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Sir David Tweedie
Chairman
International Accounting Standards Board
First Floor, 30 Cannon Street
London EC4M 6XH
UNITED KINGDOM

Dear Sir David

Exposure Draft ED/2009/12 Financial Instruments: Amortised Cost and Impairment

Thank you for the opportunity to comment on this exposure draft. Australia and New Zealand Banking Group Limited (ANZ) is listed on the Australian Stock Exchange and remains one of a select group of banks who continue to be AA rated. Our operations are predominantly based in Australia, New Zealand and Asia and our most recent annual results reported profits of USD2.6 billion and total assets of USD419 billion.

We note that the methodology proposed in the exposure draft has not substantially changed from the proposals set out in the Request for Information: Impairment of Financial Assets – Expected Cash Flow Approach and as such we reiterate the concerns detailed in our submission dated 31 August 2009.

Our observations in relation to the proposed approach are as follows:

Improvements

- Expected loss is a conceptual improvement from the incurred loss model and it is more easily understood and consistent with the way credit risk is managed, assessed and priced within ANZ.
- Achieves greater alignment with provisioning requirements under Basel II Advanced Internal Ratings Based approach.

Concerns

- The proposed approach does not address the critical concern that provisioning is pro-cyclical and does not facilitate the establishment of provisions to draw upon through the economic cycle.
- The examples provided using the EIR method are complex and suffer from some methodological challenges related to the use of IRR.
- For some portfolios, in particular retail loans, expectations of credit losses are updated continuously in accordance with Basel II pooling methods. The example provided suggests that adjustments would only be made when expectation changes, for example with a corporate loan regrading. The example provided may imply that changes in expectations are to be only discrete events.

- The proposed approach is not consistent with the approach proposed by the US Financial Accounting Standards Board and therefore does not assist in providing global convergence.
- The disclosure requirements in this exposure draft together with a raft of current and pending changes to other accounting standards result in adding length and complexity to financial statements at the expense of making them valuable to everyday users of financial statements. In particular, the disclosure requirements with respect to disaggregation of changes in expected loss estimates and stress testing will require significant system changes and may reduce the useability and comparability of financial statements.
- The trigger events for recognising gains or losses on changes in expectation of credit losses are not clearly defined and therefore subject to interpretation which may limit comparability.

In summary, whilst we are generally supportive of the principles of an expected loss methodology we do not support the proposed change to the accounting model, given the cost of implementation of an approach that we do not believe will substantially change the level of provisions, nor address important pro-cyclical concerns. We do believe that modifications to the current methodology are possible which would allow for the implementation of this provisioning philosophy in a more practical manner.

Should you have any queries on our comments, please feel free to contact me at Rob.Goss@anz.com.

Yours sincerely

Robert Goss

ROB GOSS
Group Finance, Head of Accounting Policy, Governance and Compliance

Copy: Australian Accounting Standards Board (AASB)

Appendix A

Question 1 - Is the description of the objective of amortised cost measurement in the exposure draft clear? If not, how would you describe the objective and why?

No. The objectives described combine the concept of expected returns with the consideration paid for the asset. This effectively introduces a new concept of amortised cost which is inconsistent with the concept used in the remainder of the framework, for example property, plant and equipment. The requirement to capitalise changes in loss expectations means that the amortised cost measure in this exposure draft is more akin to a defacto fair value, absent the impact of changes in credit spreads.

Question 2 - Do you believe that the objective of amortised cost set out in the exposure draft is appropriate for that measurement category? If not, why? What objective would you propose and why?

No. The inclusion of expected credit losses in the amortised cost of a financial asset and disclosure of the initial estimate of this within the Net Interest Margin (NIM) will lead to confusion by the users of our accounts as NIM is a key metric for a financial institution and currently well understood.

In addition, the inclusion in the amortised cost of a financial instrument of only the initial estimate of expected credit losses is inconsistent with the treatment of changes in expectations of those credit losses as it is currently proposed that these are not amortised over the remaining life of the instrument. This requirement to recognise initial loss expectations over the life of the instrument and changes in loss expectations immediately results in a carrying value which has no intuitive meaning to users of financial statements.

Question 3 - Do you agree with the way that the exposure draft is drafted, which emphasises measurement principles accompanied by application guidance but which does not include implementation guidance or illustrative examples? If not, why? How would you prefer the standard to be drafted instead, and why?

Yes. Whilst we disagree with the measurement principles, we believe that the emphasis on these principles supported by appropriate guidance is appropriate and leads to a user friendly standard.

Furthermore, whilst the current application guidance and basis of conclusion are useful we believe that the complexity of the measurement methodology and the practical implementation challenges would be enhanced by further guidance, including illustrative examples of how the approach would work, for example, credit cards, other retail and standardised Basel asset class loans and variable rate loans.

