EU - Japan Business Round Table
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Recommendations of the EU-Japan Business Round Table to the Leaders of the European Union and Japan

Rome, 28 & 29 April 2011

Working Party D
Financial Services, Accounting and Tax Issues

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List of Abbreviations

Abbreviation	**Meaning**

Recommendations to the EU and Japan

< Financial Services >

WP-D / #01 / EJ to EJ <u>Progress in the financial market reform since the financial crisis</u>

- In response to the global financial crisis, the G20 countries have agreed to the common principles for financial market reform, which are: (1) strengthening transparency and accountability, (2) enhancing sound regulation, (3) promoting integrity in financial markets, (4) reinforcing international cooperation, and (5) reforming international financial institutions. The G20 countries are now taking actions for their implementation. Since the G20 summit in November 2010 in Seoul, the process for these regulatory reforms has moved from the phase of the consideration to implementation.

- Specifically, under the G20 framework, the Basel Committee of Banking Supervision (BCBS) published the rule book for Basel III in December 2010, which stipulates the details for the banking regulation and which is to be implemented internationally. Each country shall carry out procedures in preparing its domestic rules as the next phase for application of Basel III starting from January 2013.

- Regarding Systemically Important Financial Institutions (SIFIs), the concrete regulations for SIFIs are now being built at the global level following the adoption of the proposal by the Financial Stability Board (FSB) at the G20 summit in Seoul. Global SIFIs (G-SIFIs) will be specified in 2011. In consideration that G-SIFIs are not only large in scale but also considered to be important in the markets and to have significant impact on society and the economy as a whole, G-SIFIs will be required to have higher capacity for loss absorptions than other institutions, and the framework for those orderly resolutions will be built.

  We agree in general that these financial reforms will stabilize the financial system and enhance the transparency and accountability of financial institutions, financial markets, and financial products, while ensuring their fairness and integrity. The stabilization of financial markets and the financial system is important for market users including companies that raise capital.

- However, given that measuring systemic risks is very difficult and the acquisition of consistent data across countries and industries would be difficult as well, **the criteria (or benchmarks) to measure the "SIFIness" should be cautiously set out.** In addition, when the FSB specifies SIFIs it would need to mitigate moral hazard and to avoid an excessively politicized process. **Considerations of financial reforms with systemic risks should be delivered through the framework of comprehensive and macro-prudential supervision.**

WP-D / # 02 / EJ to EJ Issues to be mindful of when proceeding with reform

- We shall, at the same time, point out that there are several issues we should bear in mind as we proceed with regulatory reform. Innovation and appropriate risk appetite are important and necessary for financial actors to perform their role of financing economic growth. **A careful balance must be struck between innovativeness, risk appetite and regulation.** Also we should bear in mind that strengthening the regulation on large financial institutions could result in distorting the conditions for a level playing field and could end up creating “too-big-to-fail” institutions.

- **One must not give in to the temptation of a “one size fits all” solution.** The new regulatory framework should take into account the circumstances that are specific to each country and/or the variety of financial players, and respect their business models and their time horizons. The different economics of financial activities should be appropriately reflected in the new regulatory regimes. Failing to do so would lead to herd behaviour and heightened volatility rather than to stability and transparency.

- We also have to recognize that maintaining liquidity in the secondary market is important. One of the most serious problems in the financial crisis was the lack of liquidity in the secondary market. Although regulatory reform should move forward in order to prevent the next financial crisis, **we also have to be mindful of preventing a lack of liquidity in the secondary market.** Asian countries are expected to be the driver of economic growth after the financial crisis. In these countries, the role of capital markets is still limited and their financial system is still based on the traditional banking system. If low liquidity in the secondary market and credit restraint due to the capital requirements for banks should happen in such countries, corporate finance could face constraints from both the capital market and the banking system, and this could result in a negative impact on economic activities and growth.

- Even though the financial industry is one of the most globalized industries, **we should still bear in mind that regulation and practices vary greatly from country to country, particularly for small and mid-sized financial institutions.**

- According to “Basel III”, investments in the capital instruments of banking, financial and insurance entities would be deducted. However, for countries where reciprocal cross holdings in the capital between financial institutions are prevalent, sensitive handling such as giving an adequate transition period would be necessary. And **regulatory capital instruments such as contingent capital or debt instruments with bail-in clauses designed by financial regulatory authorities need to be introduced with sufficient consideration for market**

capacity. Furthermore tightening regulation on shadow banking, led by the FSB, needs to fully consider the role of the shadow banks to the real economy and to take measures not to disturb bona fide business activities.

