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International Accounting Standards Board

Japanese Bankers Association

Comments Concerning the IASB's Exposure Draft of Proposed Amendments to IAS 39 "Financial Instruments: Recognition and Measurement"

The Japanese Bankers Association is an industry association whose membership consists of 152 Japanese banks and 34 foreign banks. We are very grateful to have been afforded this opportunity to state our views concerning the Exposure Draft of revised IAS 39 "Financial Instruments, Recognition and Measurement," published on June 20, 2002.

In respect of applying International Accounting Standards, we have no objections to making improvements that take their consistency into consideration, but we wish to make the following comments about problems relating to the exposure draft. We hope our comments will be given due consideration at the time of the final revisions of the standards.

Question 1 -- Scope: loan commitments (paragraph 1(i))

Do you agree that a loan commitment that cannot be settled net and the entity does not designate as held for trading should be excluded from the scope of IAS 39?

Although we basically agree, the loan commitments subject to net settlement or designated as held for trading that these proposed amendments refer to are difficult to envisage in many countries, and since measuring them at fair value is likely impossible, we do believe this proposal is meaningless.

(Measuring loan commitments at fair value)

One reason for subjecting loan commitments to fair value accounting is the view that they can be considered in the same light as financial derivatives such as written options (Basis for Conclusions paragraph C10). In practical terms, however, we are sceptical about the possibility of measuring loan commitments at fair value for the following reasons.

(1) It is true that a commitment is a transaction whereby a certain call option is provided to a potential borrower, but a major consideration in reality is the existence of unmeasurable factors that include: (a) fund withdrawal procedures for the borrower are more convenient than other funding methods; (b) withdrawal conditions other than interest rates are in line with customers' needs; (c) the overall profitability of all transactions to each counter party for the lender (bank). For these reasons, there are problems in treating commitments in the same way as other financial options whose market value can be measured with ease.

(2) Since it is problematical to find similar transactions easily, it is difficult to calculate estimated market values using prices from similar individual transactions.

(3) In loan commitments, there is no custom of offsetting positions with reversing trades, and in the case where the borrower no longer has any financial needs through commitment, the commitment contract will be cancelled.

(Past practice of selling the assets resulting from loan commitments)
Paragraph 1(i) refers to "a past practice of selling the assets resulting from its loan commitments shortly after origination." We would like to clarify whether this refers to cases where resulting loans based on commitments are securitized on a revolving basis. Even if it does, it would be difficult in practice to measure loan commitments at fair value for the above-mentioned reasons.

(Conditions for net settlements)
The second paragraph of Basis for Conclusions paragraph C14 implies equivalence between "selling the resulting loan assets shortly after origination" and net settlement. We believe "selling… shortly after" should be amended to "selling … on the same day of origination." This is because the possibility of net settlement pertaining to the execution of a loan and sales of the resulting loan assets is limited to cases where settlement is possible without funding (i.e., when the loan and the sale are carried out on the same day).

Question 2 -- Derecognition: continuing involvement approach (paragraphs 35-57)

Do you agree that the proposed continuing involvement approach should be established as the principle for derecognition of financial assets under IAS 39? If not what approach would you propose?

We oppose the introduction of the continuing involvement approach.
Given that financial transaction schemes are likely to become more sophisticated and complex, we believe that the financial component approach is superior for the following reasons.

(1) Within the current framework of the financial component approach that constitutes the current basic derecognition concept of IAS 39, introducing the proposed continuing involvement approach has the result of inviting the introduction of a different approach. For this reason, we believe that no overall consistent concept will govern treatment of derecognition. From the point of view of accounting theory, the financial component approach is superior as a consistent concept in our view. The following lists the problems from the viewpoint of economic substance.

- The proposed amendments require that transactions such as repurchase agreements or securities lending where the assets in question are always returned to the transferor, as well as transfers of assets attached to options transactions, are regarded as borrowings and treated as liabilities in the accounts on the grounds that they involve continuing involvement. However, the form of the contract for the latter is clearly different from that for the former, and from the viewpoint of economic substance we believe the ownership of the transferred asset is transferred to the transferee. For this reason, expression of their economic substance comes not from treating the latter as secured borrowings like the former, but as recognizing the fair value of call options or put options as assets or liabilities after derecognition of underlying assets by the financial component approach.

