ISDA®

International Swaps and Derivatives Association, Inc.
Shiroyama Trust Tower, 31st Floor
4-3-1 Toranomon
Minato-ku, Tokyo 105-6031
Japan
Telephone: 81 (3) 5733 5500
Facsimile: 81 (3) 5733 5501
email: isdajp@isda.org
website: www.isda.org

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International Accounting Standard Board
1st Floor
30 Cannon Street
London
EC4M 6XH

Ref.: Proposal on Hedge Accounting and Answers to the questions posed by the IASB Staff during May Roundtable

Dear Sirs,

The IASB recently contacted ISDA concerning the hedging practices of Japanese corporates, the impact of the proposed changes to hedge accounting on these market participants, and possible simplifications to existing hedge accounting requirements which might enhance the quality of financial statements of these hedgers. In response to this, the Japan Accounting Committee of the International Swaps and Derivatives Associations, Inc. ("ISDA") is pleased to provide the following comments with respect to the proposed revisions to IFRS hedge accounting rules which are under consideration. ISDA has over 800 member institutions from 57 countries including 37 members headquartered in Japan, and these members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. As such, we believe that ISDA brings a unique and broad perspective to the work of the IASB.

ISDA has recognized the need to actively improve accounting for financial instruments in Japan in order to foster sustainable growth of domestic derivatives markets. As a step towards this aim, ISDA established the Japan Accounting Committee (the “Committee” or “we”) in October 2008 as a forum to examine accounting practices for derivatives and deliberate on future developments. Since its first meeting in November 2008, the Committee’s discussions have primarily focused on revisions to the accounting for financial instruments in line with

the convergence plans. The Committee has worked to ensure that the voice of the Japanese corporate community is reflected in international standard setting process. In May 2010, the Committee held a Round Table discussion with IASB staff where it expressed its proposals for hedge accounting and explained the related strengths of JGAAP practices. At the Round Table, the Committee was able to engage in a productive dialogue with the IASB staff and the discussion opened up new avenues for on-going discussions, especially with regard to ideas on hedge effectiveness testing, treatment of hedge ineffectiveness, and certain JGAAP practices worthy of examination. The Committee subsequently deliberated such issues internally to further advance the proposal to the IASB.

In this letter, we outline our key messages on hedge accounting with further explanation of the proposal for hedge accounting detailed in Appendix A, and our answers to the questions posed by the IASB staff during May roundtable included in Appendix B,.

Key Messages:

- The derivatives market in Japan has grown steadily mainly driven by the hedging needs of Japanese corporates. Japanese corporates are in a unique position to be exposed to the various risks arising from its business activities and have resorted to hedging derivatives as stated below:

  - Japanese economy is heavily reliant on final goods exports and raw materials imports and is inherently susceptible to FX risks. To contain the FX risks, Japanese corporates have entered into FX-related derivatives (forwards and currency options) to fix the cashflow.

  - In Japan, corporate financing is mainly sourced by commercial banks which tend to provide floating rate based funds in long-term loans to avoid interest rate fluctuation risks. On the other hand, corporates have preference for fixed-rate loans for capital investment and acquisitions purposes. To bridge the gap, interest rate swaps are entered into on the origination of the loan to convert the floating rate payment to fixed rate payment by the coporates.

  - Nowadays raw material price volatility is difficult to be passed onto downstream due to weak domestic demand. An increasing number of corporates are turning to commodity-related derivatives to mitigate the price fluctuation risk of raw materials.

  In most of the above cases, the hedging is structured one-by-one and the terms of the hedging derivative is strictly matched to that of the hedged item. In other words, the risk profile of the hedged item is completely altered to that of the hedging instrument. From corporate risk management perspective, the hedged item and hedging instrument forms single risk management unit. Corporates have found it more suitable to account for them as one transaction rather than recording them separately.

  In response to this motivation, JGAAP has provided the following hedge accounting treatments which reflect the specificities of Japanese corporate hedging and which should

therefore be available for Japanese corporates.

- "Hedge accounting treatment applicable only to certain interest rate hedging"

  When an interest rate swap is entered into for the purpose of converting the interest receipt/payment of an amortized-cost-accounted asset/liability to that of the swap, on the condition that the critical terms between them such as notional amount and interest receipt/payment conditions match and that the hedge accounting criteria is satisfied, the swap and hedged associated asset or liability are jointly accounted for on an accrual basis.

- "Hedge accounting treatment applicable only to certain FX hedging"

  When FX forward or currency swap is entered into for the purpose of fixing the future cash flow of the foreign currency denominated amortized cost -accounted asset/liability, the functional currency-equivalent amount in each settlement of the FX forward is attributed to the relevant cashflow of foreign currency denominated asset/liability, with the initial difference between spot and forward prices (forward points) amortized over the contract term.