- **When regulation is discussed in the global context, the characteristics of each country and region should be fully considered.** We believe that we should build harmonized regulations through multilateral discussions on a global basis. Among other things, we should take fully into account the impact on the economy and the outcome of the combined impact of several individual regulations when they are concurrently implemented.

<Accounting>

WP-D / # 03 / EJ to EJ **<u>Accounting Issues in EU and Japan</u>**

- Working Party D (previously Working Party 2) has recommended enhancement of the governance of the accounting standard setting bodies and the convergence of accounting standards. The Financial Stability Board (FSB) is going to undertake a strategic review of the policy development work of international standard setting bodies, and the IASB has established an external Monitoring Board, members of which include the International Organization of Securities Commissions (IOSCO), the European Commission, the US Securities and Exchange Commission, and Japan's Financial Services Agency. In addition, IASB and FASB have established the Financial Crisis Advisory Group (FCAG), which is comprised of senior leaders with broad international experience in financial markets. FCAG will advise the IASB and FASB on the standard-setting implications of the global financial crisis and on potential changes to the global regulatory environment. Since its inception, FCAG has announced a wide-ranged report on the activities of the Accounting Standard Board. We support these trends and look forward to further developments. We also support the progress towards the introduction of IFRS in Japan and look forward to further discussions on convergence.

- While the purpose of financial accounting is to provide financial information to a company's outside stakeholders such as shareholders and creditors, we strongly point out that the view of a company's management is also important when setting standards. Changes in accounting standards have impact on corporate activities and thus on the economy. We believe that net income with a recycling arrangement is useful as accounting information. Accounting costs affect the behaviour of enterprises. If items not recycled such as actuarial gains and losses in pension accounting are expanded, and thus profit and loss not reflected in net income are expanded too, we are concerned that underlying business activities such as cost management and selling price formation could be disrupted.

- IASB is in the process of revising its financial instrument accounting standard and we support the approach to recognize the net unrealized gain on available-for-sale securities as other comprehensive income (OCI). However, **it is also proposed that if the net unrealized gain is recognized as OCI, the dividend is recognized as net income but the realized gain is recognized as OCI, not as net income. We cannot agree with this approach.**

- Net realized income has been described by some as a kind of income manipulation. We believe, however, that management is able to send out its message by the sale of the securities. Thus, recognizing the net realized income as net income gives more useful accounting information. For example, on the measurement of assets and liability in insurance companies which IASB calls one of its priority projects, assets held by insurers are managed consistently with the asset liability management and the risk management of the company in order to back insurance liabilities and to meet insurers' commitments toward policyholders and not in the interest only of the shareholders (and so not for "managing earnings" over time). Furthermore, the removing of the available for sale (AFS) category is inconsistent with the business model approach on which IFRS 9 is based: the long term business model of insurance should be recognized through the AFS.

- As part of the process to strengthen immediate recognition in the accounting standards of employee benefits, the actuarial gains and losses may be recognized immediately upon accrual as OCI. The immediate recognition of actuarial gains or losses coming from short term financial market fluctuations could cause pension plans, which are long term promises between employers and participants, to give excessive fluctuation to net income. **We support the approach to recognize actuarial gains and losses as OCI and not as net income.** On the other hand, **we believe actuarial gains and losses should be recycled** for the above-mentioned reason.

- **We ask IASB to discuss revenue recognition criteria with careful consideration of the actual business practices in countries around the world.** It is necessary to recognize the possibility that changing the accounting standards would affect business practices. We believe that already-established accounting practices should not be overruled unless the accounting standard reform is truly necessary, such as when concrete problems that may hinder investor's decision-making already exist.

- The IASB and the FASB published the exposure draft (ED) in August 2010 in which they proposed drastic revisions. The exposure draft proposes a single model for operating and finance leases by eliminating separate treatments. However, **we point out that this rule that treat operating and finance leases together has quite a few challenges** since there is plenty of room for arbitrariness in that it is necessary to carry operating leases on the balance sheet and to revaluate the estimate of the leasing period or variable lease fees regularly. **We call for an application that adequately reflects business practices.** Moreover, if the leasing accounting standard is applied to the entire contracts in the case in which the contracts of leases and services are not separable, even elements other than utilization rights of an underlying asset, such as "services offered to help an original asset work appropriately" or " added value offered through the transaction concerned" would need to be recorded on the balance sheet. These elements might not only be corresponding to the definition of the lease, but also could lead to the transformation of the concept of the asset and the liability of financial statements of such an element. We request accounting treatment that reflects the business realities appropriately.