- In the case of a subordination in a securitization scheme, if the superior tranche is sold and the junior tranche is retained, the transferor does not incur more than the first-loss position in respect of the junior tranche, so no repayable or contingent liabilities are generated. If continuing involvement is applied to the superior tranche that has been sold, it does not match the economic substance from the transferor's viewpoint because it leads to the posting of excessive assets on the balance sheet.

- The proposed amendments explain that the continuing involvement approach has the advantage of simplifying the criteria for derecognition, but we can envisage cases where judgements may not be easy to make. For example, if we take into account the transactions such as warranties against defects, sales of financial assets with credit guarantees or credit enhancements for securitisation, it is difficult to apply the continuing involvement approach to the transferor without comprehensive decision-making. When the actual facts of the transaction are taken into consideration, moreover, it is unreasonable to apply the continuing involvement concept as a basis for disallowing derecognition even in cases where the transferee is able to sell or repledge the transferred asset.

. We believe that under the continuing involvement approach, recognition of assets even though they have no economic benefit, recognition of liabilities even though they are conditional obligations, are inconsistent with the IAS Framework for the Preparation and Presentation of Financial Statements. If the continuing involvement approach is to be introduced, said conceptual framework will require revision.

. As pointed out in the questions raised in C47(a) of the Basis for Conclusions, we believe that transaction history does matter. Conforming with the approach of the proposed amendments will lack consistency because transferring assets with credit guarantees and guaranteeing the assets of third parties will be accounted for differently even though the rights and duties involved are the same. Consideration of transaction history is treated as a remaining issue for the future, but since it is a fundamental issue that has a major impact on derecognition, we believe it should not be postponed but considered as one of the conceptual issues of the current exposure draft.

. Appendix A paragraph A9(a) illustrates the application of the derecognition approach by saying that "if the transferee obtains the right to sell or pledge the asset, the transferor reclassifies the asset on its balance sheet, for example, as a loaned asset …". Not only is this treatment troublesome in practice, but we do not believe that the information is useful for investors, either.

. As Appendix A paragraph A9(l) states, in the case where the continuing involvement approach applies to clean-up calls held by the transferor, derecognition is precluded to the extent of the amount of the assets that is subject to the call. In the United States and Japan, however, derecognition of transferred asset is allowed as far as the balance of an unredeemed claim against the initial total amount of a transferred claim falls below 10%. Uniform application of the continuing involvement approach runs counter to the trend towards simplification.

(2) In practical terms, too, an examination of the standards for derecognition established in Japan and the United States shows that the criterion is whether or not the transferor has control, and derecognition is allowed in cases where (i) legal isolation and (ii) the transferee has the right to sell or repledge, and (iii) the transferor has no right or obligation to repurchase the transferred assets.

In the case of the proposed continuing involvement approach, however, no consideration is given to conditions like those mentioned above, leaving a wide discrepancy among accounting standards, including the basic concepts.

Moreover, the proposed amendments adopts the continuing involvement approach, yet for judgements concerning derecognition they are inconsistent, referring here and there to examples of another criteria of "control" over the right to receive cash flow, as in A9(d) for example. When exploring the future convergence of international accounting standards, we believe it is necessary to look at realistic possibilities as well as theoretical consistency.

(3) After giving due consideration to the above, we believe that a financial component

approach that reflects the economic substance is more consistent and superior. We believe the following measures can be used for dealing with the above-mentioned problems.

- We believe the actual facts of a transaction concerning the subordination of a securitization would be appropriately presented by a procedure whereby an impairment or allowance for junior tranche is established by taking into consideration the possibility of loss after the superior tranche is derecognised. The issue of derecognition of transferred assets and the issue of measuring the possible loss amount of the portion retained by the transferor should be considered separately.

- Furthermore, with regard to transfers of financial assets with credit guarantees, it should be possible to derecognise the transferred financial assets then disclose the credit guarantee amount through notes similar to those used under Japanese accounting standards; or, in the case where a rational estimate of the guaranteed obligations is also possible, we propose to establish an allowances in accordance with the financial component approach perspective.

