

**The LIAJ's Comments on Supplement to ED  
Financial Instruments : Impairment**

**1<sup>st</sup> April 2011**

**The Life Insurance Association of Japan (LIAJ)**

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## 1. General opinions on the supplementary document

1. With our greatest respect to the continuing efforts of the International Accounting Standards Board (IASB) for financial instrument project, the Life Insurance Association of Japan (LIAJ) would like to extend our gratitude to the Board for providing us with the opportunity to submit our comments on the supplement to the exposure draft, *Financial Instruments: Impairment* (hereinafter referred to as 'the supplementary document'), published in January 2011.
2. The LIAJ is a trade association comprised of all 47 life insurance companies operating in Japan. Its aim is to promote the sound development of the life insurance industry and maintain its reliability in Japan. We would like to respectfully request that the Board carefully consider the comments submitted from the sole representative body of the life insurance industry in Japan, which holds the second largest life insurance market in the world.

### 1.1 Proposals for improvement to appropriately represent the life insurance business

3. We think that the amendments to accounting standards for financial instruments that account for a large part of the life insurers' assets and the activities of Insurance Contract project on measurement of insurance liability that accounts for a large part of the life insurers' liabilities, would have a great impact on the practice of life insurers. Therefore, we believe that all the phases of IFRS 9, including this impairment phase, need to be considered consistently with the Insurance Contract project.
4. The nature of life insurance business is to underwrite risks over a long period and requires insurers to firmly fulfil obligations to policyholders, instead of gaining profits through changes in fair value of financial assets and liabilities they hold. We think life insurers need to appropriately represent the nature of their business to users of the financial statements, and we are concerned that recognising in profit or loss 'unrealised gains and losses', such as changes in fair value of equity instruments held for a long period, would cause misunderstanding among the users. Therefore, even if the financial assets and insurance liabilities are presented at fair value in the statement of financial position, we believe that changes in fair value should not be recognised in profit or loss before realisation, but they should be recognised when realised in a way that ensures the consistency between the accounting for financial instruments and the accounting for insurance contract.

(Proposals for improvement of IFRS 9)

5. Accounting standards for financial assets that account for a large part of the assets of life insurers were issued as IFRS 9 *Financial Instruments (Classification and Measurement)* in November 2009. Under IFRS 9, although an entity is allowed to make an irrevocable election to present in other comprehensive income (OCI) subsequent changes in the fair value of an investment in an equity instrument that is not held for trading, the amounts presented in OCI shall not be subsequently recognised in profit or loss (i.e. recycling). We are concerned that without recycling, the nature of profit or loss would be changed. Accordingly, we would like to suggest that IFRS 9 be amended as follows in order to appropriately represent the nature of life insurance business:
  - For an equity instrument that is not held for trading, if an entity recognised subsequent changes in the fair value of the instrument in OCI, the entity shall be allowed to recognise

the amounts presented in OCI in profit or loss when realised.

- For a financial instrument that is not an equity instrument, it shall also be broadly allowed to recognise subsequent changes in the fair value of the instrument in OCI and then recognise the amounts in OCI in profit or loss when realised.
6. Although we understand that an impairment model needs to be revisited in order to make the above amendments to IFRS 9 *Classification and Measurement*, we believe that it would be unreasonable for the IASB not to start amending IFRS 9 because of the need for revisiting the impairment model.
7. In addition, in January 2011, the US Financial Accounting Standards Board (FASB) published an exposure draft that generally required the measurement of financial asset at fair value. But in response to the feedback received from constituents, the FASB has tentatively decided following points;
- To change the proposal to categorise financial assets into three categories (i.e. Fair Value-Net Income (FV-NI), Fair Value-Other Comprehensive Income (FV-OCI) and Amortised Cost) according to an entity's business strategy, and
  - To reaffirm its decision to recognise any realised gains and losses from sales of financial assets classified as FV-OCI in net income when such gains or losses are realised from sales or settlements.

In light of the discussion at the FASB, we believe that the IASB should redeliberate IFRS 9 *Classification and Measurement* so that constituents can have an opportunity to reiterate their comments to the IASB. In doing so, we hope that the IASB will achieve convergence with the FASB.

(Proposals for valuation of insurance contract liability)

8. In order to appropriately represent the nature of insurance business, 'to underwrite risks over a long period and to firmly fulfil obligations to policyholders', an entity should recognise subsequent changes in the fair value of the insurance liability in OCI and then recognise the amounts presented in OCI in profit or loss when realised, in a way that is consistent with the proposals for improvement we mentioned above. We believe that it would be useful for the users of financial statements to distinguish the comprehensive income which represents all gains and losses including unrealised gains and losses clearly from the profit or loss which represents the proper performance of an entity excluding unrealised gains and losses, and to disclose the two different measures.

