



30 November 2010

Sir David Tweedie
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sir David

Exposure Draft ED/2010/8: Insurance Contracts

Thank you for the opportunity to comment on the Exposure Draft (ED). Australia and New Zealand Banking Group Limited (ANZ) is listed on the Australian Securities Exchange and remains one of a select group of banks who continue to be AA rated. Our operations are predominately based in Australia, New Zealand and Asia and our most recent annual results reported profits before tax of A\$6.6 billion and total assets of A\$532 billion.

Summary

We agree with the Boards' objective to establish a single principle based standard for recognising and measuring insurance contracts. Generally we are supportive of the proposals contained within the ED, however there are some specific areas of the ED that we do not agree with, or areas where we believe the ED could be improved. These concerns and recommendations for improvement are outlined below.

Residual margin

The residual margin largely represents expected profits. We do not believe that it is appropriate to lock-in the expected profit in a current value model. We believe that the residual margin should be remeasured because a locked-in margin would create spurious volatility. For example, a reassessment of the fulfilment cash flows might indicate that the contract is expected to remain profitable, however, the expected profits are reduced. Under the proposed model a loss will be recognised in the profit and loss for the change in assumptions, but the residual margin will remain unchanged and will continue to run off as before.

The expected underwriting profit will emerge over the life of the contract, however at inception the premiums that will be received will be subject to contractual restraints and the acquisition costs will have been incurred. The claims or benefits payments will, therefore, largely drive the ultimate underwriting profit. As the insurer's estimate of claims and benefits changes so the expected profit changes. In our view, therefore, any changes to the expected cash flows and risk adjustment (subject to the two exceptions below) should be recognised as a corresponding adjustment to the residual margin. The residual margin should then be released according to profit drivers. For some contracts this might be premiums and for others it might be claims. The two exceptions would be experience adjustments which should be reflected in profit and loss, as any gain or loss would have crystallised, and changes in economic assumptions would also be reflected in profit and loss as these will largely be offset by changes in the fair value of the assets backing insurance liabilities. The approach described above is the approach adopted under the Margin on Services Model (MoS) for life insurance contracts in Australia, the key difference being that the ED requires a risk adjustment to be recognised in addition to the expected cash flows. We regard this as a positive improvement to the MoS model as under the Australian requirements, the residual margin could be completely

eliminated and the liability will then reflect expected cash flows only with no additional allowance for risk.

Risk adjustment

We do not support the ED's proposal that the risk adjustment shall not reflect the effects of diversification between portfolios of insurance contracts. We believe that the risk adjustment should reflect the effects of diversification between portfolios. Conceptually, actuaries would argue that a risk adjustment can only be determined at the entity level because of the impact of diversification. The fulfilment model proposed in the ED is entity-specific, and different insurers have a different cost of risk. A single-line insurer has a different cost of risk to an insurer that issues similar contracts but as part of a wider package of products. In determining the fulfilment cash flows, therefore, it is appropriate to reflect the diversification benefits that exist and that are expected in the ultimate cash flows.

Diversification is fundamental to the business of insurance. An insurer is able to offer an insurance product because it diversifies the risk of one policyholder across a pool of policyholders. We note that the Australian accounting standard for non-life contracts allows insurers to recognise diversification benefits. The Australian regulator also allows insurers to reflect the benefits of diversification in determining insurance liabilities for regulatory purposes that Solvency II will allow diversification to the legal entity level.

Financial guarantees

We do not support the inclusion of financial guarantee contracts within the scope of the ED and believe these contracts should be accounted for under IAS 39. For a bank, a financial guarantee contract is akin to a loan or credit facility. In pricing the contract the bank considers the credit risk of its customer. In considering impairment, a bank will assess its overall credit exposure to a particular customer through loans, guarantees and credit facilities.

The ED, by requiring financial guarantees to be accounted for as insurance contracts, is implicitly suggesting that a financial guarantee is no different to a credit insurance contract. We would argue that the economic substance of the arrangements is quite different. In a credit insurance arrangement the insurer has a contract with the policyholder and the policyholder has a contract/s with its debtor/s.

In a financial guarantee arrangement a 'triangle' exists:

1. the insurer (the bank) has a contract with the debtor (its customer);
2. the debtor (the customer) has a contract with the policyholder (the third party); and
3. the insurer (the bank) has a contract with the policyholder (the third party) – the financial guarantee.

From the perspective of the bank, the financial guarantee contract is secondary to the underlying relationship between the bank and its customer. The financial guarantee contract would not exist were it not for the contract between the bank and its customer. In addition, the financial guarantee contract facilitates the contract between the customer and the third party.

We believe that where a guarantee is issued to a third party in relation to a bank's customer that the ED should 'look through' the guarantee arrangement and consider whether the arrangement is in substance primarily a financing transaction between the bank and its customer, rather than an insurance contract between the bank and the third party. Where the arrangement is primarily a financing arrangement we believe the contract should be treated under IAS 39.

We note that other contracts that meet the definition of an insurance contract are scoped out of the ED, in particular certain warranty contracts. Given this precedent, and our arguments

outlined above, we believe it would be appropriate to exclude financial guarantee contracts from the scope of the final insurance standard.

If the current proposals are carried forward into the final standard, we believe that the final IFRS should provide guidance which clarifies whether certain contracts meet the definition of an insurance contract. ANZ issues financial guarantee contracts that require it to settle the guarantee, on presentation "without regard to the performance or non-performance of the customer or third party" under the terms of the underlying contract or agreement. In our opinion such contracts do not meet the definition of an insurance contract because there is no requirement for the policyholder to have suffered a loss as a result of an adverse event. We believe that the final IFRS should provide guidance that addresses such contracts.

