The Securities Analysts Association of Japan
5F, Tokyo Stock Exchange Bldg., 2-1, Nihonbashi-Kabutocho,
Chuo-ku, Tokyo 103-0026 Japan

Telephone: (03) 3666-1515
Facsimile: (03) 3666-5843
E-mail address:intl @ saa.or.jp

17 October 2014

Hans Hoogervorst
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Mr. Hoogervorst:

re: Comments on Discussion Paper
"Accounting for Dynamic Risk Management:
a Portfolio Revaluation Approach to Macro Hedging"

The Corporate Accounting Committee (CAC) of the Securities Analysts Association of Japan (SAAJ) is pleased to comment on Discussion Paper "Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging" (hereinafter referred to as DP) put out by the International Accounting Standards Board (IASB). The SAAJ is a not-for-profit organization providing investment education and examination programs for securities analysts. Its certified members number 26,000. The CAC is a standing committee of the SAAJ composed of 15 members, most of whom are users including equity and credit analysts, and portfolio managers, while a few others are academicians and public accountants. The CAC writes comment letters to global standard setters, including the IASB and the Accounting Standards Board of Japan (ASBJ), and exchanges opinions with organizations including the ASBJ and Financial Services Agency.

Before drafting this comment letter, the SAAJ sponsored a study session on the DP, inviting an ASBJ staff member as a lecturer. Some 62 of our certified members participated. A questionnaire was subsequently sent to each and 33 responded, making for a 53% response rate. This comment letter fully takes into account the views expressed in the questionnaire replies as well as discussion among CAC members. The survey results are attached as an Appendix. For this survey, respondents were asked if they were (1) financial statement users, (2) preparers, or (3) "other" (including public accountants and consultants). This was because opinions regarding the DP were expected to be influenced by respondents' job categories and also because certified members of the SAAJ work in various fields within financial institutions and other organizations. The result was (1)

36.5 % financial statement users, (2) 24.2% preparers, and (3) 39.4% “other”. Responses to some questions exhibited differences according to job categories.

General Comments

The CAC commends the IASB’s endeavor to solve the problems of current hedge accounting and to present the actual results of open portfolio based dynamic risk management to financial statements. However, it is not clear whether the DP is pursuing (1) achieving short-term improvements in hedge accounting, or (2) proposing a generic model to be broadly applicable to businesses, typically by banks, which make profits by investing deposits taken in assets that carry different interest rate risks (duration) and credit risks. The IASB needs to determine which of the two directions to pursue.

If the direction is determined to be (1) above, then the nomenclature of the DP is quite misleading and it should be renamed, for example, “Improvements in Macro Hedge Accounting” when the exposure draft is put out. In this case, many issues discussed in the DP will be useless in the exposure draft. If the direction is determined to be (2) above, new accounting standards including FVTOCI valuation of derivatives and principles to determine duration of core demand deposits, that are scarcely discussed in the DP, need to be fully developed in order to gain support from financial statement users and preparers. The CAC’s views on specific questions are explained below.

Question 1—Need for an accounting approach for dynamic risk management

Do you think that there is a need for a specific accounting approach to represent dynamic risk management in entities’ financial statements? Why or why not?

The CAC thinks the actual results of dynamic risk management at financial institutions are not satisfactorily reflected in current financial statements and that current note disclosure is insufficient. This is primarily because current hedge accounting requires a one-to-one designation between the hedged item and the hedging instrument. As dynamic risk management can be an important competitive edge for financial institutions, better presentation of the actual results of dynamic risk management in financial statements would provide decision useful information. In this regard, the CAC agrees that there is a need for a specific accounting approach.

In our survey, 79% of respondents supported the need for new accounting standards and no major differences according to job categories were observed (see Question 2 in the Appendix).

Question 2—Current difficulties in representing dynamic risk management in entities’

financial statements

(a) Do you think that this DP has correctly identified the main issues that entities currently face when applying the current hedge accounting requirements to dynamic risk management? Why or why not? If not, what additional issues would the IASB need to consider when developing an accounting approach for dynamic risk management?

(b) Do you think that the PRA would address the issues identified? Why or why not?

