



31 July 2009

Sir David Tweedie
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sir David:

re: Comments on Exposure Draft “Derecognition”

The Corporate Accounting Committee (CAC) of the Securities Analysts Association of Japan (SAAJ) is pleased to comment on the exposure draft, “Derecognition”, put out by the International Accounting Standards Board (the Board). The SAAJ is a not-for-profit organization providing investment education and examination programs for securities analysts. Its certified members exceed 22,000. The CAC is a standing committee of the SAAJ composed of 12 members, most of whom are users including equity and credit analysts, and portfolio managers, while a few others are academicians and public accountants.

General remarks

The exposure draft tries, to the extent possible, to eliminate ‘risks and rewards’ and ‘continuing involvement’ concepts that exist in current standards as requirements in derecognizing financial products, and proposes to focus on the concept of ‘control’. This helps simplify the derecognition standards which should basically be applauded but the exposure draft includes unacceptable problems from a practical point of view which are caused by too much adherence to the ‘control’ concept. The exposure draft also presents an alternative approach. The CAC prefers the original approach to the alternative one. The alternative approach comes to recognize a lot of derivative positions associated with derecognized financial products, and it is very hard, if not impossible, to verify the appropriateness of fair value measurement of these derivatives.

The exposure draft achieves its objective to simplify the accounting standards, but, at the same time, causes several serious problems in terms of practical application and some important revisions are thus deemed necessary. Repos (sales and repurchase transactions), stock lending (stock lending transactions), and securitization are examples where serious problems arise.

Repos and stock lending (Question)

The CAC is opposed to paragraph 17A(c) and AG52L of the exposure draft as they regard repos and stock lending as securities sales and purchases.

Economically, repos are secured borrowings and stock lending is lending/borrowing securities (sometimes repos are also used for bond lending/borrowing). The exposure draft proposes treating repos and stock lending as sale/purchase transactions, forcing accounting entries that do not reflect economic reality.

The exposure draft rests on the view that a repo can be notionally construed as a synthetic position of selling a bond and taking a long position in the relevant futures. However, a repo and the synthetic position are completely different transactions. In a repo, which is essentially borrowing with collateral, the financing rate will be uniquely determined, reflecting current financial markets. In the synthetic position, as the timing of transaction and counterparties are different, there is no guarantee that the effective rate is the same with that of a repo. In other words, one who wishes to borrow money through a synthetic position is trying to get a better rate than available in a repo. Economically, this is arbitrage trading, the nature of which is completely different from that of a repo. It should be added that, legally, a repo is typically written in a single contract, while the synthetic position is composed of two different contracts.

Under current accounting conventions regarding repos, a bond can have more than one owner at a given time. Apparently, the Board regards this as a problem that needs to be rectified. However, these are daily occurrences in the financial markets. For example, assume the CAC effects a short sale of stock A, which the Board buys. From the trade date to the delivery date, the Board owns a stock that does not exist. Apparently, it is absurd that a security is owned by more than two parties, or some people own securities that do not exist. However, the financial markets are based upon trust whereby such phenomena are not a problem because they will be resolved sooner or later by the delivery of the relevant securities. The accounting standards reflect such trust and permit the current accounting treatment.

The following problems would occur if repos and stock lending are regarded as selling/buying transactions. The first is market liquidity. If profit and loss are to be recognized at the time of each transaction, practically nobody would engage in these transactions and market liquidity would dry up. In the Tokyo market at end-2008, bond repos (*gensaki*) outstanding totaled 27 trillion yen; in addition, very short term (typically overnight) repos outstanding totaled 64 trillion yen. The two combined account for more than 50% of the Tokyo short-term money market. Liquidity in these transactions is a lifeline of the Japanese economy.

The second problem lies in corporate valuation. If financial instruments used in repos and stock lending are derecognized, the balance sheet looks slimmer and some financial ratios will improve. Time consuming adjustments will be needed to obtain data compatible to the past and to other companies.

The third problem is the flip side of the second one. Companies may be induced to 'window dress' their balance sheets by using repos and stock lending. Not only to streamline their balance sheets, but they may also be tempted to realize profits by lending stocks with unrealized gains.

The exposure draft focuses on the concept of 'control' and tries to eliminate, to the extent possible, 'risks and rewards' and 'continuing involvement' concepts to simplify the derecognition standards. The CAC does not deny this approach, but thinks flexible judgment is needed where this approach ends up with practically unreasonable standards. The CAC, therefore, proposes rewriting paragraph 17A(c) and/or AG52L, in such a way that repos and stock lending will not be regarded as sales.

Impact on securitization business

Some members, who are sell-side analysts and an accountant, have raised concern that the exposure draft may excessively suppress the securitization business. These members expressed the following opinions.

- The key element of securitization has been bankruptcy remoteness. Like US GAPP, the exposure draft should incorporate a rule to allow derecognition when bankruptcy remoteness is secured.
- The exposure draft will create a fat balance sheet which will result in increased financial leverage. As the prudential regulators are tightening the grip on leverage, if the proposals in the exposure draft are actually adopted as new accounting standards, the incentive for securitization will be decisively lost. The IASB should maintain close communication with the prudential regulators to monitor the potential impact on the securitization business.
- The exposure draft would practically annihilate securitization products with a preferred/subordinated structure. Partially keeping the 'risks and rewards' concept, the larger of the risks or rewards retained by the originator should be kept on the balance sheet of the said originator, while the rest should be allowed to be derecognized, subject to very detailed notes.

Disclosure (Question 11)

The CAC supports the disclosure requirements in the exposure draft as a whole, but

the following opinions have been voiced by some members regarding some specific issues.

- As the definition of transfer is substantially broadened (paragraph 9 of the proposed IAS 39), it should be scrutinized so that the scope of disclosure will not be expanded meaninglessly.
- If financial products used for repos and stock lending are to be derecognized, then detailed disclosure, including type, name, amount, and terms and conditions, is necessary.

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,

A handwritten signature in black ink that reads "Keiko Kitamura". The signature is written in a cursive, flowing style.

Keiko Kitamura

Chair

Corporate Accounting Committee