SAAJ The Security Analysts Association of Japan
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9 January 2009

Paul Beswick
Deputy Chief Accountant – PPG
United States Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549

re: Pro-cyclicality of Accounting Standards and Banking Provisions

Dear Paul,

It was a pleasure to participate in the telephone conference on the captioned matter on 6 January and I again appreciate your kind invitation. As you requested, I am herewith presenting my views in writing, most of which are an elaboration of my comments during the conference.

SAAJ survey

The Securities Analysts Association of Japan (SAAJ*) conducted an opinion poll of its certified members on the subject of the credit crisis. The survey was made primarily in preparation for the IASB-FASB round table discussion held in Tokyo on 2 December, but it contained some questions relevant to the pro-cyclicality issue as shown below. For your reference, the survey results are attached.

Who should address the pro-cyclicality issue?

We asked our members who should respond to the pro-cyclicality issue, prudential regulators or accounting standard setters? The majority (56.2%) were of the opinion that prudential standard setters should handle the problem. Our members apparently think accounting standards are sacred and should not be changed because of market developments. The questions and results were as follows:

Q4 Pro-cyclicality of fair value accounting

Fair value accounting and the prudential regulation of financial institutions based upon it, are said to accelerate business cycles and have undesirable effects on the macroeconomy. How should this problem be solved?

	Number	%
A. Prudential regulators should handle the problem.	374	56.2
B. Accounting standard setters, too, should give some consideration to the matter.	232	34.8

C. Other	60	9.0

Q1 Credit crisis and accounting standards—general view

What do you consider the status of accounting standards should be, theoretically, in a crisis?

	Number	%
A. Accounting standards, once set, should not be changed because of current market developments.	363	54.5
B. Fair value accounting assumes that the markets are efficient and rational prices are readily available. When this assumption is not met for a prolonged period and to a significant extent, some emergency measures should be permitted.	262	39.3
C. Other	41	6.2

Fair value accounting, but where to show it?

We asked members whether the current 'mixed bag' approach to financial instrument valuation should continue or the use of fair value valuation be expanded. Only about 25% supported the current approach, while 66.3% preferred expanded use of fair value measurements. Some 49.4% said financial liabilities should also be measured by fair value. On the subject of where to show valuation differences, there was quite an interesting finding—53.3% said they should be reflected in changes in equity while only 13.0% wanted them included in net income, a very different view from some non-Japanese analysts who assert everything should be marked to market and included in net income. Japanese analysts apparently want to see net income the performance measure of a company's innate business, while valuation differences caused by external factors should be included in other comprehensive income. As a consequence, we would have two distinct important performance measures. Net income as the performance of a company's innate business, and comprehensive income, which includes all valuation differences, representing net income plus the result of a company's exposure to external factors. This model would help mitigate the pro-cyclical nature of performance presentation as investors and other parties can make judgments based upon two equally important numbers rather than one single number whether it is net income or comprehensive income. The question and results were as follows:

Q5 Future of the fair value accounting of financial instruments

Under current accounting standards, financial assets are valued differently according to holding purpose, and financial liabilities, except derivatives, are not marked to market. Do you support current standards or do you think use of fair value measurements should be expanded?

	Number	%
A. Basically support the current method in the future too.	173	26.0

B. All financial assets should be marked to market and valuation differences recognized on income statements.	15	2.2
C. All financial assets should be marked to market, but valuation differences should be reflected as changes in equity.	98	14.7
D. In addition to financial assets, financial liabilities should also be marked to market and valuation differences recognized on income statements.	72	10.8
E. In addition to financial assets, financial liabilities should also be marked to market but valuation differences reflected as changes in equity.	257	38.6
F. Other	51	7.7

Flexible bank capital requirements

The Financial Stability Forum's report dated 10 October (Attachment A of the conference call) contains the following (page 8):

> *The capital regime: The project will examine the impact of Basel II on the cyclicality of capital requirements, and will explore measures that can be taken to strengthen capital buffers in good times and enhance banks' ability to dip into them during adverse conditions.*

I think this the most legitimate and straightforward way to mitigate pro-cyclicality—it is on a sunny day the umbrella should be prepared. The current credit crisis is being termed 'a once in a hundred years' tsunami'. Having observed securities prices way out of the theory for such extended period, I second the observation. But, it should be remembered that there is no guarantee that the next tsunami will wait 100 years. Expeditious efforts by regulators are thus highly desirable.