Acquisition costs

We believe the final standard should include acquisition costs incremental at the portfolio level in the initial measurement of the insurance contract as this would mitigate:

1. the lack of consistency between insurers depending upon their distribution model, and
2. different patterns of profit emergence for the same product, and between products, for an insurer that uses a variety of distribution models.

The current acquisition cost proposals will create spurious profit emergence under insurance contracts as the residual margin will be directly impacted by the extent of the acquisition costs recognised as part of the cash flows.

We are also concerned by the inconsistency between the ED's approach and the treatment of acquisition costs relating to investment contracts under the revenue recognition ED and the opportunities for accounting arbitrage that will exist. We believe that the IASB should consider the treatment of acquisition costs in relation to investment contracts under the revenue recognition ED as a matter of urgency.

Unit of account

We believe the current proposals create significant practical difficulties and complexity because of the different units of account that are applied to different components of the overall model:

1. acquisition costs are determined at the contract level;
2. the residual margin is determined at the level of 'time cohorts'; and
3. the risk adjustment and cash flows are determined at the portfolio level.

We believe that all components of the measurement model should be determined at the portfolio level (this is the approach adopted under AASB 1038 Life Insurance Contracts):

1. whilst conceptually we consider the risk adjustment is determined at an entity level, for practical reasons, we believe it is appropriate to determine risk adjustments at a portfolio level and then to reflect the benefits of diversification between different portfolios;
2. we believe the residual margin should be determined at a portfolio level, this is facilitated by our proposed approach to the remeasurement and release of the residual margin;
3. we believe that acquisition costs should be determined at the portfolio level; and
4. we agree that cash flows should be determined at a portfolio level.

Premium allocation approach

We do not agree that insurers should be required to use a modified measurement approach for the pre-claims liabilities of some short-duration contracts but believe that the modified approach should be permitted where it produces materially the same result as the fulfilment approach. For an insurer to be required to run two models adds unnecessary complexity.

We also note that the current proposals could create accounting mismatches where a reinsurance contract, and a direct insurance contract protected by the reinsurance contract, are accounted for using different measurement models. If the final standard permitted the modified approach an accounting mismatch could be avoided.

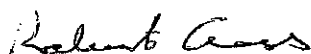
Transition

Given the current Australian requirements we would envisage that many life insurers would be required to effectively write off an existing margin (akin to a residual margin) on transition to the final insurance standard under the current proposals, we do not believe that this is appropriate. We would propose the following approach:

1. where practicable, insurers should apply the IFRS retrospectively, this is consistent with the principles of IAS 8. Guidance should be provided which clarifies that in many situations retrospective application will not be practicable;
2. where such retrospective application is not practicable, insurers should determine the present value of fulfilment cash flows on transition, with any difference between the existing net insurance assets/insurance liability and the present value of fulfilment cash flows on transition, recognised either as a reduction in retained earnings (where the present value of fulfilment cash flows exceeds the balance brought forward) or recognised as a residual margin on transition (where the present value of fulfilment cash flows is less than the balance brought forward).

Detailed comments on the questions raised in the ED are attached as an Appendix to this letter. Should you have any queries on our comments, please contact me at Rob.Goss@anz.com.

Yours sincerely



Rob Goss
Head of Accounting Policy, Governance and Compliance

Copy: Chairman, Australian Accounting Standards Board (AASB)

Appendix

Question 1 – Relevant information for users (paragraphs BC13–BC50)

Do you think that the proposed measurement model will produce relevant information that will help users of an insurer's financial statements to make economic decisions? Why or why not? If not, what changes do you recommend and why?

In the context of the current myriad of accounting models in existence globally, we regard the proposed measurement model as a significant step forward in global insurance accounting and an improvement on the discussion paper which preceded it.

However, in the context of the existing insurance accounting requirements in Australia, we are concerned that the residual margin proposals will not produce relevant information and that they will produce misleading and confusing information for users. Related to this concern is the proposal that changes in actuarial assumptions relating to the expected cash flows and risk adjustment should be recognised in the profit and loss. Under fair value accounting it is appropriate to take such changes to profit and loss as they are reversal of day one gains. However, under the ED's proposals day one gains are carried in the balance sheet as a residual margin. We have raised these concerns in our response to question 6 below. We would also have significant concerns with the composite margin model, favoured by the FASB; we also address these concerns in our response to question 6.

Question 2 – Fulfilment cash flows (paragraphs 17(a), 22–25, B37–B66 and BC51)

- (a) Do you agree that the measurement of an insurance contract should include the expected present value of the future cash outflows less future cash inflows that will arise as the insurer fulfils the insurance contract? Why or why not? If not, what do you recommend and why?
- (b) Is the draft application guidance in Appendix B on estimates of future cash flows at the right level of detail? Do you have any comments on the guidance?

- (a) We agree that the measurement of an insurance contract should include the expected present value of the future cash flows less future cash inflows that will arise as the insurer fulfils the insurance contract. Whilst we can see conceptual merit in a current exit value model, we do not support the recognition of profits at inception, the use of market consistent assumptions for servicing costs or recognition of changes in credit risk, and for this reason we support the notion of fulfilment. This reflects the insurer's expected cash flows and provides relevant information to users.
- (b) We believe the draft application guidance is at the right level of detail.

Question 3 – Discount rate
(paragraphs 30–34 and BC88–BC104)

- (a) Do you agree that the discount rate used by the insurer for non-participating contracts should reflect the characteristics of the insurance contract liability and not those of the assets backing that liability? Why or why not?
- (b) Do you agree with the proposal to consider the effect of liquidity, and with the guidance on liquidity (see paragraphs 30(a), 31 and 34)? Why or why not?
- (c) Some have expressed concerns that the proposed discount rate may misrepresent the economic substance of some long-duration insurance contracts. Are those concerns valid? Why or why not? If they are valid, what approach do you suggest and why? For example, should the Board reconsider its conclusion that the present value of the fulfilment cash flows should not reflect the risk of non-performance by the insurer?

