31 July 2009

Comments on the Exposure Draft on Derecognition

Securitization Forum of Japan
Accounting Subcommittee

With regard to the Exposure Draft on Derecognition which was published by the International Accounting Standards Board on March 31, 2009, we, the Securitization Forum of Japan (http://www.sfj.gr.jp/, "SFJ"), would like to make the following comments. The Accounting Subcommittee of SFJ examined the Exposure Draft and prepared the comments on its own responsibility. However, since that SFJ, including the subcommittee, consists of originators, arrangers, trustees and investors as well scholars, lawyers, accountants and tax counsels, and that they are involved in securitization from their respective position, their individual opinions may be different from those contained in our comments. While keeping this in mind, we would like to submit our opinions from the perspective of the sound development of the securitization market.

In the Japanese securitization market, assets held by originators, such as housing loans and automobile loans, are used as underlying assets of securitized products in granular and in a senior-subordination structure (subordinated beneficial interests are to be held by the originator) mainly under trust arrangements. This type of securitized products has become one of the important fund-raising instruments for originators. The senior beneficial interests purchased by investors carry a higher credit rating (usually AAA) than the credit rating of the originator, as bankruptcy remoteness from the originator is ensured and credit enhancement measures, such as senior-subordination structure, are taken.

Under the Exposure Draft, even if an originator transfers senior beneficial interests under the method described above, the originator cannot remove the rights from its balance sheet. Despite the fact that a measure to ensure bankruptcy remoteness from the originator has been taken from the legal point of view, the transferred assets will continue to be recorded as assets on the originator's balance sheet. On the other hand, proceeds from the sale of the senior beneficial interests will be recorded as originator's liability, despite the fact that the originator has no obligation to liquidate its own assets to repay the proceeds, resulting in the originator filing a financial report that is not legally and economically practical.

Based on this perspective, we would like to submit our comments on Question 2 and Question 5 as follows.

Re: Question 2 — Determination of 'the Asset' to be assessed for derecognition

(Our Response to the question 2)

We do not agree with the criteria proposed in paragraph 16A of the Exposure Draft for the following reasons.

1. In determining which "asset" will qualify to be assessed for derecognition, the Exposure Draft proposes separate treatments between the contract for the sale of the first 90% of the cash flows from a financial asset and the contract for the sale of the proportionate share of the cash flows from the financial asset, pertaining to the transfer of cash flows of the financial asset. This is not consistent with the Exposure Draft's idea that the assessment of assets for derecognition should be based on the control rights to the cash flows.

2. Under the approach proposed by the Exposure Draft, even when a transferor, after determining the whole assets as "assets" for derecognition, has actually transferred most of the financial assets through the "continuing involvement" filter and the "practical ability to transfer" test, and when the transferor no longer has the right to the cash flows from the financial assets, these facts will not be reflected and the transferor will continue to recognize all of the financial assets. We believe such an accounting treatment will not lead to an improvement in the financial report.

3. Paragraph BC35 says that if "the Asset" that can be assessed for derecognition is defined as "a right to any cash flows of a financial asset," it would allow an entity to achieve derecognition of the transferred part of a financial asset even when (1) the part transferred includes some or all of the risks or economic value of the part retained, and (2) the performance of one part is dependent on that of the other part. For these reasons, the Exposure Draft says the Board decided to restrict the scope of "assets" that might qualify for derecognition. However, we believe these reasons are not sufficient grounds for denying derecognition of parts of the financial assets that are actually transferred.

4. We do not think the alternative approach is appropriate in that it allows derecognition of the whole of a financial asset even in the case of a transfer of the right to a fraction of the cash flows from the asset and treats the right reserved as a new asset of the remaining cash flows from the asset. Under this approach, if a financial asset which the Mark to Market method does not apply is used as the asset to be transferred, for example, even a transfer of a fraction of cash flows from the asset may produce the effect of having sold the whole asset at a fair value. This may lead to the use of this approach for the purpose of adjusting profits and losses of the transferor.

5. On the other hand, under the approach proposed by the Board, if a part of a financial asset is transferred and the control of that portion of the asset is abandoned, the right reserved for the cash flows from the remaining financial asset is treated not as a new asset but as a retained part of the previously recognized asset. If this approach is adopted, any gain or loss is only on the part of the asset transferred and thus the concern mentioned in 4. above become minimal. Since the risk of derecognition of the whole financial asset by way of partial transfer of the asset is smaller under the approach proposed in the Exposure Draft than under the alternative approach, we believe it would not need to set strict requirements on the "asset" to be transferred. Therefore, we believe that, even in the case of a contract for transferring the first 90% of a financial asset, it is appropriate to allow the derecognition of parts of the financial asset that are actually transferred.

Re: Question 5 — 'Practical ability to transfer for own benefit' test

(Our Response to the question 5)

We believe that neither the idea nor the guidance in the Exposure Draft is appropriate and that therefore they should be reviewed.

1. The Exposure Draft restrics "the practical ability to transfer" to the transfer of "asset" by a transferee to a third party. However, in the case of a financial asset, the transferee can enjoy economic benefits through methods other than transferring the asset to a third party. Therefore, the restriction in the Exposure Draft does not reflect the characteristics of financial assets. Moreover, if the restriction concerning the transfer by a transferee is mainly for the benefit of the transferee (SFAS 140

ED paragraph 54A) or in the case where the holders of beneficial certificates issued by a transferee (special purpose entity) have the right to offer the certificates as collateral or exchange them (SFAS 166 paragraph 9b), then the restriction would not constitute a factor denying the control of economic benefits by the transferee.

2. In the case of securitization under trust arrangements, a transferor of a financial asset acquires senior and subordinated beneficial interests in exchange of transferring the financial asset to a trustee (at this point, the economic value of the financial asset transferred is equivalent to that of senior and subordinated beneficial interests) and transfers the senior beneficial interest to investors. With regard to the senior beneficial interest transferred, the transferee (i.e., investors) can transfer it to a third party. Even in this case, the Exposure Draft does not allow derecognition if there is a restriction under which the trustee (i.e., SPE) should not transfer the financial asset to a third party, a restriction aiming at safely maintaining fund to redeem the senior beneficial interests. As such, the economic activity of the transfer of senior beneficial interests will not be adequately reflected in the financial report.