Albeit many financial institutions dynamically manage risks on a portfolio basis, they have to record artificial one-to-one designation between the hedged item and the hedging instrument as required by current accounting standards. The portfolio revaluation approach (PRA), on the other hand, intends to present the actual results of dynamic risk management based on portfolios. The CAC basically supports the PRA because it regards it as having the potential for users to understand the relationship between source of profits and corresponding risks more easily. The improvement in understandability, however, depends on presentation of financial statements and note disclosures. Detailed disclosure, including, for example, hedged positions and their price sensitivity, is required.

In our survey, 73% of respondents thought the PRA would make it easy to understand the source of profits and corresponding risks. Only 50% with a preparer's background, however, supported the PRA. They are concerned that the PRA could increase volatility of net income even when risks are actually reduced (see Question 3 in the Appendix)

Question 4—Pipeline transactions, EMB, and behaviouralisation

Behaviouralisation

(c) For the purposes of applying the PRA, should the cash flows be based on a behaviouralised rather than on a contractual basis (for example, after considering prepayment expectations), when the risk is managed on a behaviouralised basis? Please explain your reasons, taking into consideration operational feasibility, usefulness of the information provided in the financial statements and consistency with the Conceptual Framework.

Question 5—Prepayment risk

When risk management instruments with optionality are used to manage prepayment risk as part of dynamic risk management, how do you think the PRA should consider this dynamic risk management activity? Please explain your reasons.

Question 9—Core demand deposits

(a) Do you think that core demand deposits should be included in the managed portfolio on a behaviouralised basis when applying the PRA if that is how an entity would consider them for dynamic risk management purposes? Why or why not?

Conventional dynamic risk management uses expected or behaviouralised cash flows, rather than contractual terms, for such instruments like core demand deposits and mortgages with prepayment option. The CAC supports the use of behaviouralised cash flows in the PRA in view of consistency with the purpose of the PRA which is to present the results of dynamic risk management to financial statements.

There is serious concern, however, that too lenient use of behaviouralised cash flows would lead to arbitrary abuses by preparers. The CAC thinks the scope of behaviouralised cash flows should be cautiously defined and the majority of its members opined pipeline transactions and EMB should not be included in the scope. The CAC expects the IASB to clearly define such scope.

The use of behaviouralised cash flows for demand deposits and mortgages in general is a gigantic jump from current accounting standards. Accordingly, robust accounting standards on how to estimate and reflect future behavior need to be developed simultaneously if the use of behaviouralised cash flows is extended to those mentioned above.

In our survey, 76% of respondents supported the use of behaviouralised cash flows. Only 40% of those with a preparer's background supported this and 60% of them answered "Cannot decide at this moment", citing behaviouralised cash flows should not be recognized as net income. (see Question 10 in the Appendix).

Question 15—Scope

(a) Do you think that the PRA should be applied to all managed portfolios included in an entity's dynamic risk management (ie a scope focused on dynamic risk management) or should it be restricted to circumstances in which an entity has undertaken risk mitigation through hedging (ie a scope focused on risk mitigation)? Why or why not? If you do not agree with either of these alternatives, what do you suggest, and why?

In our survey, 61% of respondents supported a scope focused on dynamic risk management while 35% supported one focused on risk mitigation. Respondents with a user's background gave slightly more support to scope focused on risk mitigation than average (see Question 7 in the Appendix).

Supporters of a scope focused on risk mitigation opined that limited scope would help understand the effects of dynamic risk management better.

Supporters of a scope focused on dynamic risk management contended that limiting

the scope would be practically difficult and that judgment could be arbitrary. Further, some contended that this approach would enable them to understand the results and state of dynamic risk management from a broader perspective including the decision not to hedge.

The CAC thinks scope solely depends upon which direction the DP is to pursue, as discussed in General Comments above. If the DP is to pursue (1) achieving short-term improvements in hedge accounting, then the scope should be focused on risk mitigation. On the other hand, if the DP is to pursue (2) proposing a generic model to be broadly applicable to businesses, typically by banks, then the scope should be focused on dynamic risk management.

Question 15—Scope

(c) Please provide comments on the operational feasibility of applying the PRA for each of the scope alternatives. In the case of a scope focused on risk mitigation, how could the need for frequent changes to the identified hedged sub-portfolio and/or proportion be accommodated?

In our survey, 50% supported a sub-portfolio approach, 10% a proportional approach, while 40% answered "Cannot judge at this moment", regarding a scope focused on risk mitigation (see Question 8 in the Appendix).

