interpreted, entities might be forced to discontinue hedge accounting due to a "voluntary" use of central counterparties. This would not solve the issues raised.

(Limiting the scope to novations involving the use of a central counterparty)

6. After the financial crisis, financial institutions have been working on the enhancement of their counterparty risk management, and the use of central counterparties is considered to be one of the mitigants of such risk.
7. A vast array of measures have been taken to enhance the management of counterparty risk, and novations of derivatives occur in various situations.
8. Examples include the novation of derivative contracts among three parties without using a central counterparty (e.g. the counterparty transfers the derivative contract to a third party) and the concentration of derivative contracts into a group's swap house to integrally manage the group's counterparty risk.
9. Paragraph BC7 of the Exposure Draft states that "accounting for the hedge relationship that existed before the novation as a continuing hedging relationship [...] would provide more useful information to users of financial statements". Such a rational from the IASB can be applied to any novations of derivatives.