We also believe that further guidance on what is considered to be a change due to estimates of credit losses is required to ensure consistent application. For example:

- it is illogical to reflect a change in interest rates on floating rate loans as a change in our expectation of credit losses; and
- rating change expectations that attach to a loan reflect the term structure of defaults forward from the balance date, and not from the date of origination (as is required by the standard).

Question 4 (a) - Do you agree with the measurement principles set out in the exposure draft? If not, which of the measurement principles do you disagree with and why?

No. Whilst we support the introduction of an expected loss methodology for the measurement of credit losses, we do not believe that the measurement of expected losses on an EIR basis and the inclusion of these expected credit losses in the amortised cost of a financial asset is appropriate as this is inconsistent with the management of a financial instruments yield and credit losses in a financial institution.

The proposed methodology also has significant limitations when applied to open portfolios.

In addition, the principal that requires gains and losses from changes in credit loss expectations to be recognised immediately when estimated rather than amortised over the remaining life of the financial instrument, appears inconsistent with the objective of measuring amortised cost to create a distribution of yield that reflects the returns on an instrument over its life. We would therefore recommend that such changes be recognised over the remaining expected life of the impacted portfolio/asset and a balance sheet adequacy measure be introduced into the standard to complement this.

Question 4 (b) - Are there any other measurement principles that should be added? If so, what are they and why should they be added?

Yes. We believe that rather than focussing solely on the EIR method that guidance be provided on acceptable criteria against which individual banks can adapt their internal modelling methods applicable for a range of solutions and further examples be provided. This would potentially accommodate a range of bank practices and allow for simplification where the results are not materially different from an EIR approach.

We believe that any approach adopted should differentiate between the credit loss allowance required for a "good" book and "bad" book. This is consistent with regulatory requirements and the way risk is managed internally.

The loan loss allowance on the bad book could be based on a net present value approach or based on expected losses over the remaining life of the loan (ELL). The loan loss allowance would be reassessed periodically with any changes in the ELL booked in the current period.

For the calculation of any loan loss allowance on the good book, we understand that there are a number of alternative approaches being considered and developed to assist with the practical implementation of the IASB proposals. We would support the review of these alternative models by the IASB and would welcome the opportunity to provide feedback on any alternative approaches being considered by the board and staff and the opportunity to provide feedback on a re-exposure of the standard prior to its finalisation.

We believe that there is considerable merit in the Strawman approach that has been tabled for consideration and discussion by the EAP. We believe that produces a sensible profit and loss charge over the life of the loan portfolio and in addition provides measures to assess balance sheet adequacy which address the "too little, too late" concerns inherent in the current incurred loss methodology.

In addition it can be applied to both simple and complex loan portfolios which include open and closed pools.

The feasibility of the proposed method and any alternatives considered are dependant upon the system capability to produce discounted cash flow data and for the organisations without this capability the proposed changes represent a significant impost.

Question 5
(a) Is the description of the objective of presentation and disclosure in relation to financial instruments measured at amortised cost in the exposure draft clear? If not, how would you describe the objective and why?
(b) Do you believe that the objective of presentation and disclosure in relation to financial instruments measured at amortised cost set out in the exposure draft is appropriate? If not, why? What objective would you propose and why?

Yes we believe the objectives are clear however we do not believe these are met by the presentation and disclosure requirements detailed in the proposal.

Question 6 - Do you agree with the proposed presentation requirements? If not, why? What presentation would you prefer instead and why?

We are not supportive of the proposal to separate the disclosure of initial expected credit losses and gains or losses resulting from changes in estimates. We believe that it is important to present these items together provide users with an understanding of the credit loss included in the results. We consider this separation to be arbitrary and potentially subject to variation in application amongst preparers of financial statements which would ultimately be at the expense of financial statement comparability.

Furthermore we do not support the inclusion of initial expected credit loss expense within interest revenue as we believe that this will lead to confusion amongst users who currently have a good understanding of Net Interest Margin (NIM).

Question 7
(a) Do you agree with the proposed disclosure requirements? If not, what disclosure requirement do you disagree with and why?
(b) What other disclosures would you prefer (whether in addition to or instead of the proposed disclosures) and why?

No. We believe that the quantity and complexity of the disclosures detailed will reduce the useability and comparability of the financial statements and users will not be able to fully understand the credit quality of financial instruments and the effect of these on the result of an entity.

IAS7 and Pillar III already provide an existing framework for significant disclosures covering how an entity measures risk, including detailed requirements with respect to credit risk and as such we believe that additional disclosures with respect to credit risk are not required and will only serve to confuse everyday users if financial statements.