We believe the above hedge accounting treatments reflect the Board's desire to avoid accounting mismatch between a hedged item and a qualifying hedging instrument and accurately reflect the realities of Japanese corporate practices. Also, they serve to fulfill the Board's target to reduce complexity of financial instruments reporting. Lastly, this well serves the hedge accounting objective which the Board tentatively adopted in the previous discussions to provide a link between an entity's risk management and its financial reporting.

❒ We further propose that the Board provide an option not to separate ineffectiveness conditional upon certain additional criteria.

Under the current JGAAP, the ineffectiveness is not required to be separated in all cases on the ground that this is too onerous for reporting entities. Changing the hedge accounting model for Japanese corporates brings about the fundamental change in their business model, risk management, systems, and operational processes. Further, separating ineffective portion is operationally challenging for non financial institutions and as a result may be prohibitive in utilizing derivatives as a risk management tool.

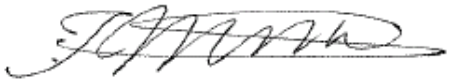
The proposed additional criteria might include：

- Periodical retrospective quantitative testing, which, under our proposed model, is not mandatory.
- Detailed analysis of underlying risks to which hedged item or hedging instrument is exposed (in case of FV hedge for a portfolio hedge of interest rate risk)

- Checking of critical terms matching

We hope you find ISDA's comments informative and beneficial. Should you have any questions or desire any clarification concerning the matters addressed in this letter please do not hesitate to contact the undersigned.

Masamichi Ishikawa
Mizuho Corporate Bank, Ltd.
Chair, Japan Accounting Committee



Tomoko Morita
Head of Tokyo Office
International Swap and Derivatives Association

Appendix A

Our proposal on hedge accounting

In order to provide concrete options that the Board may consider, ISDA has established eight propositions stemming from the needs of Japanese corporates.

Proposition 1: Qualitative testing should be mandatory. When the qualitative testing could not provide sufficient evidence for "high effectiveness", then quantitative testing should be performed.

- Please see Appendix B for further explanations.

Proposition 2: Quantitative testing guidance should be enhanced to encourage the use of widely accepted statistical methods.

We would encourage the Board to enhance quantitative testing guidance. Under current IFRS as well as USGAAP, the statistical effectiveness testing is explicitly required. The effectiveness criteria is tied to the numerical target of 80%-125% which was originally developed as part of the dollar offset method and does not necessarily bring about the same results across methodologies. Further, the guidance for statistical testing, especially regression analysis, is not provided in the GAAP, while some prevalent practices are shared among preparers. We would encourage the Board to provide a comprehensive quantitative testing guidance covering major statistical methods.

Proposition 3: The Board should provide an option not to separate ineffectiveness conditional upon certain criteria.

- Explained in the key messages.

Proposition 4: "Hedge accounting treatment applicable only to certain interest rate hedging" and "Hedge accounting treatment applicable only to certain FX hedging" under JGAAP which are heavily used by Japanese corporate will serve the Board's target to simplify hedge accounting.

- Explained in the key messages.

Proposition 5: Partial hedging for both financial and non-financial transactions should be allowed by eliminating restrictive rules

Under current IFRS, if the hedged item is a non-financial asset or liability, designation is

possible only for foreign currency risks, or for all risks in their entirety. While a hedge covers only a part of the applicable period, hedge accounting is possible for cash flow hedges but very difficult for fair value hedges because the effectiveness testing is measured against the fair value changes as a whole or as a ratio.

ISDA is aware of many examples in current Japanese practice which show the need for partial hedges as stated below:

- Many of the indices (e.g., WTI for crude oil, coal) used for hedging raw material prices are USD-denominated. However, since many Japanese corporates will make their actual purchases domestically in JPY, the raw material prices are subjected to the price volatility risk of the raw materials as well as FX risk. They hedge the price volatility risk on a USD basis using USD denominated derivatives and the FX risk using FX forward contracts.

- In Japan, the domestic sugar price is based on the ALIC's (governmental agency) sales price, which is incorporated into the international index named NY#11 Sugar, USD denominated future. Sugar manufacturing companies have a need to hedge the sugar sales by this index.

- Corporates holding certain securities (terms such as fixed-rate dividends for first 5 years, floating-rate thereafter) may wish to enter into a receive-floating, pay-fixed swap matched against the initial fixed-rate dividends received.

In these and numerous other cases, partial hedges on non-financial transactions are an essential element to risk management by Japanese corporates and therefore ISDA would encourage the Board to eliminate the restrictive rules on partial hedges.