- (a) We consider it appropriate that the discount rate should reflect the characteristics of the liability as opposed to the characteristics of the assets backing those liabilities. Whilst we acknowledge that in pricing an insurance contract the insurer is likely to consider the asset mix supporting the insurance liabilities, we would be concerned if those insurers with a more risky asset portfolio recognised a lower present value of fulfilment cash flows than those with a more conservative asset portfolio. We also believe that the value of the insurance liability is independent of the value of the assets backing that liability.
- (b) We agree with the proposal to consider the effect of liquidity in determining the discount rate and note that this is currently permitted under Australian accounting standards for insurance and is common practice for life insurers.
- (c) We acknowledge the difficulties that arose at the height of the global financial crisis as financial asset values were impacted by the spread in credit yields, however the measurement of financial liabilities was not able to reflect this spread. However, we believe that this difference reflects the economic reality, whilst asset prices were dropping insurers were nevertheless under an obligation to settle their insurance liabilities.

Question 4 – Risk adjustment versus composite margin
(paragraphs BC105–BC115)

Do you support using a risk adjustment and a residual margin (as the IASB proposes), or do you prefer a single composite margin (as the FASB favours)? Please explain the reason(s) for your view.

We support using a risk adjustment and a residual margin, as opposed to the single composite margin favoured by the FASB.

Such a model is consistent with the current accounting requirements for non-life insurance contracts in Australia. Moving towards the composite margin approach favoured by the FASB would be seen as a significant backwards step for insurance accounting in Australia. Information about risk adjustments is considered useful information for users and reflects the way in which insurers price and manages their business. It is also consistent with the IASB's approach to the measurement of other liabilities under IAS 37, and a fair value model.

Australian non-life insurers have been successfully calculating risk adjustments for a considerable period of time.

Question 5 – Risk adjustment
(paragraphs 35-37, B67-B103 and BC105–BC123)

- (a) Do you agree that the risk adjustment should depict the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected? Why or why not? If not, what alternatives do you suggest and why?
- (b) Paragraph B73 limits the choice of techniques for estimating risk adjustments to the confidence level, conditional tail expectation (CTE) and cost of capital techniques. Do you agree that these three techniques should be allowed, and no others? Why or why not? If not, what do you suggest and why?
- (c) Do you agree that if either the CTE or the cost of capital method is used, the insurer should disclose the confidence level to which the risk adjustment corresponds (see paragraph 90(b)(i))? Why or why not?
- (d) Do you agree that an insurer should measure the risk adjustment at a portfolio level of aggregation (ie a group of contracts that are subject to similar risks and managed together as a pool)? Why or why not? If not, what alternative do you recommend and why?
- (e) Is the application guidance in Appendix B on risk adjustments at the right level of detail? Do you have any comments on the guidance?

- (a) We agree that the risk margin should be measured by considering the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected, however, we do not believe that the risk margin should be defined as depicting this amount. Conceptually, we do not believe that the definition of the risk adjustment is consistent with the fulfilment model proposed in the ED and we do not believe that the ED has articulated the objective of the risk adjustment.

The IASB's insurance project started with a discussion paper proposing a current exit value model that was seen as a proxy for fair value. A fair value model is one in which the insurer measures the liability at the amount at which an insurance liability could be settled between knowledgeable, willing parties in an arm's length transaction. The model therefore assumes a transfer. Under this model, the risk adjustment would reflect the amount a market participant would demand to take on the insurance obligation. However, this model did not sit well with insurance contracts because insurance liabilities are very rarely transferred, and hence it is very difficult to determine market consistent assumptions and is also arguably misleading to measure insurance contracts assuming such a transfer.

Under the fulfilment model subsequently proposed by the ED, the risk adjustment reflects the inherent uncertainty in the cash flows for which the insurer seeks compensation from the policyholder. It is the cost of bearing risk for the insurer and part of the cost of fulfilling the insurance contract. The insurer agrees to not only compensate the policyholder for any losses but also to accept the uncertainty around when the loss will arise and/or how much the loss will be.

The risk adjustment, as proposed by the ED is "the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected." This definition introduces the notion of transfer as it asks the insurer to consider what it would pay to be relieved of the risk. We believe that given the history of the IASB insurance project, and the many discussions that have taken place around the objective of a risk margin under the various models discussed, it should be entirely clear what the risk adjustment is representing, and what the objective of the risk margin is. We believe that the risk adjustment, as defined in the ED, is a proxy for the cost of risk

to the insurer in choosing to issue an insurance contract and fulfil the cash flows. This should be made clear in the final standard.

- (b) Actuarial science is continually evolving and we do not believe that it is appropriate to limit actuarial approaches as this could hinder the development and improvement of actuarial models. We do not believe it is the role of accounting standards to prescribe actuarial valuation models, rather accounting standards should focus on the objective and principles of recognition and measurement. In the interests of consistency we believe the standard could state that one of the three models will generally provide an appropriate valuation model but that the insurer should choose a model appropriate to the business written. An insurer's accounting policy note should clearly explain the actuarial models adopted.
- (c) We agree that a disclosure of this nature encourages consistency. In Australia, disclosures of this nature have been considered by some to have contributed to the successful implementation of accounting models incorporating risk adjustments. However, we believe that if an insurer chooses to adopt a model other than the confidence level approach, that being required to determine the confidence level to which the risk adjustment corresponds is unduly onerous, and effectively requires the insurer to perform two actuarial calculations. Insurers should be required to provide disclosure appropriate to the actuarial method adopted.
- (d) Conceptually, actuaries would argue that a risk adjustment can only be determined at the entity level because of the impact of diversification on the cost of risk. The fulfilment model proposed in the ED is entity-specific and different insurers have a different cost of risk. A single-line insurer has a different cost of risk to an insurer that issues similar contracts but as part of a wider package of products. In determining the fulfilment cash flows, therefore, it is appropriate to reflect the diversification benefits that exist and that are expected in the ultimate cash flows.