We consider this to be another example of the disclosure overload which is being introduced by a number of current and pending changes to accounting standards. Whilst we are fundamentally in favour of succinct transparent disclosures, the current practice of adding disclosures with every new or revised accounting standard adds length and complexity to financial statements at the expense of making them valuable to everyday users of financial statements. This disclosure agenda seems to have been driven by an argument that such information is requested by analysts. We believe that such an approach is inappropriate as it elevates the needs of one select group of users at the expense of others users who we believe need shorter simpler financial statements and are currently turning to shareholder reviews and other similar short form documents.

In particular, we have concerns with the following disclosure requirements:

- Disaggregation of gains & losses into amounts attributable to changes in estimates of credit losses and those attributable to other factors

  We do not believe that credit losses should be impacted by the amounts attributable to other factors eg. changes in interest and prepayment rates and we believe that the inclusion of these amounts with gains or losses due to changes in estimates of credit losses limits the ability of users to fully understand the credit quality of financial instruments and the effect of these on the result of an entity.

  Furthermore the impacts of these changes would be complex to separately identify and capture in systems and therefore impractical to include.

- Origination and maturity (vintage) information

  Financial institutions do not manage credit loss risks by year of origination or vintage, instead assets are managed in open portfolio by similar credit rating. Nor is there any current regulatory requirement to report credit information by vintage which again reinforces the notion that it is not relevant to understanding the credit quality of the book. Hence, year of origination disclosures do not enable users of financial statements to evaluate the quality of financial assets including credit risk. This is an especially onerous disclosure requirement which will require significant systems changes to achieve compliance.

- Stress testing

  Under the current proposals, if an entity performs stress testing for internal risk management purposes, it must disclose this fact together with the implications on the financial position and performance of the entity. Credit risk is an input into a range of stress tests we perform as a financial institution, it is unclear whether we would be required to disclose all of these results (eg. market risk, liquidity risk etc.) and what relevance this would have to the objectives of this exposure draft.

  This may limit comparability as the absence of these disclosures in organisations that do not perform stress testing may be misleading when compared to disclosures of an organisation that performs this testing. For example, Australian Financial Institutions are required, by regulators, to perform "catastrophic" stress testing. Disclosure of the results of such testing could mislead users of the accounts.

Question 8 - Would a mandatory effective date of about three years after the date of issue of the IFRS allow sufficient lead-time for implementing the proposed requirements? If not, what would be an appropriate lead-time and why?

The current proposal requires an opening balance sheet adjustment for the earliest period for which comparative amounts are disclosed and furthermore requires an approximation of the effective interest rate (as calculated under the current proposal) for all financial instruments measured at amortised cost that were recognised before the date of initial application of this standard. Given the complexity of the method currently proposed and the, the system changes required to implement this methodology and the detail required in the disclosures, we do not believe that a three year period will be sufficient.

We therefore believe that a four year period between issue and mandatory adoption would be more appropriate.

Question 9
(a) Do you agree with the proposed transition requirements? If not, why? What transition approach would you propose instead and why?
(b) Would you prefer the alternative transition approach (described above in the summary of the transition requirements)? If so, why?
(c) Do you agree that comparative information should be restated to reflect the proposed requirements? If not, what would you prefer instead and why? If you believe that the requirement to restate comparative information would affect lead-time (see Question 8) please describe why and to what extent.

The proposed transition requirements are appropriate and in theory we would support the requirement to disclose comparative information using the measurement principals in the standard however this would require a significantly longer transition period due to the system changes required to implement this methodology and the detail required in the disclosure.

If we weren't required to include comparative disclosures this would ease the transition process, reduce the overall cost of adopting the standard and assist in making a three year transition period more practical and achievable.

Question 10 - Do you agree with the proposed disclosure requirement in relation to transition? If not, what would you propose instead and why?

Yes. We believe that the qualitative nature of the disclosures in relation to transition impacts are appropriate.

Question 11 - Do you agree that the proposed guidance on practical expedients is appropriate? If not, why? What would you propose instead and why?

Question 12 - Do you believe additional guidance on practical expedients should be provided? If so, what guidance would you propose and why? How closely do you think any additional practical expedients would approximate the outcome that would result from the proposed requirements, and what is the basis for your assessment?

As noted at Question 3, we would support the inclusion of further illustrative guidance and examples on the application of the practical expedients.

If the current proposal is implemented, we would support practical expedients that allow for the following approach.

For corporate Basel asset class loans the use of an annuity approach. Whilst this is a different mechanical approach we believe that it achieves the same outcome. In summary this approach:

- Takes the present value of promised cash flows less present value of expected (default adjusted) cash flows
- Converts this to stream of annualised annuity payments that earns an exogenous rate of return
- Deducts the annuity from income and add to loan loss allowance
- The discount rate based on long run return on assets as this would capture the time value of money cost

For retail and standardised Basel asset class loans where the expected loss attaches to a homogenous pool or for loans with maturities less than 12 months, we believe that the use of an annual loss rate with allowance for expected growth over the average maturity would be materially consistent with the use of an EIR approach.