Proposition 6: A broader range of risks, including business risk, should be allowed to be a hedged item if they are proven to be identifiable and the hedging relationship is verifiable.

Under IFRS, it is not possible to apply hedge accounting to business risk on the ground that this is not identifiable or measurable. ISDA urges scrutiny of this presumption as suggested by numerous real life examples demonstrating the opposite. For example, royalties/dividends from the interests in commodities enterprise were proven to be closely correlated to commodity-linked derivatives. We believe that the hedged risk in royalties/dividends is identifiable and measurable and that the hedging relationship between the royalties/dividends and commodity-linked derivatives is verifiable. We would encourage the Board to allow hedge accounting for broader range of risks if the hedged risk is proven to be identifiable and measurable and the hedging relationship is verifiable.

Proposition 7: Rules should be established to enable application of hedge accounting to internal contracts

Currently, internal contracts are not eligible for hedge accounting in consolidated financial

statements on the grounds that they are eliminated in consolidation.

In many aspects of corporate risk management, internal contracts are used as hedging instruments as stated below:

Central management of financial risks

Corporates often establish a desk to centrally manage various financial risks. The desk will transfer the risks to external parties in due course but this is not done individually for efficiency and cost effectiveness reasons.

Providing hedges by a parent

Some Japanese companies, especially, trading companies, engage in various businesses through subsidiaries and the parent often provides hedges to subsidiaries. The parent ultimately transfers the risks to external parties but this is not done individually for efficiency and cost effectiveness reasons.

Application Guidance of IAS39 provides that internal contracts between separate divisions within the same legal entity or those between separate entities within the consolidated group can qualify for hedge accounting either in the individual financial statements of that legal entity or in the consolidated financial statements only if the internal contracts are offset by derivative contracts with external parties. But if the internal contracts to manage risks other than FX risks are first netted against each other and only the net exposure is offset in the marketplace with external contracts, hedge accounting is not allowed on the ground that this virtually allows the hedged non-derivative exposures at the division or subsidiary levels being used to offset each other on consolidation.

It is onerous exercise to reverse hedge accounting using internal contracts first and establish hedging relationship again with the same hedged items and the external contracts. So long as net position is proven to be laid off to external parties, hedge accounting should be allowed to internal contracts. We recommend the Board to establish more flexible hedge accounting rules for internal contracts to properly reflect the economic substance of hedging activities using internal contracts.

Proposition 8: Strict criteria for portfolio hedging should be revisited to reflect common risk management practices

Current IFRS allows portfolio hedges only when individual assets or individual liabilities in the group share the risk exposure that is designated as being a hedge; it further requires that the change in fair value attributable to the hedged risk for each individual item in the group shall be expected to be approximate proportional to the overall change in fair value attributable to the hedged risk of the group of items.

We believe that the rule is counterintuitive to corporate risk management activities. For

example, corporates often transact index derivatives for hedging index basket in order to contain equities price volatility risks but are unable to apply hedge accounting due to the above rules.

We recommend the Board to revisit the above rules in order to further the objective for hedge accounting.

Appendix B

Responses to the IASB

Proposition 1: Qualitative testing should be mandatory. When the qualitative testing could not provide sufficient evidence for "high effectiveness", then quantitative testing should be performed.

Question from IASB –

- If the qualitative testing were mandatory and quantitative testing supplementary, under what scenarios would quantitative testing be necessary?

Reply from ISDA –

- Quantitative testing would be used when qualitative testing yields a "non-qualifying" result, i.e., when not recognized as "highly effective" from a qualitative analysis. This includes a case where qualitative testing during the period of hedging relationship cannot corroborate the effectiveness.

  Examples include:

  › hedged item and hedging instrument do not refer to the same index
  › hedged item and hedging instrument do not have the same period (a gap exists)

Proposition 2: Quantitative testing guidance should be enhanced to encourage the use of broadly-conceived legitimate statistical methods.

Question from IASB –

- Please share what sort of numerical targets are preferable for quantitative testing.

Reply from ISDA –

- At present, the (1) dollar offset method and, (2) regression analysis are the two of the main quantitative methods used.
- For the (1) dollar offset method, changes in the FV or CF of the hedging instrument are required to be within 80%-125% of the changes in the FV or CF of the hedged item.
- For (2) regression analysis, while not stated explicitly in the standards, in common practice the following are considered requirements:
  › the coefficient of determination should be 0.8 or higher;

  - the slope of the hedging instrument with respect to the hedged item should be within 80%-125% with a high degree of certainty (e.g., significance level of 5%);
  - an economic relationship between the variables can be demonstrated;
  - if the economic relationship can be demonstrated, the line of regression does not necessarily need to pass through the origin

- As shown above, the 80%-125% numerical baseline is used in both the dollar offset method and the regression analysis. This treatment is also similar to USGAAP. However, it is not logically follow that this common baseline will in fact lead to consistency. R-squared is the square of the correlation coefficient and indicates the degree that the independent variable explains the dependent variable. While a higher R-squared does indicate greater explanatory power of the model, a value exceeding 80% is not equivalent to a dollar offset method result of 80% or higher.