## **1.2 Proposals for improvement to the proposed impairment model**

9. We think the approach to recognising credit losses proposed in this supplementary document has been improved practically compared to the approach proposed in the IASB's original exposure draft *Financial Instruments: Amortised Cost and Impairment*.
10. From a cost-benefit perspective, we believe that it would be reasonable for an entity to take the following approach: while placing financial assets which have no uncertainty about the collectibility into 'good book' and then recognise impairment allowance in a collective and simplified way, and placing financial assets which have uncertainty about the collectibility into

'bad book' and then recognise impairment allowance by conducting detailed due diligence on each assets.

(Concerns about the proposed impairment model)

11. As only those assets that have uncertainty in collectibility would raise concerns about the adequacy of the impairment allowance, we think that the financial assets placed into 'good book', i.e. assets which have no uncertainty about the collectibility should be treated in a simplified approach.
12. In this supplementary document, it is proposed that for 'good book', the expected credit losses would be recognised at the higher of the amount determined using two different approaches. However, we think this approach would result in making the model complicated and thus, there might be concerns that it would not only impose a practical burden on preparers but also reduce users' understandability. Therefore, we believe that these proposed approaches would not be appropriate for an impairment model.
13. Also, we believe that the time-proportional approach proposed in paragraph 2(a)(i) is inappropriate for the following reasons (Our specific concerns on this approach are set out in responses to Question 3):
  - It does not appropriately represent the nature of credit loss occurrence patterns.
  - It might differ from the nature of entities' risk management.
  - It might impose a practical burden including system developments on entities.

(Alternatives to the proposed impairment model)

14. In order to address above stated concerns, as for the 'good book', we would like to propose an alternative that recognises the impairment allowance only by 'credit losses expected to occur within the foreseeable future' proposed in paragraph 2(a)(ii) of this supplementary document. We believe that this alternative is appropriate for the impairment model for the 'good book' because of the following reasons:
  - This alternative would result in the improvement of incurred loss approach which tends to be too late to recognise the impairment, as it would enable an entity to recognise the expected credit losses earlier.
  - This alternative would be simpler than the impairment model proposed in this supplementary document and thus, more appropriate as an impairment model for the 'good book'.

## **2. Responses to the questions**

### **2.1 Question 2**

*Is the impairment model proposed in the supplementary document at least as operational for closed portfolios and other instruments as it is for open portfolios? Why or why not ?*

*Although the supplementary document seeks views on whether the proposed approach is suitable for open portfolios, the boards welcome any comments on its suitability for single assets and closed portfolios and also comments on how important it is to have a single impairment approach for all relevant financial assets.*

15. We would like to urge the boards to clarify the concepts of portfolios and books (i.e. the 'good book' and the 'bad book'). We are not able to comment on whether the impairment model proposed in this supplementary document could be applied to closed portfolios because the inclusion relation between portfolios and books is not clarified in the proposals.
16. If the two books are not included in a portfolio, as for closed portfolios, risk characteristics of assets included in the portfolios will change with the passage of time. Therefore, it will be difficult for an entity to identify whether it is the 'good book' or the 'bad book' in this case.

### **2.2 Question 3**

*Do you agree that for financial assets in the 'good book' it is appropriate to recognise the impairment allowance using the approach described above ? Why or why not?*

[(a) We do not agree with the proposal.]

17. In this supplementary document, it is proposed that for 'good book', expected credit losses would be recognised at the higher of the amount determined using two different approaches. However, as we stated in the General Opinions, we think this approach would result in making the model complicated and thus, it would not fit into our view that the 'good book' should be treated in a collective and simplified way.
18. Also, we believe that the time-proportional approach proposed in paragraph 2(a)(i) is inappropriate for the following reasons:
  - Under this approach, expected credit losses are to be allocated equally, but in actuality, the credit losses do not necessarily occur equally at each period. Therefore, there might be a concern that the amount allocated would differ from the actual losses.
  - If an entity has various financial instruments with same lives and same expected credit losses but with different ages in a portfolio, the entity would recognise different impairment allowance amounts for each financial instrument. Therefore, there would be a concern that this practice would differ from the nature of entities' risk management.
  - In introducing this approach, it would impose a practical burden including system developments on preparers of financial statements because they do not generally manage 'the age of portfolios'. In terms of 'the life of portfolios', this approach does not identify how to treat the lives of the financial instruments which originate portfolios if the instruments may be prepaid or extended.