Reasons to support a sub-portfolio approach include coherence to risk mitigation scope and relative simplicity. Many voiced, however, concerns that both approaches might induce arbitrary applications and that information provided might not be decision useful. The CAC thinks further deliberation is needed in this regard.

Corresponding to the second part of Question 15(c), we asked "Do you think it would be practically possible to apply a risk mitigation approach to portfolios that are changing dynamically every moment?" The responses were evenly divided between "Yes", "No", and "Cannot judge at this moment". Half of those respondents with a preparer's background answered "No", suggesting practical difficulties of the approach (see Question 9 in the Appendix).

Question 18—Presentation alternatives

(a) Which presentation alternative would you prefer in the statement of financial position, and why?

The CAC thinks that all three approaches addressed in the DP are still insufficient but with a slight preference for the "separate lines for aggregate adjustments" approach. The CAC proposes disclosing a breakdown of major items in the notes which would take the advantage of the "line-by-line gross up" approach in the "separate lines for aggregate

adjustments” approach.

In our survey, 39% of respondents supported the “separate lines for aggregate adjustments” approach. This approach gathered a majority (60%) of support from among users (see Question 6 in the Appendix).

Question 18—Presentation alternatives

(b) Which presentation alternative would you prefer in the statement of comprehensive income, and why?

The CAC strongly believes actual net income should be presented in the statement of comprehensive income. Stable net income can be useful for managerial accounting but the CAC regards it as an unreliable figure for use in financial accounting.

In our survey, 86% of respondents supported the actual net income presentation while none supported the stable net income presentation (see Question 5 in the Appendix).

Question 26—PRA through OCI

Do you think that an approach incorporating the use of OCI in the manner described in paragraphs 9.1–9.8 should be considered? Why or why not? If you think the use of OCI should be incorporated in the PRA, how could the conceptual and practical difficulties identified with this alternative approach be overcome?

The whole purpose of dynamic risk management is to stabilize net interest income after dynamic risk management (NII after DRM). NII after DRM includes DRM which belongs to the current period, while DRM revaluation gains & losses and derivative trading gains & losses that relate to future periods are included in net income, not in NII after DRM. As a result, with stable NII after DRM, net income can be quite volatile. The CAC regards this as the most serious vulnerability in the DP. Many survey respondents with a preparer’s background pointed this out as their major concern (see our comments on Question 2 above).

Presenting DRM revaluation gains & losses and derivative trading gains & losses that relate to future periods in other comprehensive income, not in net income, will resolve this vulnerability. Specifically, this means to move “Revaluation effect from dynamic risk management” in the tables on pp. 71-72 of the DP to OCI. As “Revaluation effect from dynamic risk management” includes gains & losses from derivative instruments, the CAC’s proposal seems to contradict current standards where derivative instruments’ valuation gains & losses are included in net income (FVTPL). The rationale behind FVTPL valuation is that derivatives are typically short-term contracts and due dates will soon come when gains & losses are realized and that derivatives typically have observable

market prices. Most, if not all, derivatives used in PRA are rolled over when due. In other words, they are *de facto* long-term contracts which make OCI valuation acceptable to most constituents as an exception to the current standards regarding derivatives valuation.

As explained in the answer to Question 1, several CAC members think all assets and liabilities should be measured by fair value for the business model used by financial institutions. For these members, the use of OCI is the first step to realize full fair value accounting and they expect the IASB to seriously and sincerely deliberate the issue.

Paragraph 1.33 of the DP states "The PRA is not a full fair value model because managed exposures are only revalued for the risk that is being managed; managed exposures are not being remeasured at fair value." A few CAC members are concerned that expansion of the scope of PRA will potentially lead to *de facto* full fair value accounting while several others think, as far as financial institutions are concerned, full fair value accounting is desirable.

In this context, a question in the survey asked "Do you think PRA is substantially the same with full fair value accounting?" Opinions are divided into 33% "Yes", 42% "No", and 24% "Cannot decide at this moment" (see Question 4 in the Appendix).

If you have any questions or need further elaboration, please do not hesitate to contact Sei-Ichi Kaneko, Executive Vice President, SAAJ (s-kaneko@saa.or.jp).