- With regards to the IASB' s financial statement presentation project, in addition to OCI issues and the removing of the two separate statements (income statement and statement of comprehensive income), **we are concerned about the requirement for the use of direct method in cash flow statement.** Users of financial statements are able to acquire sufficient useful information from disclosures with the indirect method. Based on the fact that companies will incur large amounts of costs, we do not see any overriding benefit coming from the requirement of direct method.

<Tax >

WP-D / #04 / EJ to EJ **<u>Tax Issues in the EU and Japan</u>**

- The governments of Japan and Europe should ensure that dividend payments from subsidiaries to parent companies and royalty and interest payments between related parties are, to the greatest possible extent, exempted from withholding taxes in the source country. While there have been some improvements with respect to the dividend taxation between Japan and some EU member countries, we believe that the removal of double taxation is still an important issue, and we hope that all the EU Member States and Japan will conclude tax treaties. In order to reduce the risk of economic double taxation, furthermore, it is important to ensure an arena for wide-ranging dialogues between the tax authorities. **In particular, as seen in the recently revised Japan - Holland Tax Treaty, they should introduce clauses that will enable corresponding adjustments and arbitration in tax treaties.** In addition, **they should harmonise and simplify documentary requirements in transfer pricing taxation** and promote and facilitate the conclusion of bilateral and multilateral APAs.

- With the progress of convergence of Accounting Standards, **new deviations arise between corporate accounting and tax practice. We ask that the Governments of Japan and Europe respond flexibly to the deviations.**

- When companies conduct their businesses on a global basis, transparent and fair taxation in countries are extremely important. If the taxation on some specific industry or sector is introduced, it could distort resource allocation and damage the sound growth of companies and economies. **We hope that transparent and fair tax reform and implementation are continued.**

- Participation exemption, by which dividends and capital gains received from business investment are exempted from further corporate taxation, is one measure to encourage mutual direct investment. **The authorities of the EU and Japan should consider introducing participation exemption and exempt dividends and capital gains received from business investment from further corporate taxation.**

Recommendations only to Japan

<Financial Services>

WP-D / # 05 / EJ to J **Financial Service Issues in Japan**

- The Japanese Government changed its Postal privatization policy and announced a policy that would allow its entry into new business areas under special, privileged regulation, while the government share ownership is maintained, and financial institutions in EU and Japan have expressed strong concerns. **We believe that new product development and business expansion, as well as the lifting or abolishment of the limit on both postal savings amounts and insurance, should not be implemented until a level playing field is established.** In addition, it is necessary to establish procedures with transparency and to involve a constructive discussion through the reform process.

  FSA has deregulated insurance sales through banks, and consumer convenience is improving. However, there are still some regulations to avoid banks' "pressure sales". For example, small- to medium-sized corporate clients who have a loan or even larger corporations borrowing from a regional bank cannot purchase insurance products through their lender bank. The regulation will be reviewed this year, and **the regulatory reform should be discussed for further enhancement of consumer convenience, while paying attention to the protection of consumers' interests.**

- We believe that a rapid recovery from Great East Japan Earthquake is and should be a top priority. The Government of Japan has shown unprecedented coordination among agencies in dealing with foreign businesses in a flexible way during this emergency and we hope that will continue. At the same time, due consideration should be given to soundness of fair market competition while the Japanese government provides support to enterprises that were seriously hit by the disaster. Furthermore, the stability of the secondary market for bonds or restraint of inflation should be cautiously considered when the Japanese government raises funds for revival, such as through the issuance of government bonds.