(Alternatives to the proposed impairment model)

19. In order to address above stated concerns, as for the 'good book', we would like to propose an alternative that recognises the impairment allowance only by 'credit losses expected to occur within the foreseeable future' proposed in paragraph 2(a)(ii) of this supplementary document. We believe that this alternative is appropriate for the impairment model for the 'good book' because of the following reasons:

- This alternative would result in the improvement of incurred loss approach which tends to be too late to recognise the impairment, as it would enable an entity to recognise the expected credit losses earlier.
- This alternative would be simpler than the impairment model proposed in this supplementary document and thus, more appropriate as an impairment model for the 'good book'.

### **2.3 Question 4**

*Would the proposed approach to determining the impairment allowance on a time-proportional basis be operational? Why or why not?*

[We do not agree with the proposal.]

20. As we stated in the General Opinions and the responses to Question 3, the time-proportional approach proposed in this supplementary document has the following practical problem:

- In introducing this approach, it would impose a practical burden including system developments on preparers of financial statements because they do not generally manage 'the age of portfolios'. In terms of 'the life of portfolios', this approach does not identify how to treat the lives of the financial instruments which originate portfolios if the instruments may be prepaid or extended.

### **2.4 Question 5**

*Would the proposed approach provide information that is useful for decision-making? If not, how would you modify the proposal?*

[We do not agree with the proposal.]

21. As we stated in the General Opinions and the responses to Question 3, concerning the 'good book', we think an entity should recognise the impairment allowance only by 'credit losses expected to occur within the foreseeable future.' However, from a users' perspective, there is still a concern as below. In order to resolve this concern, we would like to urge the boards to consider supplementing the method for estimating credit losses by providing a guidance that identifies specific period (e.g. for one year or three years), which would not rely on a preparer's ability to forecast the loss amount to be recognised.

- As it is stated in paragraph B13, the development of the estimate of expected credit losses for the foreseeable future relies heavily on a preparer's ability to forecast. Therefore, the comparability of financial statements might be undermined in a situation where each preparer of financial statements recognises different amounts of credit losses for financial instruments even if they have similar risk characteristics.

## 2.5 Question 16Z

*Would the proposed requirements be operational if applied to loan commitments and financial guarantee contracts? Why or why not?*

22. At the Board meeting for the Insurance Contract project in March, the IASB tentatively decided to exclude financial guarantee contracts from the scope of the Insurance Contract project, and to retain the exception in IFRS 4. We support this tentative decision.

## 2.5 Question 18Z

*(a) Do you agree with the proposed disclosure requirements? If not, which disclosure requirements do you disagree with and why?*

*(b) What other disclosures would you prefer (whether in addition to or instead of the proposed disclosures) for the proposed impairment model and why?*

[We do not agree with the proposal.]

23. We would like to request the IASB to reconsider the followings for the proposed disclosure requirements:

- In this document, an entity is required to disclose the same level of information for both the 'good book' and the 'bad book'. However, we think that financial instruments are placed into the 'good book' because of the low probability of credit losses, thus, the entity does not need to disclose the same level of information for the 'good book' compared with the 'bad book.' We are in the view that this information would not necessarily result in the useful information for users of financial statements, and it would not be preferable for preparers of financial statements from a cost-benefit perspective. With that in mind, we would like to urge the IASB to reconsider the disclosure requirements so that an entity would be required to disclose only the information about the opening and closing balance rather than a reconciliation for the financial instruments placed in the 'good book'.
- Concerning the requirement to disclose the impairment allowance of financial instruments placed into the 'good book' for the previous four annual periods proposed in paragraph Z8, we would like to urge the IASB to reconsider the requirement because there is a concern that it would, for example, force preparers to manage detailed information on records of the past balance related to the portfolio and impose an excessive burden including system development on preparers. In particular, we are strongly concerned that it would impose a significant burden on preparers if the retrospective application is required at the first-time adoption.
- Concerning the disclosures of 'the entity's internal credit rating grades' proposed in paragraph Z15 (b)(i), (ii) and (c), and the disclosures of a 'watchlist' proposed in paragraph Z15 (b)(iii) and (d), there is a concern that these disclosures may include proprietary information which could leave the financial institutions at a competitive disadvantage. Besides, we are concerned about the fact that borrowers and investees are listed in the 'watchlist' may result in the disadvantageous information for their business. Therefore, we would like to request the IASB to reconsider the requirement so that the entity needs not to disclose this type of information.