Sincerely yours,

Keiko Kitamura
Chair
Corporate Accounting Committee

APPENDIX

Results of SAAJ Survey on "Accounting for Dynamic Risk Management"

Background and methodology

The Securities Analysts Association of Japan (SAAJ) sponsored a study session on IASB's discussion paper (DP) "Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging", inviting a lecturer from the Accounting Standards Board of Japan (ASBJ). Some 62 of our certified members participated in the session held on 6 August. A questionnaire was subsequently sent to each participant and 33 responded, making for a 53% response rate. The respondents were also invited to make comments. The survey, although small in size, focused on a cohort with the same background (certified members of the SAAJ) and same knowledge level (participation in the study session). This focus and very high response rate gives credibility to the reliability of the survey. As the DP is highly technical, Q5 to Q10 were put as optional questions.

Survey questions and answers

Q1**:** Amongst the following three categories, what is the closest to your job description?

(a) Financial statement user: analyst, investment manager, investment banker, etc.

(b) Financial statement preparer: accounting, financing, investor relations, cash management, risk management, etc.

(c) Other: public accountant, information services provider, consultant, etc.

(a) Financial statement user	12	36.4%
(b) Financial statement preparer	8	24.2%
(c) Other	13	39.4%
Total	33	100.0%

Q2: Do you think new accounting standards are required in order to present the results of dynamic risk management which uses open portfolios that change over time?

(a) Yes	26	78.8%
(b) No	2	6.1%

(c) Cannot judge at this moment	5	15.2 %
Total	33	100.0%

	User		Preparer		Other	
(a)	9	75.0%	7	87.5%	10	76.9%
(b)	1	8.3%	0	0.0%	1	7.7%
(c)	2	16.7%	1	12.5%	2	15.4%
Sub-total	12	100.0%	8	100.0%	13	100.0%

Q3: The DP discusses the use of the portfolio revaluation approach (PRA) for dynamic risk management of interest rate and other risks often used by financial institutions. Do you think the PRA will make it easy to understand the source of profit and corresponding risks that are dynamically managed based on the asset and liability matching principle?

(a) Yes	24	72.7%
(b) No	3	9.1%
(c) Cannot judge at this moment	6	18.2%
Total	33	100.0%

	User		Preparer		Other	
(a)	10	83.3%	4	50.0%	10	76.9%
(b)	2	16.7%	1	12.5%	0	0.0%
(c)	0	0.0%	3	37.5%	3	23.1%
Sub-total	12	100.0%	8	100.0%	13	100.0%

Q4: Paragraph 1.33 of the DP states "The PRA is not a full fair value model because the managed exposures are only revalued for the risk that is being managed; the managed exposures are not being remeasured at fair value."

On this, some raise concern that expansion of the scope of the PRA will lead to *de facto* full fair value accounting. Do you think the PRA is substantially the same with full fair value accounting?

(a) Yes	11	33.3%

(b) No	14	42.4%
(c) Cannot judge at this moment	8	24.2%
Total	33	100.0%

	User		Preparer		Other	
(a)	3	25.0%	3	37.5%	5	38.5%
(b)	7	58.3%	3	37.5%	4	30.8%
(c)	2	16.7%	2	25.0%	4	30.8%
Sub-total	12	100.0%	8	100.0%	13	100.0%

Q5: The DP addresses the following two alternative presentations of the PRA in the comprehensive income statement.

(A) Actual net income presentation: present actual net income using interest revenue, interest expense, and net interest from dynamic risk management.

(B) Stable net interest income presentation: present stable net interest income with an assumption that the aim of dynamic risk management is to stabilize net interest income.

Which one of the above do you think would provide the most useful information for financial statement users?

(a) Actual net income presentation	19	86.4%
(b) Stable net income presentation	0	0.0%
(c) Cannot judge at this moment	3	13.6%
Total	22	100.0%

	User		Preparer		Other	
(a)	9	90.0%	4	80.0%	7	100.0%
(b)	0	0.0%	0	0.0%	0	0.0%
(c)	1	10.0%	1	20.0%	0	0.0%
Sub-total	10	100.0%	5	100.0%	7	100.0%

Q6: The DP addresses the following three alternatives for the presentation of the revaluation adjustments arising from the PRA in the statement of financial position.

(A) Line-by-line gross up: the carrying amounts of the exposures included within the managed portfolio would be adjusted to reflect the revaluation for the managed risk.