- In addition to the above, regression also requires number of observations, *t*-statistics, etc., but GAAP does not provide comprehensive guidance.

- Therefore, for the main statistical methods, comprehensive guidance should be provided within GAAP.

Proposition 3: The Board should provide an option not to separate ineffectiveness conditional upon certain criteria.

Question from IASB –

- Please describe concrete examples of difficulties in separating the ineffective portion and taking it to profit or loss.

Reply from ISDA–

- For financial institutions, calculating the ineffective portion of millions of claims and obligations is highly challenging because this requires changes in business model, risk management, systems and operational processes.

- For many non-financial institutions, separating ineffective portion and calculating the present value using the hypothetical derivative is technically challenging and costly.

Question from IASB –

- The IASB considers taking the ineffective portion to profit or loss to be the standard, fundamental approach but would like to know the rationale Japanese corporates consider justifies taking to OCI.

Reply from ISDA –

- During the hedge accounting deliberations, the Board tentatively decided that one of the objectives of hedge accounting is to provide a link between an entity's risk management and its financial reporting. The Board also notes that hedge accounting can convey the context of hedging instruments, which allows insights into their purpose and effect. In Japanese corporates' risk management, the hedging instrument and the hedged risk are treated as a single risk management unit and the corporate does not separate the effective portion and the ineffective portion. Corporates manage the risk of the hedged item from various perspectives including the liquidity and the counterparty credit risks and examine whether to continue hedging. So long as the hedging strategy which intended by management is corroborated by rigorous effectiveness testing, this intention and the risk management realities should be reflected to the financial reporting.

Proposition 4: "Hedge accounting treatment applicable only to certain interest rate hedging" and "Hedge accounting treatment applicable only to certain FX hedging" under JGAAP which are heavily used by Japanese corporate will serve the Board's target to simplify hedge accounting.

Question from IASB –

- Please provide the details on the supplementary requirements of the JGAAP treatments for our reference.

Reply from ISDA –

- The fundamental requirements and supplementary guidance are stated below:

(1) The notional amount of the interest rate swap is almost identical to the principal amount of the related asset or liability on the balance sheet.

If the difference between the notional amount of the interest rate swap and the principal of the related asset or liability is no more than 5%, they shall be considered almost identical and therefore subject to this method.

(2) The term of the interest rate swap is almost identical to the contract term or maturity of the hedged asset or liability.

While it is not possible to declare a certain number of days or months of difference in the contract term or maturity that would, without exception, disqualify the hedge from meeting this requirement, it can be considered to be almost identical if the number of days of the gap is within 5% of the contract term or maturity of either the interest rate swap or the hedged asset or liability. Accordingly, a difference of six months for a 10-year interest rate swap, or three months for a 5-year interest rate swap, could be considered "almost identical" for this purpose.

(3) If the interest on the related asset or liability is floating rate, the reference index is almost identical to the reference index of the interest rate swap.

Although, for example, 3-month TIBOR and 3-month LIBOR can be expected to have a high degree of correlation, they should not automatically be assumed to be "almost identical" – rather, an examination of the actual market conditions in the recent past should be made. If such examination does indeed indicate high correlation, then the "almost identical" determination is warranted.

It should be noted that in the case of examining the prime rate with respect to TIBOR or LIBOR, TIBOR and LIBOR are in constant movement while the prime rate will tend to remain unchanged for relatively long periods of time. Accordingly, a prospective determination of "almost identical" is presumed to be impossible and subsequently the special method would be inapplicable.

(4) The interval for resetting the interest rate of the interest rate swap is almost identical to the interval for resetting the interest rate of the related asset or liability.

Since it is relatively common for interest rate transactions to be made for 3-month periods, the interval for resetting the interest rate of the interest rate swap and the related asset or liability do not differ by less than 3 months. Then they would not be considered "almost identical."

(5) The pay and receive conditions of the interest rate swap do not change throughout the swap period (the same fixed rate and the same reference index for the floating rate are used throughout the swap period).

(6) If the interest rate swap contains an early termination option or there is a floor on interest paid or a cap on interest received, it is for the purpose of offsetting similar conditions which apply to the hedged asset or liability. *(4) The interval for resetting the interest rate of the interest rate swap is almost identical to the interval for resetting the interest rate of the related asset or liability.*