Diversification is fundamental to the business of insurance. An insurer is able to offer an insurance product because it diversifies the risk of one policyholder across a pool of policyholders. We note that the Australian regulator allows insurers to reflect the benefits of diversification in determining insurance liabilities for regulatory purposes and that Solvency II will allow diversification to the legal entity level. We believe this supports the view that conceptually and economically a risk margin is determined at the entity level. We believe that Solvency II limited diversification to the legal entity level, rather than the group entity level, for regulatory, rather than economic or conceptual, reasons.

For practical reasons, however, we believe it is appropriate to determine risk adjustments at a portfolio level and then to reflect the benefits of diversification between different portfolios. We believe, for practical reasons, this is the level at which all of the components of the insurance liability should be determined including the residual margin, the fulfilment cash flows and acquisition costs. The standard should however clarify that, conceptually, the contractual cash flows are determined at a contract level.

- (e) We agree that the guidance is at the right level of detail.

Question 6 – Residual/composite margin
(paragraphs 17(b), 19–21, 50–53 and BC124–BC133)

- (a) Do you agree that an insurer should not recognise any gain at initial recognition of an insurance contract (such a gain arises when the expected present value of the future cash outflows plus the risk adjustment is less than the expected present value of the future cash inflows)? Why or why not?
- (b) Do you agree that the residual margin should not be less than zero, so that a loss at initial recognition of an insurance contract would be recognised immediately in profit or loss (such a loss arises when the expected present value of the future cash outflows plus the risk adjustment is more than the expected present value of future cash inflows)? Why or why not?
- (c) Do you agree that an insurer should estimate the residual or composite margin at a level that aggregates insurance contracts into a portfolio of insurance contracts and, within a portfolio, by similar date of inception of the contract and by similar coverage period? Why or why not? If not, what do you recommend and why?
- (d) Do you agree with the proposed method(s) of releasing the residual margin? Why or why not? If not, what do you suggest and why (see paragraphs 50 and BC125–BC129)?
- (e) Do you agree with the proposed method(s) of releasing the composite margin, if the Board were to adopt the approach that includes such a margin (see the Appendix to the Basis for Conclusions)? Why or why not?
- (f) Do you agree that interest should be accreted on the residual margin (see paragraphs 51 and BC131–BC133)? Why or why not? Would you reach the same conclusion for the composite margin? Why or why not?

- (a) We agree that an insurer should not reflect a gain on inception of an insurance contract as any profit should be earned over the period of the contract as the obligations under the contract are performed, consistent with the IASB's revenue recognition project.
- (b) We agree that the residual margin should not be less than zero, such that a loss at initial recognition of an insurance contract would be recognised immediately in profit or loss. We believe that such an approach is consistent with the principles of onerous contracts.
- (c) We agree that an insurer should estimate the residual or composite margin at a level that aggregates insurance contracts into a portfolio of insurance contracts but do not agree that insurers be required to determine 'time cohorts'. We believe that this would create a significant level of complexity in the determination of insurance contracts. We also believe that such an approach would become increasingly unwieldy over time for contracts that can be as long as 20 years and that very few existing IT systems would be able to cope with maintaining the hundreds of time cohorts that be required by a large life insurer with many different products. In our preferred approach cohorts would not be required. See our response to question 6(d) for our preferred approach to residual margins.
- (d) We believe that the residual margin should be remeasured and we do not agree with the proposed method(s) of releasing the residual margin. The residual margin, as acknowledged by the ED, largely represents expected profits. We do not believe that it is appropriate to lock-in the expected profit in a current value model. A locked-in margin would create spurious volatility. For example, a reassessment of the fulfilment cash flows might indicate that the contract is expected to remain profitable, however, the expected profits are reduced. Under the proposed model a loss will be recognised in the profit and loss for the change in assumptions, but the residual margin will remain unchanged and will continue to run off as before. Such a result is confusing to users and bears no resemblance to the substance of what has occurred. In addition, an insurer may estimate that it will increase premium rates towards the upper end of the range allowed under the existing contract, rather than using the mid-point estimated at inception. Under the ED

the insurer would recognise a profit in profit and loss. We do not believe that it is appropriate to recognise a profit in such circumstances.

The expected underwriting profit will emerge over the life of the contract, however, at inception the premiums that will be received will be subject to contractual restraints and the acquisition costs will have been incurred. The claims or benefits payments will therefore largely drive the ultimate underwriting profit. As the insurer's estimate of claims and benefits changes so the expected profit changes. In our view therefore any changes to the expected cash flows and risk adjustment (subject to the two exceptions below) should be recognised as a corresponding adjustment to the residual margin. In this way the residual margin will continue to reflect expected profit. The residual margin should then be released according to profit drivers. For some contracts this might be premiums and for others it might be claims. The two exceptions would be experience adjustments which should be reflected in profit and loss, as any gain or loss would have crystallised and changes in economic assumptions would also be reflected in profit and loss as these will largely be offset by changes in the fair value of the assets backing insurance liabilities. The approach described above is the approach adopted under the Margin on Services Model (MoS) for life insurance contracts in Australia, the key difference being that the ED requires a risk adjustment to be recognised in addition to the expected cash flows, we regard this as a positive improvement to the MoS model.

