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International Accounting Standards Board

Japanese Bankers Association

Comments on the IASB's Exposure Draft of Proposed Amendments to IAS 39 "Financial Instruments: Recognition and Measurement"
- Fair Value Hedge Accounting for A Portfolio Hedge of Interest Rate Risk -

The Japanese Bankers Association is delighted to have this opportunity to comments on the Exposure Draft of Proposed Amendments to IAS39: Financial Instruments: Recognition and Measurement "Fair Value Hedge Accounting for A Portfolio Hedge of Interest Rate Risk." We hope our comments below will prove to be useful to the International Accounting Standards Board in building up appropriate framework for hedge accounting.

1. We first wish to confirm that the Exposure Draft does no more than propose one method of fair value hedge accounting and does not deny hedge accounting for a portfolio hedge that hedges groups of similar assets or similar liabilities under IAS39 Paragraph 132. We are firmly opposed to forcing the proposals in the Draft on countries like Japan that have already introduced, completed system adaptation for, and implemented hedge accounting for a portfolio hedge under the Paragraph 132.

2. We appreciate that the Draft stipulates treatments that take into consideration practices conducted by banks, such as allowing the carrying amount of the hedged item not to be adjusted, allowing the use of the expected prepayment date for prepayment risk, and recognising hedging instruments that are derivatives containing offsetting risk positions.
However, there are still problems in the application of the proposals considering risk management methods used by banks.
In this regard, we oppose the introduction of approach D recommended by IASB.
Hedge accounting for a portfolio hedge used in Japan is based on the Paragraph 132 as mentioned above and we adhere to our stance of opposing the introduction of comprehensive fair value accounting. However, if we were to choose among the approaches presented, we would agree with approach A and approach C.
If IASB is to adopt approach D, we strongly request that the effectiveness of hedge accounting is recognized in the case where the entity is under-hedged.
Followings are reasons why we are of above position.

(1) Approach D which does not recognise effectiveness in the case where the entity is under-hedged, is inconsistent with the cash flow hedge accounting under IAS39 (Paragraph 159) which recognises ineffectiveness only in the case where the entity is over-hedged.
Even if the entity is under-hedged, a portion of the hedged item is hedged from the viewpoint of bank's interest rate risk management practices. According to BC16, the Board decided to propose that a portion of assets or liabilities may be designated as the hedged item.
When an estimate of the amount of assets is revised downwards, it means that the hedge is excessive and recognizing the excessive portion as ineffectiveness is consistent with bank's risk management practices. On the other hand, when an estimate of the amount of

assets is revised upwards, we believe that in bank's risk management practices it means no more than that additional hedging is necessary and there is no need to recognise ineffective portion.

(2) With regard to hedging instruments, trading volumes in the markets and liquidity differ according to the degree to which the market has developed in each country, making it difficult to implement a full hedge to keep the hedge ratio suggested by approach D.

(3) Approach B is inappropriate because it completely ignores the bottom layer of the hedged item throughout the period.

(4) Our reasons for agreeing with approach A are as follows.

Bank's risk management practices do not mean applying hedge instruments for each individual banking transaction but accumulating numerous banking transactions as hedged items and treating them as cumulative hedged items once they reach a certain amount. Approach A is the most compatible approach in this case. This treatment is applicable in the case of cash flow hedge accounting.

Furthermore, in light of actual conditions in the current derivatives markets, where there are not enough derivatives instruments to cope with prepayment risk, deeming the expected prepayment dates as the maturity time periods of the hedged item is an appropriate approach for linking accounting with bank's risk management practices. As stated in the Draft, taking the view that prepayable assets include interest rate risk and prepayment options, and incorporating prepayment risk into time periods based on expected repayment dates, we can consider the intended scope of the hedged risk is in fact the interest rate risk on assets or liabilities. It should be noted that IAS39 (Paragraph 128) permits a portion of the fair value as the hedged risk. We believe that approach A is rational, even if the prepayment risk and the interest rate risk cannot be clearly distinguished as the Draft points out. Because banks designate a part of assets or liabilities as the hedged item, they can exclude the duplicated portion of both interest and prepayment risks arising from market interest rate fluctuations by not treating the entire amount as the hedged item.

3. With regard to demand deposits, we concur with treating core deposits as hedged items in situations where it is possible to identify core deposits.

Although they do not have maturities, the "Principles for the Management and Supervision of Interest Rate Risk" currently under consideration by the Basel Committee on Banking Supervision states "Core deposits would be slotted according to an assumed maturity of no longer than five years" under "Annex4: An example of a standardised framework."

4. The issues proposed in the Draft are not subject to IASB's convergence project with US SFAS133 at this stage. This means that accounting treatment will differ considerably from SFAS133. There is a possibility that international accounting standards concerning hedge accounting for a portfolio hedge may become dualistic. There are also cases where Japanese hedge accounting has adopted the SFAS133 approach. We are concerned about how these issues should be dealt with.

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