If you have any questions or need further clarification, please do not hesitate to contact me.

Sincerely yours,

Seiichi Kaneko

Sei-Ichi Kaneko
Executive Vice President

cc: Kevin Bailey
Deputy Comptroller
Office of the Comptroller of the Currency

*SAAJ is a not-for-profit organization established in 1962. Today, its main activities comprise education and examination programs focusing on financial and investment analysis. Our CMA (Chartered Member of the Association) program is composed of distance education and four examinations divided into first and second levels with a total exam time of 13 hours. Passing the second level exam and three years' working experience in the financial industry qualifies one to become a CMA. Typically, a new CMA is in his or her late 20s or early 30s with several years working experience following a university education. Each year, more than 10,000 candidates take the exams, and we now have about 22,000 CMAs, making us the second largest analysts association after the CFA Institute in the United States. Most of our members play important roles in the financial industry, but some use the CMA designation to enhance their responsibilities as public accountants while others find opportunities in non-financial areas, particularly as accounting and IR professionals. For the continuing education of our diversified membership, we hold about 80 seminars/conferences and more than 900 company meetings annually. SAAJ is also pro-active in enhancing corporate disclosure and improving accounting standards. Each year, the Corporate Disclosure Committee surveys members and gives awards to companies exhibiting excellence in disclosure. The Corporate Accounting Committee studies accounting issues and submits comment letters to standard setters. SAAJ's activities are widely supported by the business community and major financial institutions are important corporate members.

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2 December 2008

SAAJ NEWS RELEASE

Securities analysts support fair value accounting; cautious about changing accounting standards to accommodate the credit crisis

The Securities Analysts Association of Japan (SAAJ) conducted an opinion poll of its certified members on the subject of accounting standards in relation to the current credit crisis. Securities analysts are major users of financial statements. The survey, conducted in late November, covered 14,384 certified members of SAAJ who had registered their e-mail address. Some 666 responded, making for a 4.6% response ratio. As the subject is highly technical and complicated, SAAJ had prepared a background document for members to read before answering the questions.

The International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) of the US are going to hold a public round-table meeting on the credit crisis and accounting standards in Tokyo on 3 December. A representative of SAAJ will attend and speak based upon the consensus views of members identified in the survey.

Major Findings

✓ The majority (54.5%) supported *"Accounting standards, once set, should not be changed because of current market developments."*

✓ Regarding the respective decision of the Accounting Standards Board of Japan (ASBJ) and IASB to allow the reclassification of securities, slightly more than half (52.0%) replied *"Do not support the decision as it allows for arbitrary accounting and means a retreat from fair value accounting."*

✓ With respect to the EC's recent request to the IASB, including the mitigation of impairment tests, the lion's share of responses (61.3%) went to *"Do not support the requests as most do not even have a legitimate basis such as for establishing a level playing field with the US GAPP, and are seemingly aimed at hiding losses."*

✓ Fair value accounting and the prudential regulation of financial institutions based upon it, are said to accelerate business cycles and have undesirable effects on the macroeconomy. Some 56.2% of the respondents responded that *"Prudential regulators should handle the problem," not accounting standard setters.*

✓ As for the future of fair value accounting, about the two-thirds (66.3%) said all financial assets should be marked to market, while nearly half (49.4%) said financial liabilities should also be valued at fair value. Regarding valuation

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differences, the majority (53.3%) said they should be directly reflected on the balance sheet. The SAAJ intends to conduct further surveys on these important issues that have medium- to long-term implications.

Attachments

1. Credit crisis and accounting standards—survey questions and results.
2. Accounting standards and the current credit crisis—background reading.

For further information, please contact:
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Attachment 1

Survey of Analyst Opinions Regarding the Credit Crisis and Accounting Standards

Q1 Credit crisis and accounting standards—general view

What do you consider the status of accounting standard should be, theoretically, in a crisis?

	Number	%
A. Accounting standards, once set, should not be changed because of current market developments.	363	54.5
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C. Other	41	6.2

Q2 Reclassification of securities

What do you think of the respective decision of ASBJ (Accounting Standards Board of Japan) and IASB (International Accounting Standards Board) to allow the reclassification of securities?