We note that some commentators believe that the residual margin should be remeasured in a different way by considering the 'current value margin'. Under a fulfilment model we do not believe that such remeasurement is appropriate. Under a current exit value model it would be appropriate to remeasure any service or profit margin as the model measures the contract using market consistent assumptions and hence if there has been a change in the profits or service margins required by market participants this would be reflected in the amount required by a market participant in a transfer. However, the ED proposes a fulfilment approach, the amount that the insurer expects to pay in fulfilling the contract. As noted above, two of the three key determinants of underwriting profit are either subject to contractual constraint or determined at inception, it is not relevant to the existing contracts what profit margin the insurer would demand if it were to underwrite a new contract at the reporting date.

- (e) As already noted, we do not support the composite margin approach. However, if it were adopted, we would prefer the approach for release described in our response to question 6(d).
- (f) We agree that interest should be accreted on the residual margin.

**Question 7 – Acquisition costs
(paragraphs 24, 39 and BC135–BC140)**

Do you agree that incremental acquisition costs for contracts issued should be included in the initial measurement of the insurance contract as contract cash outflows and that all other acquisition costs should be recognised as expenses when incurred? Why or why not? If not, what do you recommend and why?

We support such a proposal as it allows the accounting to reflect the economics of the underlying insurance contract and is consistent with the amortised cost approach under IAS 39 and the proposed leasing standard.

However, we believe the final standard should include acquisition costs incremental at the portfolio level in the initial measurement of the insurance contract as this would mitigate the following problems:

- The current requirements will lead to a lack of consistency between insurers depending upon their distribution model;
- The current proposals will create confusing results even at a product level for an organisation like ANZ that will distribute the same product through a variety of channels, with only some of these distribution costs meeting the incremental costs definition. The distribution mix will also be different across different products. In this case the different treatment of acquisition costs will confuse the pattern of profit emergence, as the residual margin will be directly impacted by the extent of the acquisition costs recognised as part of the cash flows, and will make this difficult for users to interpret.

We also believe that using the portfolio as the unit of account consistently for all aspects of the measurement model will reduce the level of complexity and will be far more practical to implement.

We are also concerned by the inconsistency between the ED's approach and the treatment of acquisition costs relating to investment contracts under the revenue recognition ED. Under the insurance ED, incremental acquisition costs can be included in the cash flows that determine the residual margin; under the revenue recognition ED, incremental transaction costs are not addressed, and under IAS 39 they would be expensed as incurred.

When IFRS 4 was introduced investment contracts were effectively removed from the scope of existing insurance accounting standards and came within the scope of IAS 39. This gave rise to particular concerns, one of which was the treatment of acquisition costs. Under IAS 39 these costs could not be deferred, which would have resulted in day 1 losses for many contracts that were expected to be profitable. The IASB addressed this concern by adding guidance in IAS 18 which allowed the deferral of incremental acquisition costs. This guidance does not appear in the revenue recognition ED and the concerns that arose when IFRS 4 was issued have now resurfaced. We are concerned with the opportunities for accounting arbitrage that will exist if the IASB does not address these issues. We believe that the IASB should consider the treatment of acquisition costs in relation to investment contracts under the revenue recognition ED as a matter of urgency.

Question 8 – Premium allocation approach

- (a) Should the Board (i) require, (ii) permit but not require, or (iii) not introduce a modified measurement approach for the pre-claims liabilities of some short-duration insurance contracts? Why or why not?
- (b) Do you agree with the proposed criteria for requiring that approach and with how to apply that approach? Why or why not? If not, what do you suggest and why?

- (a) We are concerned by the lack of debate to support the change in the IASB's position from permitting a modified measurement approach to requiring a modified measurement approach. We do not agree that insurers should be required to use a modified measurement approach for the pre-claims liabilities of some short-duration contracts. If the IASB believes a current fulfilment model to be the superior model for measuring insurance contracts this model should be required. The modified approach should be permitted, however, where it produces materially the same result, which is likely to be the case for short tail vanilla products with minimal liability components. For an insurer to be required to run two models adds unnecessary complexity.

We also note that the current proposals could create accounting mismatches where a reinsurance contract and a direct insurance contract protected by the reinsurance contract are accounted for using different measurement models. ANZ has some reinsurance protections that are for a period of 2 or 3 years protecting short term contracts that would be required to be measured using the modified measurement approach. If the final standard permitted the modified approach an accounting mismatch could be avoided.

- (b) We believe that if a modified measurement approach is permitted that insurers should be required to add a risk adjustment to the assessment of future cash flows in considering whether or not the contract is onerous. This is consistent with the fulfilment approach in the ED and is the approach taken by the non-life insurance standard in Australia and by the Australian regulator.

We also note that when IFRS 4 was implemented in Australia that the AASB addressed the issue of whether the liability adequacy test was performed net or gross of reinsurance and concluded that it was performed net. As a result, the insurance standard allowed insurers to assume that, where existing direct insurance contracts continued beyond the date of the existing reinsurance coverage, the reinsurance would be renewed, unless there was evidence that this would not be likely; again this is consistent with the regulatory approach.

Question 9 – Contract boundary principle

Do you agree with the proposed boundary principle and do you think insurers would be able to apply it consistently in practice? Why or why not? If not, what would you recommend and why?

We believe the proposed contract boundary principle represents an improvement on the guaranteed insurability notion proposed in the discussion paper. We believe the contract boundary principle allows the accounting to reflect the economics of the underlying contracts. However, we are unclear about the application of the principle to group life insurance plans. The principle refers to individual policyholders: the contract boundary is the point at which the insurer can “reassess the risk of the particular policyholder”. Under a group life plan is the group/employer the policyholder (as the contract holder) or are the members of the plan policyholders? In our view the members of the plan are policyholders as they have the right to compensation. However, we believe that the final standard should provide guidance in this area. It would be our preference to measure these contracts as long term contracts as this is consistent with the measurement of other life insurance contracts, however, for this we would need to argue that whilst there is one contract it covers a group of individual policyholders and we are unable to re-price at the individual policyholder level and can only re-price at the plan level.