(4) In respect of the question raised by paragraph C47(d) of the Basis for Conclusions, we believe that since some potential purchasers of financial assets are qualifying SPEs (special purpose entities), it is necessary to consider, from a consistent point of view, the criteria governing the consolidation of SPEs when addressing derecognition of financial assets.

Question 3 -- Derecognition: pass-through arrangements (paragraph 41)

Do you agree that assets transferred under pass through arrangements where the cash flows are passed through from one entity to another (such as from a special purpose entity to an investor) should qualify for derecognition based on the conditions set out in paragraph 41 of the Exposure Draft?

We agree with the proposed amendments. We believe it should be possible to allow pass-through arrangements to be derecognized.

According to paragraph 35 of the exposure draft of revised IAS 39, a financial asset should be derecognized when "the contractual rights to the cash flows that constitute the financial asset … expire or are forfeited."

When seen in terms of economic substance that emphasizes the control of cash flow (economic benefits) without necessarily being constrained by legal rights, the above approach should not be rejected. For example, in the pass-through arrangements, even if receivables themselves are not legally transferred, the transferees receive the cash flow in the form of participation rights, and the transferors do not in any way obtain benefits for themselves from reinvesting the cash flow.

While we proposed the financial component approach in our response to Question 2, we believe that from the viewpoint of presenting the actual facts of a transaction to investors and others, the sole exception to this approach should be to allow derecognition in respect of pass-through arrangements.

Question 4 -- Measurement: fair value designation (paragraph 10)

Do you agree that an entity should be permitted to designate any financial instrument irrevocably at initial recognition as an instrument that is measured at fair value with changes in fair value recognised in profit or loss?

We oppose the proposed amendments since we believe the current standards are adequate.

Assuming that any financial instruments can be measured at fair value irrespective of the purpose for holding them, we believe this proposal could lead to results that contradict the original basic principle of IAS 39, namely to use different measurement methods according to the purpose for which the financial instruments are held.

Question 5 -- Fair value measurement considerations (paragraphs 95-100D)

Do you agree with the requirements about how to determine fair values that have been included in paragraphs 95---100D of the Exposure Draft? Additional guidance is included in paragraphs A32---A42 of Appendix A. Do you have any suggestions for additional requirements or guidance?

We oppose the proposed amendments in the following points.

(Adjusting fair value when there is no market)

Paragraph 100A allows the use of a valuation technique when it is not possible to determine fair value otherwise. However, when transaction prices in a market are actually available, they can be used to adjust valuation techniques, but we do not believe it is possible to enhance the reliability of such measurements as fair values when prices from transactions that very rarely occur are used in such adjustments. Moreover, we believe there is little merit in surveying transactions in markets around the world in an attempt to ascertain whether such transaction prices are available. We therefore believe this paragraph should be deleted.

(Mid-market prices)

The use of mid-market prices as the basis for establishing fair value is limited to cases of entities with matching asset and liability positions (see paragraph 99). However, use of mid-market prices for calculating fair value should also be allowed when the difference between the bid price and the offer price is small enough, or when it is possible to observe that even though the difference between the two is large, transactions normally take place around the mid-market price.

Question 6 -- Collective evaluation of impairment (paragraphs 112 and 113A--113D)

Do you agree that a loan asset or other financial asset measured at amortised cost that has been individually assessed for impairment and found not to be individually impaired should be included in a group of assets with similar credit risk characteristics that are collectively evaluated for impairment? Do you agree with the methodology for measuring such impairment in paragraphs 113A-113D?

We agree with the inclusion of said individual asset in a group of assets having similar credit risk characteristics that are collectively assessed for impairment after assessment for the existence of impairment has determined that an individual asset is not impaired,

However, we oppose the proposed amendments as to paragraph 113D stating that the discount rate used when discounting expected cash flows should equate the initial carrying amount of the asset with the present value of the expected cash flows for the asset based on past loss experience. This approach is not inadequate or realistic. The reasons are as follows.

At first, according to the examples shown in paragraph B32 through 36, amount of impairment will be accumulated toward maturity (i.e. allowance for general provisioning is increased) while the credit rating of a portfolio does not change (for example, BB-rated rating is same). On the other hand, we concern that incorrect information will be provided to interest parties if accumulated impairment will be shown on the balance sheets as if the loan portfolio is deteriorated in spite of the same credit grade. Therefore, the method shown above is not adequate.