<Accounting>

WP-D / # 06 / EJ to J **Accounting Issues in Japan**

- Under IFRS, compensated absences are recognized as a liability. However, **since the reserve for compensated absences has never been recorded in Japan and such requirement could have a relatively heavy impact, we believe prudent discussion should be held.**

- Under IFRS, income is classified into "net income" and "other comprehensive income." We request organizing the concept of a profit and the range of recycling in the early stage. In particular, "net income" is regarded as the basis of performance indicators in

Japan and compatibility between the Companies Act and the Tax Code is secured. Therefore, **the conventional treatment for recycling should be maintained even after the convergence of Japanese standards to IFRS advances.**

<Tax>

WP-D / #07 / EJ to J **Tax Issues in Japan**

- In order for companies to carry out international business expansion smoothly, **we ask the tax administration of Japan to review its transfer-price taxation based on an international common model such as the OECD model, and to secure further transparency in its implementation.**

- We request the Japanese government to consider further reducing corporation tax rates. We support the proposal of the government stated in Proposed 2011 Tax Reform of December 2010 to reduce effective corporation tax rate by 5%-point from the current 40%, which is the highest level throughout the world. However, while many countries are accelerating the reduction of effective corporation tax rates, **Japan should lower its corporation tax rate even further to the international equivalent of around 30%** in order to ensure Japanese companies' international competitiveness and also to stimulate investments from home and abroad.
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- As Japanese society ages, Japanese individuals in the workforce will need to invest and accumulate more assets for retirement. The role of private sector insurance will be more important in such fields as medical (hospital), long term care and pension insurance. **We ask the Japanese tax authority to continue to expand tax breaks to encourage the development of individual preparation for retirement.**

Recommendations only to the EU

<Financial Services>

WP-D / #08 / EJ to E **<u>Solvency margin regulation</u>**

- Under the prudential regulation for insurers in the EU, the Solvency II to be introduced in January 2013, EIOPA (European Insurance and Occupational Pensions Authority) is now engaging in equivalence assessments between third-country regulatory and supervisory regimes and the Solvency II Directive. As Japan is included in the first wave under one part of this process (Reinsurance – Article 172), we have been working together with Japan's FSA, and have provided evidence and comments as requested by EIOPA.

- We are confident that the regulatory environment for insurers and insurance groups in Japan is on a par with that in the EU. **We shall therefore point out that it is of utmost importance for Japan to receive a positive equivalence determination from EIOPA** and then not be disadvantaged by duplicative regulations, such as the pledging of assets to cover unearned premiums and outstanding claims between the home country and the host country. Also, we add that the whole assessment procedure which is expected to take until 2015 should be conducted in a constructive manner.

<Tax>

WP-D / #09 / EJ to E **<u>Tax Issues in the EU</u>**

- It is extremely important to maintain a transparent and fair tax system in each country when the enterprises develop their business globally. Introduction of tax regulation focusing on specific industry or category of business, such as a Bank Tax, would pose a distortion of resource distribution and damage the sound development of enterprises and the economy. **We ask the EU and the Member States not to introduce the tax regulation which foreseeability would lead to distortion of economic activities in the private sector.**

- Many Japanese companies in the EU are implementing integration and rationalization of their European business organizations. Examples are the centralization of such functions as sales support and accounting. The relation between intra-group transactions and taxation is an important element in decision making in a business. **We ask the EU and the Member States to establish a tax system that will enable companies conducting business in the EU to enjoy the benefit of the Single Market to its full extent.** In particular,we request to achieve the following:

- We welcome the proposal for a Council Directive on a CCCTB (Common Consolidated Corporate Tax Base) proposed on 16 March. **In a common consolidated corporate tax base, non-taxation of unrealised gains on goodwill within a group of companies that form a CCCTB,non-application of the arms-length principle within a group of companies that form a CCCTB and the off-setting of profits and losses within a group of companies that form a CCCTB should be realised.**

- As for amendment of the Merger Directive (Directive 90/434/EEC), **we request to extend the scope to cover the transfer of real estate and other intangible assets in reorganisation and to abolish the requirements in certain Member States to maintain the holding of shares received in exchange of contributed assets for a specified of years.**

- Transfer Pricing;To provide sufficient incentive for compliance with the EU TPD, **the EU and the Member States should commit themselves to exemption from penalties** (i.e. penalties related to non-compliance with documentation requirements, penalties related to transfer pricing adjustments and interest related to adjustments) **if a company submits an EU TPD acting in good faith and in a timely manner.**

- VAT:Although the VAT system is a common system in the EU, Member States have certain discretion in it. Presently, therefore, the centralisation of VAT administration carries a high financial risk. **The EU should go further in the simplification and harmonisation of the VAT system so that companies with Europe-wide businesses could centralise VAT accounting in a cost-effective manner.**