Question 10 – Participating features

- (a) Do you agree that the measurement of insurance contracts should include participating benefits on an expected present value basis? Why or why not? If not, what do you recommend and why?
- (b) Should financial instruments with discretionary participation features be within the scope of the IFRS on insurance contracts, or within the scope of the IASB's financial instruments standards? Why?
- (c) Do you agree with the proposed definition of a discretionary participation feature, including the proposed new condition that the investment contracts must participate with insurance contracts in the same pool of assets, company, fund or other entity? Why or why not? If not, what do you recommend and why?
- (d) Paragraphs 64 and 65 modify some measurement proposals to make them suitable for financial instruments with discretionary participation features. Do you agree with those modifications? Why or why not? If not, what would you propose and why? Are any other modifications needed for these contracts?

- (a) We agree that the measurement of insurance contracts should include participating benefits on an expected present value basis as we consider this to be consistent with the accounting for insurance liabilities, and presents the economic substance of participating contracts.
- (b) We believe that financial instruments with discretionary participation features should be within the scope of the IFRS on insurance contracts, unless IAS 39 were to be amended to specifically address such contracts. We do not believe that IAS 39/IFRS 9, as they currently stand, provide enough guidance to adequately address the recognition and measurement of such contracts. It would be uncertain whether such contracts fell within the definition of an equity or debt instrument and it would also be unclear how such contracts would be measured at fair value if they were treated as financial liabilities. This would lead to inconsistency in application and potential accounting arbitrage.
- (c) As participating contracts are a small and declining proportion of our overall portfolio we do not have any comments to make.
- (d) As participating contracts are a small and declining proportion of our overall portfolio we do not have any comments to make.

Question 11 – Definition and scope

- (a) Do you agree with the definition of an insurance contract and related guidance, including the two changes summarised in paragraph BC191? If not, why not?
- (b) Do you agree with the scope exclusions in paragraph 4? Why or why not? If not, what do you propose and why?
- (c) Do you agree that the contracts currently defined in IFRSs as financial guarantee contracts should be brought within the scope of the IFRS on insurance contracts? Why or why not?

- (a) We agree with the definition of an insurance contract carried forward from IFRS 4, however, we have a concern with one of the changes proposed in the ED. IFRS 4 states that "insurance risk is significant if it could cause an insurer to pay significant additional benefits in any scenario, excluding scenarios that lack commercial substance". The ED adds: "In addition, a contract does not transfer insurance risk if there is no scenario that has commercial substance in which the present value of the net cash outflows paid by the insurer can exceed the present value of the premiums." In our opinion this additional

text provides an additional test that needs to be met before a contract can be classified as an insurance contract, under IFRS 4 there was just the first test. The Basis for Conclusions notes that the IASB has added this additional text because this ensures consistency with US GAAP, not because the original definition in IFRS 4 has given rise to any issues in classification of insurance contracts. We are concerned that the additional guidelines could be seen as requiring an entity to perform stochastic modelling in every scenario to determine whether or not a contract is an insurance contract. We are not convinced that the additional text is necessary; however, if the additional text is carried forward to the final IFRS, we believe that this additional test should only be applied in situations where the first test does not provide a clear classification.

- (b) We agree with the scope exclusions proposed in the ED, however, we would add a further scope exclusion in relation to financial guarantees issued by banks in which the insurance risk is effectively created by the financial guarantee contract (see our response to question 11(c) below).
- (c) We do not support the inclusion of financial guarantee contracts within the scope of the ED and believe these contracts should be accounted for under IAS 39. We also believe that if the current proposals stand in the final insurance IFRS, that additional guidance should be provided to clarify whether or not certain contracts meet the definition of a financial guarantee contract, and hence an insurance contract, under the IFRS.

For a bank, a financial guarantee contract is akin to a loan or credit facility. The contract guarantees the performance of a bank customer to a third party. In pricing the contract the bank considers the credit risk of its customer in the same way as the bank would consider the credit risk of any customer in providing a loan or credit facility.

The ED, by requiring financial guarantees to be accounted for as insurance contracts, is implicitly suggesting that a financial guarantee is no different to a credit insurance contract. We would argue that the economic substance of the arrangements is quite different. In a credit insurance arrangement the insurer has a contract with the policyholder and the policyholder has a contract/s with its debtor/s.

In a financial guarantee arrangement a triangle exists:

1. the insurer (the bank) has a contract with the debtor (its customer);
2. the debtor (the customer) has a contract with the policyholder (the third party); and
3. the insurer (the bank) has a contract with the policyholder (the third party) – the financial guarantee.

From the perspective of the bank, the financial guarantee contract is secondary to the underlying relationship between the bank and its customer. The financial guarantee contract would not exist were it not for the contract between the bank and its customer. In addition, the financial guarantee contract facilitates the contract between the customer and the third party.

As the financial guarantee contract only exists because of the underlying relationship between the bank and its customer, and as the financial guarantee facilitates the contract between the third party and the customer, it could be argued that the financial guarantee contract creates the insurance risk. In other words the insurance risk would not exist were it not for the financial guarantee. We note paragraph B12 in Appendix B to the ED states that: "insurance risk is a pre-existing risk transferred from the policyholder to the insurer. Thus a new risk created by the contract is not insurance risk". The risk under a financial guarantee is the risk that the customer will fail to perform under its contract with the third party. There is no contract between the third party and the customer without the financial guarantee.

We believe that users and preparers would intuitively look to IAS 39 for accounting requirements in relation to financial guarantees as opposed to an insurance standard. We

also note that in practice in assessing whether or not a financial guarantee contract could be onerous, the bank would assess the financial guarantee in the context of its entire exposure to the customer – in other words the bank will review all loans, guarantees, credit facilities as a whole as part of its impairment review process. If financial guarantees were accounted for as insurance contracts this would be significantly out of step with the way in which these contracts are managed.