	Number	%
A. Support the decision, which makes for a level playing field with the US GAPP, from the perspective of the convergence of accounting standards.	270	40.5
B. Do not support the decision as it allows for arbitrary accounting and means a retreat from fair value accounting.	346	52.0
C. Other	50	7.5

Q3 Request from the EC

In a letter dated 27th October, the EC requested the IASB make further accounting changes, including the mitigation of impairment. What do you think of this request?

	Number	%
A. Support the requests as necessary measures to counter the current market situation.	219	32.9
B. Do not support the requests as most do not even have a legitimate basis such as for establishing a level playing field with the US GAPP, and are seemingly aimed at hiding losses.	408	61.3
C. Other	39	5.8

Attachment 1

Q4 Pro-cyclicality of fair value accounting

Fair value accounting and the prudential regulation of financial institutions based upon it, are said to accelerate business cycles and have undesirable effects on the macroeconomy. How should this problem be solved?

	Number	%
A. Prudential regulators should handle the problem.	374	56.2
B. Accounting standard setters, too, should give some consideration to the matter.	232	34.8
C. Other	60	9.0

Q5 Future of the fair value accounting of financial instruments

Under current accounting standards, financial assets are valued differently according to holding purpose, and financial liabilities, except derivatives, are not marked to market. Do you support current standards or do you think use of fair value measurements should be expanded?

	Number	%
A. Basically support the current method in the future too.	173	26.0
B. All financial assets should be marked to market and valuation differences recognized on income statements.	15	2.2
C. All financial assets should be marked to market, but valuation differences should be reflected as changes in equity.	98	14.7
D. In addition to financial assets, financial liabilities should also be marked to market and valuation differences recognized on income statements.	72	10.8
E. In addition to financial assets, financial liabilities should also be marked to market but valuation differences reflected as changes in equity.	257	38.6
F. Other	51	7.7

Attachment 2

Accounting Standards and the Current Credit Crisis

1. Summary of Responses

Newspaper headlines simply sum up the situation as the "freezing of fair value accounting" etc., but actual and pending responses can be categorized as follows:

(1) Valuation standards

Regarding the valuation of securities which have lost market liquidity, ASBJ, IASB, and FASB have all issued guidance and made it clear that, in illiquid markets, use of model prices is more rational than the use of sporadic transaction prices.

(2) Reclassification of holding purpose of securities

As for reclassification from held-for-trading purposes (marked to market on income statements) to available-for-sale (where valuation difference is directly reflected on balance sheets, impairment tests applied), or held-for-maturity (not marked to market, amortized cost method and impairment tests applied)[Note 1], the US GAAP has only permitted such reclassification "in rare circumstances". ECOFIN (the Economic and Financial Affairs Council of the EU) requested IASB to establish a level playing field with the US, and IASB subsequently made the necessary revisions on 13 October. The Accounting Standards Board of Japan (ASBJ) is currently in a due process of incorporating the changes IASB made and of permitting reclassification from available-for-sale purposes to held-for-maturity purposes which has been permitted under both IFRS and US GAAP.

IASB made the changes applicable retroactive from 1 July. The Deutsche Bank took advantage of this retroactive application and reclassified securities in the third quarter and declared pretax profits of €825 million. The bank noted that, without reclassification, it would have incurred €845 million valuation losses. It should be noted that not all major European banks applied reclassification in the past quarter.

Note 1: International Accounting Standards have a category called "loans and receivables" in which financial assets, not traded in liquid markets, with fixed or determinable redemption amount and maturity, are classified. The same accounting standards as for held-for-maturity securities are applied to this category. The IASB revision included reclassification to loans and receivables from held-for-trading and available-for-sale purposes. The abovementioned Deutsche Bank quarterly accounting used this provision.

Attachment 2

(3) Mitigation of impairment, etc.

The EC (European Commission) made the following additional requests to the IASB in a letter dated 27 October:

(a) Permit reclassification to available-for-sale or held-for-maturity purposes from fair value option(Note 2) securities.

Note 2: Companies may initially choose the fair value option for ALM and other reasons. The option can be applied not only to financial assets but also to financial liabilities

(b) Cease to separately value options included in synthetic CDOs.

(c) Mitigate impairment tests of available-for-sale securities by applying the method used for held-for- maturity securities(Note 3).

Note 3: The EC has requested changing from "book value – market value" to "book value – present value of discounted future cash flows".

(d) After equity securities included in available-for-sale are impaired (losses recognized on the income statement), if prices recover, the gains should also be recognized on the income statement (currently, the reversal of impairments through the income statement is prohibited).

