

March 8, 2011

International Accounting Standards Board
30 Cannon Street
London ED4M 6XH
United Kingdom

Submitted via www.ifrs.org

Re: Hedge Accounting Exposure Draft (ED/2010/13)

Dear Sir(s) and/or Madam(s):

We commend the Board's hedge accounting reform initiative. We believe that proposed reforms such as expanding hedge accounting's scope of application and introducing rebalancing will better align accounting practices with companies' economic activities, including risk management. Additionally, the above-referenced Exposure Draft (ED) has much in common with current Japanese hedge accounting practices. However, the ED fails to rectify certain accounting constraints on financial institutions' risk hedging activities. The comments below are our personal opinions as analysts, offered in the interest of stimulating economic activity and further improving the accuracy of information that companies provide to markets about their activities. We hope that you find them useful.

(Question 1) Do you agree with the proposed objective of hedge accounting? Why or why not? If not, what changes do you recommend and why?

We disagree. We believe that equities and other financial assets classified as measured at fair value through OCI (FVTOCI) should also qualify as hedged items.

In paragraph IN12, the ED "proposes that the objective of hedge accounting is to represent in the financial statements the effect of an entity's risk management activities that use financial instruments to manage exposures arising from particular risks that could affect profit or loss." However, Japanese companies and financial institutions' equity holdings are largely classified as FVTOCI. Japanese companies that hedge such equity holdings would be precluded from using hedge accounting under the ED's provisions.

Because Japanese companies have large risk exposures to equities, they hedge their equity holdings. Such hedging is a source of variability in their net income from one fiscal year to the next. Meanwhile, market participants are most interested in companies' earnings derived from economic activities. In valuing stocks, they therefore must net out gains/losses on hedges and changes in the fair value of companies' equity holdings.

When financial assets classified as FVTOCI are hedged, if changes in their fair value are recognized in OCI, gains or losses on the corresponding hedging instruments should likewise be recognized in OCI.

On a separate issue, if changes in a hedged item's fair value are reclassified from OCI to net income, gains or losses on the hedging instrument should be recognized in net income in accord with accounting principles. Even the FASB's financial instrument accounting reform project is in favor of recycling of OCI. From the standpoint of international accounting convergence, the Board should reconsider recycling of FVTOCI-classified assets' fair value changes in the context of hedge accounting.

We presume that the Board is continuing to work on revising accounting for macro-hedges of open portfolios. It is necessary to make sure that hedge accounting revisions and macro-hedge accounting revisions are consistent with each other. We believe that hedge accounting revisions should not be finalized until the Board has proposed macro-hedge accounting revisions.

(Question 3) Do you agree that an aggregated exposure that is a combination of another exposure and a derivative may be designated as a hedged item? Why or why not? If not, what changes do you recommend and why?

We agree. In Japan, compound financial instruments are accounted for on a unified basis similar to the ED's proposal. Additionally, such unified accounting treatment would clarify hedges' interrelationship in terms of risk management also.

(Question 4) Do you agree that an entity should be allowed to designate as a hedged item in a hedging relationship changes in the cash flows or fair value of an item attributable to a specific risk or risks (i.e., a risk component), provided that the risk component is separately identifiable and reliably measurable? Why or why not? If not, what changes do you recommend and why?

We basically agree but think revisions are needed. In our experience, hedged items are rarely decomposed into designated risk components because techniques for accurately doing so have yet to be developed. However, it is essential to upgrade risk management. Developing a hedge accounting framework that decomposes risks into risk components should be conducive to the financial industry's further development.

However, the provision in paragraph B24 regarding the relationship between a financial asset or liability's total cash flows and a component thereof needs to be revised. Companies sometimes invest in high-grade corporate bonds with sub-LIBOR yields. If such companies cannot designate "a component of the liability equal to the principal amount plus interest at LIBOR" as a hedged item as stated in B24(a), they would be unable to apply hedge accounting to their high-grade corporate bond holdings' interest-rate risk component, even if they hedged this risk with interest rate swaps. Such hedging transactions are common. Prohibiting hedge accounting for such transactions would lead to misalignment between companies' risk management and accounting and could also constrain market growth.

(Question 6) Do you agree with the hedge effectiveness requirements as a qualifying criterion for hedge accounting? Why or why not? If not, what do you think the requirements should be?

We basically agree but think revisions are needed. We believe that increased use of hedge accounting will contribute greatly to financial markets' further development. We agree that the numerical hedge-effectiveness assessment standards need to be eliminated to remove undue restrictions on companies' hedging activities.

Amid continued development of new financial products in the wake of financial technologies' ongoing evolution, hedge effectiveness assessments should be compatible with companies' internal risk management to facilitate risk management of such newly developed products. Hedge

accounting's qualifying criteria and scope should be flexible, lest the qualifying criteria impede hedging activities in practice.

Companies factor cross-asset correlations into their asset allocation decisions. From such a standpoint, they should be permitted to apply hedge accounting to FVTOCI-classified equities, which account for a key component of many Japanese companies' asset allocations.

(Question 13)

- (a) Do you agree with the proposed disclosure requirements? Why or why not? If not, what changes do you recommend and why?***
- (b) What other disclosures do you believe would provide useful information (whether in addition to or instead of the proposed disclosures) and why?***

We agree. With hedge accounting's scope of application about to be expanded, it is desirable to expand information disclosure to better clarify the relationship between companies' risk management information and accounting practices. We believe that the proposed disclosure requirements will enhance the transparency of companies' business activities.

(Question 15)

- (a) Do you agree that all of the three alternative accounting treatments (other than hedge accounting) to account for hedges of credit risk using credit derivatives add unnecessary complexity to accounting for financial instruments? Why or why not?***
- (b) If not, which of the three alternatives considered by the Board in paragraphs BC226–BC246 should the Board develop further and what changes to that alternative would you recommend and why?***

(Question 15(a))

We disagree. Although credit derivatives are utilized to manage credit risk as standard practice, hedge accounting and the fair value option are not widely used to account for credit derivatives, as noted in paragraphs BC220 and BC223. Changes in gains/losses on credit derivatives constitute noise that complicates evaluation of companies' earnings performance attributable to their primary economic activities (paragraph BC224). We accordingly favor improving hedge accounting's utility from the standpoint of company valuation by adopting an alternative approach.

Aside from the three alternative approaches already considered, the Board should continue to discuss applying hedge accounting even in cases in which credit derivatives are used to hedge a hedged item's credit risk component. In practice, some companies have internal models to quantify credit assets' credit risk. In such cases, companies should be permitted to use internal models based on their internal risk management policies to measure an asset's credit risk component for accounting purposes also.

(Question 15(b))

We basically favor alternative 3. Companies hedge credit risk exposures only when, and to the extent, that they deem such hedging necessary based on their credit assets' status, the market environment, and other relevant factors. Use of hedge accounting therefore must be permissible whenever a company needs to hedge credit risk, not only at the time of a credit asset's origination.

We expect most loans and other credit assets will be classified as amortized cost. Adjustment of any measurement change (difference between a credit asset's carrying value and fair value at hedge inception) should be amortized over the hedged item's remaining life. We accordingly agree with paragraph BC241.

Accounting treatment of alternative 3 is discussed in paragraphs BC241 and BC242. Of the proposed accounting treatments, we consider adjustment of credit assets' carrying value as proposed in BC242(a) to be the best approach. However, because such adjustment would result in a mixed amount that is neither fair value nor amortized cost, we believe that the amount of the adjustment should be disclosed.

Yours truly,

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