We believe that where a guarantee is issued to a third party in relation to a bank's customer that the ED should 'look through' the guarantee arrangement and consider whether the arrangement is in substance primarily a financing transaction between the bank and its customer, rather than an insurance contract between the bank and the third party. Where the arrangement is primarily a financing arrangement we believe the contract should be treated under IAS 39.

We note that other contracts that meet the definition of an insurance contract are scoped out of the ED, in particular certain warranty contracts. Given this precedent, and our arguments outlined above, we believe it would be appropriate to exclude financial guarantee contracts from the scope of the final insurance standard.

If the current proposals are carried forward into the final standard, we believe that the final IFRS should provide guidance which clarifies whether certain contracts meet the definition of an insurance contract. ANZ regularly issues financial guarantees on behalf of its customers to third parties. Many of these guarantees operate as follows: the guarantees refer to an underlying contract between the third party and the bank customer but require the bank to settle the guarantee, on presentation "without regard to the performance or non-performance of the customer or third party" under the terms of the underlying contract or agreement. We have not been able to obtain definitive advice from IASB staff on whether or not such contracts meet the definition of an insurance contract. In our opinion such contracts do not meet the definition of an insurance contract because there is not a requirement for the policyholder to have suffered a loss as a result of an adverse event. We believe that the final IFRS should provide guidance that addresses such contracts. A similar situation exists in relation to credit default swaps. The customer is not required to demonstrate an underlying loss before seeking recovery under the contract. In fact the bank has no visibility of its customer's position in entering into a credit default swap. The customer could have entered into the arrangement to protect an underlying credit risk or could have entered into the arrangement for speculative purposes. It is our view, therefore, that these contracts should be accounted for as derivatives.

Question 12 - Unbundling

Do you think it is appropriate to unbundle some components of an insurance contract? Do you agree with the proposed criteria for when this is required? Why or why not? If not, what alternative do you recommend and why?

The unbundling requirements are not applicable to ANZ given the nature of the products that we issue, however, we agree that it is appropriate to unbundle financial instrument components of an insurance contract and we agree with the proposed criteria for when this is required.

Question 13 – Presentation

- (a) Will the proposed summarised margin presentation be useful to users of financial statements? Why or why not? If not, what would you recommend and why?
- (b) Do you agree that an insurer should present all income and expense arising from insurance contracts in profit or loss? Why or why not? If not, what do you recommend and why?

- (a) We believe that the summarised margin approach is useful to users of life insurance reports in Australia as it is similar to some of the reporting that already exists under MoS. However, a summarised margin approach in isolation would not address all of the users information needs and we consider it inappropriate for the ED to state that an insurer shall not present premiums and claims expense in the statement of comprehensive income. It is well accepted that a KPI for life insurers is the volume of new business. In addition, users of non-life insurance reports would not be familiar with a summarised margin presentation and all of the traditional metrics (such as premiums and claims) would be absent. In these situations an expanded margin approach would be more useful to users.

We believe that an expanded margin approach (which includes the disclosures provided in the summarised margin approach) should be required; however, insurers should be permitted to present this in a manner which best suits their users. We do not believe that one size fits all and the final IFRS should allow a degree of flexibility. Insurers should be able to choose a presentation approach that is most appropriate to their users: for example, for an insurer that is part of a banking group, a summarised margin approach may be most compatible with the reporting of net interest income from banking operations. This could be supplemented with an expanded margin analysis in the notes. For a non-life insurer, the expanded margin approach on the face of the profit and loss would probably be most appropriate to meets users needs and expectations.

- (b) We agree that an insurer should present all income and expense arising from insurance contracts in profit and loss.

Question 14 – Disclosures

- (a) Do you agree with the proposed disclosure principle? Why or why not? If not, what would you recommend, and why?
- (b) Do you think the proposed disclosure requirements will meet the proposed objective? Why or why not?
- (c) Are there any disclosures that have not been proposed that would be useful (or some proposed that are not)? If so, please describe those disclosures and explain why they would or would not be useful.

- (a) We agree with the proposed disclosure principle, it is consistent with IFRS 4 and other International Financial Reporting Standards.
- (b) We believe the proposed disclosure requirements will meet the proposed objective, however, we also believe that the disclosure requirements in some situations go beyond the disclosure principle. The ED states that "an insurer shall present each portfolio of insurance contracts as a single item within insurance contract assets or insurance contract liabilities". It also states that the insurer is required to present reconciliations from opening to closing balances all insurance assets and liabilities. Whilst the ED also states that the "an insurer shall consider the level of detail necessary to satisfy the disclosure requirements" we believe that additional guidance is required to make it clear,

for example, that for a large insurer with a significant number of portfolios across a number of jurisdictions that disclosure of reconciliations at the portfolio level is unlikely to be useful.

We disagree with the IASB's approach, in this and other EDs, to require reconciliations of all insurance assets and liabilities as a matter of course. We believe the final standard should consider the merits of each reconciliation and only require reconciliation where this would be of real value to users. Alternatively, we would prefer a more principles based approach which requires reconciliations where these would be necessary to meet the disclosure principles.

- (c) We note that the claims development disclosures under IFRS 4 have caused issues of comparability because IFRS 4 did not stipulate whether the disclosures should be net or gross or reinsurance or discounted or undiscounted. We support the requirement for the claims disclosure to be undiscounted, however, we believe the IASB should consider whether the disclosure should be net or gross of reinsurance or whether both should be required, and the final IFRS should state explicitly what the requirements are.

Question 15 – Unit-linked contracts

Do you agree with the proposals on unit-linked contracts? Why or why not? If not what do you recommend and why?

We find the proposals in relation to unit-linked contracts unclear. It is not clear whether these proposals apply to:

- All unit-linked contracts;
- All insurance contracts that are unit-linked; or
- All unit-linked contracts issued by insurers.