Among the above requests, (b) is to align with the US GAAP, but others are requests unique by the EU.

(4) Equities

While discussions (1) to (3) above focus mainly on debt securities and derivatives, some suggest that the valuation of equity securities should also be modified.

(5) Disclosure

The Financial Stability Forum (FSF)(Note 4) released its "Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience" in April 2008, which was endorsed by the G7 finance ministers and central bank governors. The report included the following three recommendations to the IASB:

(a) To improve the accounting and disclosure standards for off-balance sheet vehicles.

(b) To enhance guidance on valuing financial instruments when markets are no longer active.

(c) To strengthen standards to achieve better disclosure about valuation, methodologies, and the uncertainty associated with valuations.

Note 4: FSF was established in April 1999 by the G7 to promote international financial stability through information exchange and international cooperation in financial supervision and surveillance.

Members include national and international regulatory authorities and supervisory groups.

IASB is responding to the above recommendations as follows: For (a), by accelerating existing projects (consolidation and de-recognition), (b) has already been effected as mentioned under 1 (1) above, and for (c), an exposure draft " Improving Disclosure about Financial Instruments (proposed amendments to IFRS 7)", open for public comment until 15 December 2008, has been circulated.

(6) Declaration of the summit on financial markets and the world economy

The G20 financial summit declaration, released 15 November, included the following, "The key global accounting standards bodies should work to enhance guidance for valuation of securities, also taking into account the valuation of complex, illiquid products, especially during times of stress". The actual impact of this declaration on accounting standards remains to be seen.

2. Background Information

(1) Pro-cyclicality

Fair value accounting is said to accelerate economic cycles (pro-cyclicality). When an economy is growing, securities held tend to increase in value, causing corporate capital to increase and companies to be more aggressive in making new investments. On the contrary, when an economy is shrinking, the declining value of securities held depletes capital which results in reduced risk tolerance, triggering the sale of securities and raising capital, both of which contribute to further declines in securities prices, resulting in a vicious circle. This pro-cyclicality is particularly prominent among financial institutions.

Some think this problem should be tackled by regulatory agencies through bank capital regulations etc., while others argue accounting standard setters should perhaps take this situation into consideration and make some adjustments.

(2) Valuation of financial assets and liabilities — long-term goals

In the long term, IASB thinks all financial assets and liabilities should be valued at fair value. On the other hand, some argue that the current accounting convention of using different measurements for different holding objectives(Note 5) has its own rationale and should be maintained. When financial instruments are marked to market, opinion is also divided as to where to recognize valuation differences, in net income or in other comprehensive income. As to the fair value measurement of financial liabilities, some assert it is rational, particularly for financial institutions, in view of asset and liability matching, while others point out the following problems:

(a) From a creditor's point of view, what matters regarding financial liabilities is whether the debtor

can pay back the nominal contractual amount or not, and therefore fair value is not relevant.
(b) When a credit rating is downgraded, the value of liabilities declines, causing capital to increase—a well-known paradox.
(c) If a liability is to finance the purchase of business equipment and property, refinancing will occur in due course. Applying fair value to something to be refinanced is meaningless (accumulated gains and losses will sum up to be zero at the time of refinancing).

Note 5: As various measurement methods co-exist, this is sometimes derided as the 'mixed bag approach'.

3. Pros and Cons of the Responses

(1) Pros

(a) Fair value accounting assumes that the markets are efficient and rational prices are readily available. When this assumption is not met for a prolonged period and to a significant extent, some emergency measures should be permitted.
(b) Accounting standards should be aligned to other countries' standards, so that the performance presentations of domestic financial institutions will be comparable to those of their foreign counterparts.
(c) Sticking to current accounting standards will result in very poor performance figures released by financial institutions, amplifying the credit crisis. As accounting standards exist to enhance social and economic welfare, some action should be taken to mitigate the pro-cyclicality of fair value accounting.

(2) Cons

(a) Fair value accounting guarantees the transparency of financial and capital markets, and contributes to the early recognition and settlement of bad assets. Hence, accounting standards should not be changed to meet temporary market movements.
(b) A retreat from fair value accounting would induce distrust of accounting standards and financial and capital markets, leading to further deterioration of the current situation.
(c) If accounting standards have a negative influence on bank capital requirements, then bank regulations themselves should be redressed—sending the check to accounting standard setters is just like putting the cart before the horse.