In addition, we think that the proposed measurement method is not realistic.

(1) These proposed amendments require cumulative PD (probability of default) data according on the life of the loan (10 years in this example) for calculating the estimated cumulative cash flow loss rate per year (third column in the table of paragraph B33, Appendix B). However, financial institutions in most countries currently do not have this kind of historical data on cumulative PD. Furthermore, the New Basel Capital Accord, in which credit risk measurement methodologies are currently undergoing review, requires a one-year PD. Most banks' internal credit risk management models also use transitional rating-based PDs of one year as their standard.
(2) The New Basel Capital Accord is due to be implemented from the end of December 2006, and since banks adopting Internal Rating-based Approach have just started building their systems, they cannot respond in time to implement the proposed amendments. Moreover, since banks adopting the Standardised approach (regional banks, etc.) do not adopt internal rating systems, a dual system for managing loans will be necessary, making it impossible to cope in cost terms.
(3) For banks adopting the Advanced Internal Ratings-based approach under the New Basel Capital Accord, historical data for LGD (loss given default), which factors in the recovery effect of collateral and guarantees, etc., will be necessary. In practical terms, however, it will be difficult to consider this kind of LGD data as well as cumulative PD data.
(4) The cumulative bankruptcy probability rates held by external ratings agencies pertain to bonds, not to loans. Since it is therefore inappropriate to use external data, there are constraints on data availability.
(5) Depending on the economic cycle and the extent of economic growth, historical PD rates that estimate for long periods of 10 years or more will lack precision the longer the period involved.
(6) Entities other than banks are not creating management techniques of the sort included in these proposed amendments from the cost benefits point of view.

Question 10 -- Prior derecognition transactions (paragraph 171B)

Do you agree that a financial asset that was derecognised under the previous derecognition requirements in IAS 39 should be recognised as a financial asset on transition to the revised Standard if the asset would not have been derecognised under the revised derecognition requirements (i.e. that prior derecognition transactions should not be grandfathered)? Alternatively, should prior derecognition transactions be grandfathered and disclosure be required of the balances that would have been recognised had the new requirements been applied?

We oppose the proposed amendments.
The retroactive application of new rules such as the transitional measures given in 171B would require the examination of each individual transfer transaction and subsequent adjustments of prior profits and losses. Not only would the adjustment of profits and losses be difficult in practice, but it might also invite misunderstanding and confusion among interested parties. From the viewpoint of cost and benefits, therefore, we believe retroactive application should not be compulsory.

Other issues

Financial guarantee contracts

Financial guarantee contracts are initially recognised and measured in accordance with IAS 39.

Subsequently, the issuer of such a contract measures it at the amount the entity would rationally pay to settle the obligation at the balance sheet date or transfer it to a third party (see IAS 37, Provisions, Contingent Liabilities and Contingent Assets).
The objective of the proposed amendment is to ensure that issued financial guarantee contracts that provide for specified payments to be made to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due are recognised as liabilities.

We oppose the proposed amendments.
With regard to initial recognition of financial guarantee contracts in accordance with IAS 39, we oppose this change if it requires the use of fair value measurement of financial guarantee contracts at initial recognition.

(Difficulty of fair value accounting)
As in the case of fair value accounting for loans, fair value accounting for guarantees is extremely difficult in practical terms.

(1) Although the maximum amount of the loss that a warrantee can incur under financial guarantee contracts is known, it is difficult to measure at fair value. Measuring fair value of a guarantee contract is difficult due to fair value accounting for credit risk.
(2) There are specific issues associated with fair value accounting for liabilities (fair value accounting for credit risk, internally generated goodwill, the issue of own debt's downgrade paradox), but these have yet to be resolved.
(3) In the area of guarantees, we believe it would be necessary to accumulate data relating to expected cash outflows and the probability for calculating expected cash flows, but in practical terms this is not coped with in any way whatsoever.

(The issue of counter-account classifications and the relationship with guarantee fees)
Another consideration specific to fair value accounting for guarantees is the fact that it is not clear whether the counter-account of a financial guarantee contract at fair value should be posted under assets, liabilities or capital. If a counter-account classification is envisaged, its meaning should be clarified. The relationship between accounting treatments of both guarantee fees and financial guarantee liability should also be clarified.

(end)