The ED defines unit-linked contracts as contracts for which "some or all of the benefits are determined by the price of units in an internal or external investment fund". Taken in isolation this could be read as applying to all unit-linked contracts because it does not state that these are insurance contracts for which some or all of the benefits are determined by the price of units in an internal or external investment fund. Elsewhere the ED implies that the requirements are in relation to unit-linked contracts that are insurance contracts: paragraph 71 refers to unit-linked liabilities not being co-mingled with "other insurance contract liabilities". We believe that if the proposals remain unchanged the definition needs to be amended to state that unit-linked contracts are "insurance contracts for which some or all of the benefits are determined by the price of units in an internal or external investment fund".

These proposals were introduced to address the mismatch that arises where a unit-linked liability includes investments in treasury shares and owner-occupied property but in recognising the corresponding assets the entity will not be able to recognise the treasury shares and will not be able to measure the owner-occupied property at fair value. We are not clear why the IASB has allowed this concession for unit-linked insurance contracts when the same mismatch arises in many other situations. We agree with the ED proposals but believe that these proposals should apply to all unit-linked contracts and to all other contracts of a similar nature, that is, to all contracts (not only insurance contracts) where the value of a liability is directly linked to the value of assets held for the benefit of policyholder or customers.

For example, in Australia many life insurers write investment-linked business where the value of the assets, held in a separate life insurance statutory fund, are directly related to the value

of the contract liabilities, and the same accounting mismatch arises, and yet these contracts would not meet the definition of a unit-linked insurance contract.

Question 16 – Reinsurance

- (a) Do you support an expected loss model for reinsurance assets? Why or why not? If not, what do you recommend and why?
- (b) Do you have any other comments on the reinsurance proposals?

- (a) We support an expected loss model for reinsurance assets as it is consistent with the underlying measurement model for reinsurance assets.
- (b) We do not support the proposal that an insurer can recognise a gain on purchasing a reinsurance contract. We believe that the accounting treatment should be consistent with the accounting of the underlying direct insurance contracts issued, in other words, any expected profit on inception should be recognised in a manner consistent with the recognition of the underlying residual margin on the direct insurance contract written. This reinsurance margin should be remeasured consistent with our preferred approach outlined in our response to question 6(d).

Question 17 – Transition and effective date

- (a) Do you agree with the proposed transition requirements? Why or why not? If not, what would you recommend and why?
- (b) If the Board were to adopt the composite margin approach favoured by the FASB, would you agree with the FASB's tentative decision on transition (see the appendix to the Basis for Conclusions)?
- (c) Is it necessary for the effective date of the IFRS on insurance contracts to be aligned with that of IFRS 9? Why or why not?
- (d) Please provide an estimate of how long insurers would require to adopt the proposed requirements.

- (a) We do not agree with the proposed transition requirements. It is a principle of IFRS that where there are changes in accounting requirements that these changes are implemented retrospectively unless this is impracticable. We believe this principle should be applied to the new insurance standard. Life insurers in Australia currently determine a residual margin, in the form of a planned margin, albeit that the planned margin is remeasured and the ED proposes that the residual margin is locked in. Some insurers may be able therefore to recognise a residual margin, as envisaged by the ED, retrospectively.

Where an insurer is not able to apply the new model retrospectively we do not believe it would be appropriate for insurers to write-off to retained earnings any existing margin once the present value of fulfilment cash flows has been determined on inception. Such an approach is inconsistent with the principles of the ED and the IFRS transition principles and would have long term implications on comparability given the long-term nature of life insurance contracts. It would also have tax consequences given that any existing residual margin is effectively released early.

We would propose the following approach:

- (i) where practicable, insurers should apply the IFRS retrospectively. Guidance should be provided which clarifies that in many situations retrospective application will not be practicable;
 - (ii) where such retrospective application is not practicable, insurers should determine the present value of fulfilment cash flows on transition, with any difference between the existing insurance assets/insurance liability and the present value of fulfilment cash flows on transition, recognised either as a reduction in retained earnings (where the present value of fulfilment cash flows exceeds the balance brought forward) or recognised as a residual margin on transition (where the present value of fulfilment cash flows is less than the balance brought forward).
- (b) If the Board were to adopt the composite margin approach favoured by the FASB we agree with the FASB's tentative decision on transition.
- (c) We believe it is appropriate for the effective date of the IFRS on insurance contracts to be aligned with that of IFRS 9, we note however, that this would mean that for a group such as ANZ some of our financial assets would be measured under IFRS 9, and some would be measured under IAS 39, this would require us to consider which assets are backing insurance contracts. As it is a requirement in Australia to measure assets backing insurance contracts at fair value, where permitted under IAS 39, this would not cause a problem in Australia. In other jurisdictions however, this may cause some difficulty.
- (d) Australia is relatively well placed to implement the requirements in the ED, however, we believe that insurers be allowed a period of at least one year to implement the IFRS requirements. We would expect other jurisdictions to require a longer period given the extent and complexity of the changes proposed.

Question 18 – Other comments

Do you have any other comments on the proposals in the exposure draft?

We do not have any other comments in relation to the proposals.

Question 19 – Benefits and costs

Do you agree with the Board's assessment of the benefits and costs of the proposed accounting for insurance contracts? Why or why not? If feasible, please estimate the benefits and costs associated with the proposals.

In the context of the current Australian requirements, many Australian commentators might argue that there will be considerable cost, with little if any improvement in the quality of the accounting requirements, and hence little benefit. However, we do acknowledge that, at an international level, the improvements will bring benefits to the global insurance market in increased consistency, comparability and will bring significant improvement to existing requirements in many jurisdictions. Nevertheless, we feel unable to provide a meaningful estimate of the benefits and costs associated with the proposals.