(B) Separate lines for aggregate adjustments to assets and liabilities: separate line items would be presented for both the revaluation adjustments for the revalued exposures that are assets and those that are liabilities.

(C) Single net line item: the net revaluation adjustment for all exposures subject to the PRA would be presented in a single line item in the statement of financial position.

Which one of the above do you think would provide the most useful information for financial statement users?

(a) Line-by-line gross up	6	26.1%
(b) Separate lines for aggregate adjustments to assets and liabilities	9	39.1%
(c) Single net line item	3	13.0%
(d) Cannot judge at this moment	5	21.7%
Total	23	100.0%

	User		Preparer		Other	
(a)	3	30.0%	1	16.7%	2	28.6%
(b)	6	60.0%	1	16.7%	2	28.6%
(c)	1	10.0%	0	0.0%	2	28.6%
(d)	0	0.0%	4	66.7%	1	14.3%
Sub-total	10	100.0%	6	100.0%	7	100.0%

Q7: The DP addresses the following two scopes for the PRA.

(A) A scope focused on dynamic risk management: the presence of any one of the three elements of dynamic risk management (risk identification, analysis, and mitigation through hedging) would result in application of the PRA. All risk exposure dynamically managed would be covered.

(B) A scope focused on risk mitigation: the PRA would be applied only when all three elements are undertaken. Only the hedged portion would be covered.

Which one of the above do you think would provide the most useful information for financial statement users?

(a) A scope focused on dynamic risk management	8	34.8%
(b) A scope focused on risk mitigation	14	60.9%

(c) Cannot judge at this moment	1	4.3%
Total	23	100.0%

	User		Preparer		Other	
(a)	2	22.2%	2	40.0%	4	44.4%
(b)	6	66.7%	3	60.0%	5	55.6%
(c)	1	11.1%	0	0.0%	0	0.0%
Sub-total	9	100.0%	5	100.0%	9	100.0%

Q8: The DP addresses the following two approaches for a scope focused on risk mitigation.

(A) Sub-portfolio approach: the application of the PRA would be limited to the sub-portfolios that are managed dynamically for which risk mitigation or hedging activities have been undertaken.

(B) Proportional approach: a hedged position is determined as a proportion of the dynamically managed portfolio to which the PRA would be applied.

Which one of the above do you think would provide the most useful information for financial statement users?

(a) Sub-portfolio approach	10	50.0%
(b) Proportional approach	2	10.0%
(c) Cannot judge at this moment	8	40.0%
Total	20	100.0%

	User		Preparer		Other	
(a)	4	44.4%	2	50.0%	4	57.1%
(b)	2	22.2%	0	0.0%	0	0.0%
(c)	3	33.3%	2	50.0%	3	42.9%
Sub-total	9	100.0%	4	100.0%	7	100.0%

Q9: Notwithstanding approach (A) or (B) in Q8, application of the scope focused on risk mitigation to portfolios whose risk exposures are changing every moment would require complex operation in identifying the hedged portion. Do you think it would be practically possible to apply the risk mitigation approach to portfolios that are changing dynamically every moment?

(a) Yes	7	33.3%
(b) No	7	33.3%
(c) Cannot judge at this moment	7	33.3%
Total	21	100.0%

	User		Preparer		Other	
(a)	3	37.5%	2	33.3%	2	28.6%
(b)	2	25.0%	3	50.0%	2	28.6%
(c)	3	37.5%	1	16.7%	3	42.9%
Sub-total	8	100.0%	6	100.0%	7	100.0%

Q10: In dynamic risk management for such instruments like mortgage loans with prepayment option and core demand deposits, behaviouralised, rather than contractual, cash flows are used.

Do you think behaviouralised cash flows should be used in applying the PRA?

(a) Behavioralised expectations such as prepayments should be taken into account	16	76.2%
(b) Contractual cash flows should be used	1	4.8%
(c) Cannot judge at this moment	4	19.0%
Total	21	100.0%

	User		Preparer		Other	
(a)	7	77.8%	2	40.0%	7	100.0%
(b)	1	11.1%	0	0.0%	0	0.0%
(c)	1	11.1%	3	60.0%	0	0.0%
Sub-total	9	100.0%	5	100.0%	7	100.0%