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30 May 2013

Hans Hoogervorst
Chairman
International Accounting Standards Board
30 Cannon Street
LONDON EC4M 6XH
UNITED KINGDOM

Dear Sir,

Re: Exposure Draft ED/2013/3 Financial Instruments: Expected Credit Losses

QBE Insurance Group Limited (QBE) is an Australian-based public company listed on the Australian Securities Exchange. QBE is Australia's largest international insurance and reinsurance company with operations in 48 countries. We are also one of the top 20 global insurers and reinsurers as measured by net earned premium. Our investment portfolio is over US$30 billion, comprising assets backing policyholders' liabilities and shareholders' funds, primarily managed in-house by our global investment team.

QBE fully supports the IASB in its aim to clarify, simplify and improve the consistency of accounting for financial instruments and we have a particular interest in the interaction between the proposals for accounting for financial instruments and the development of the insurance contracts standard. We welcome the opportunity to comment on the exposure draft issued.

We consider that the pricing of financial instruments takes into account credit risk along with many other risks such as interest rate, inflation, liquidity and economic risks. Applying the exposure draft proposals to credit and loan portfolios reflects the commercial practice applied in managing these portfolios. Applying the exposure draft to investment assets, requiring identification and isolation of one component of risk from the pricing of a financial instrument, is inherently a judgemental process and does not reflect the commercial reality of managing investment grade financial instruments.

For those entities whose business model results in the mandatory application of the FVOCI approach the measurement at fair value already takes into account the impact of credit risk along with other risks. Isolating the credit risk component of all financial instruments is a significant burden for no added value given this does not reflect the risk management approach and focuses on only one of many risks that need to be managed. Given this burden, we consider fair value through profit or loss should remain as an option for instruments which would otherwise be reported as FVOCI.

From our perspective of managing financial assets, we have a number of particular concerns regarding the recommendations set out in this exposure draft, in particular:

- The proposals do not reflect the commercial reality of managing investment grade financial instruments. This is likely to result in differences between management and statutory financial reporting, increasing complexity for both preparers and users of financial statements contrary to the IASB commitment to simplifying requirements and reducing complexity.
- We consider the proposals for measuring expected future losses to be overly complex and note there will be considerable cost in applying the methodology, both in terms of developing new systems and monitoring the proposed credit provisions.
- The identification of a 12 month window appears to be an arbitrary timeframe which adds more complexity and does not reflect commercial practice whereby credit risk associated with financial investments should be monitored for all future time periods in order to identify when appropriate provisioning or sale is necessary.

- Identifying and separating credit risk components is highly judgemental and likely to increase inconsistency between financial reports.
- The proposals appear one-sided with no contemplation of credit gains being reported in the P&L other than as a reversal of previous losses.

The introduction of the FVOCI category as an expedient to matching the proposals in the insurance standard, whereby movements in discount rate are reported in the OCI, is misguided. Inflation risk is a significant driver of the value of general insurance liabilities with movements in inflation risk reported in the P&L. Under the FVOCI classification, the inflation risk included in the fair value of financial instruments held to support insurance liabilities will remain in OCI.

The incurred loss impairment model required under the current standard has been applied in Australia effectively through recent turbulent financial periods. Consideration should be given to further enhancing this existing impairment model to ensure more consistent application globally, for example providing more guidance on the identification of objective evidence of impairment. In addition, the current approach is a principles based approach whereas the proposals in the exposure draft introduce a far more rules based approach which we consider unnecessary and a move away from the core philosophy of other standards.

Our comments on the specific questions raised in the Exposure Draft are included in Attachment A.

Yours sincerely,

Neil Drabsch
Chief Financial Officer

cc Kevin Stevenson, Chairman and CEO, AASB

Attachment A - ED/2013/3: Financial instruments: expected credit losses

Question 1
(a) Do you agree that an approach that recognises a loss allowance (or provision) at an amount equal to a portion of expected credit losses initially, and lifetime expected credit losses only after significant deterioration in credit quality, will reflect:
(i) the economic link between the pricing of financial instruments and the credit quality at initial recognition; and
(ii) the effects of changes in the credit quality subsequent to initial recognition?
If not, why not and how do you believe the proposed model should be revised?

(b) Do you agree that recognising a loss allowance or provision from initial recognition at an amount equal to lifetime expected credit losses, discounted using the original effective interest rate, does not faithfully represent the underlying economics of financial instruments? If not, why not?

(a) (i) We do not believe that an approach which recognises a loss provision at an amount equal to a portion of expected credit losses initially and lifetime expected losses only after significant deterioration in credit quality faithfully represents the underlying economics of a financial instrument.

Below is an S&P table which outlines the global default rates by credit rating in the past 10 years. This table illustrates that default on 'investment grade' (i.e. AAA – BBB) debt is a very rare occurrence; therefore, a default occurring on the same securities within the next 12-month period would have an even lower probability. The ED requires a provision for 12-month expected credit losses even for low risk ("investment grade") financial instruments. Recognition of a loss provision for such assets will not add any further relevance or credibility to financial statements; however, it will be an added cost burden to preparers of financial statements. We do not believe that the cost/benefits of implementing this change are reasonable.

S&P TABLE

Gobal Corporate Annual Default Rates By Rating Category

(%)	AAA	AA	A	BBB	BB	B	CCC/C
2003	0.00	0.00	0.00	0.23	0.57	4.02	32.93
2004	0.00	0.00	0.08	0.00	0.43	1.56	15.56
2005	0.00	0.00	0.00	0.07	0.31	1.72	9.09
2006	0.00	0.00	0.00	0.00	0.30	0.81	12.38
2007	0.00	0.00	0.00	0.00	0.20	0.25	14.95
2008	0.00	0.38	0.38	0.48	0.79	4.01	26.47
2009	0.00	0.00	0.22	0.54	0.73	10.56	48.94
2010	0.00	0.00	0.00	0.00	0.56	0.82	22.52
2011	0.00	0.00	0.00	0.07	0.00	1.53	15.83
2012	0.00	0.00	0.00	0.00	0.29	1.50	26.62

Setting up an initial provision where no losses are expected to occur is also likely to result in a divergence between management and financial reporting, adding to the complexity of financial statements for both preparers and users.

(a) (ii) Where objective evidence exists of a deterioration in credit quality, it is appropriate to provision for the increased credit risk and recognise the deterioration in credit quality in the reported result. The incurred loss requirements in IAS 39 have been applied successfully, in our experience, throughout turbulent periods in financial markets. We understand there is a lack of consistency in the application of this standard across different markets and consider an appropriate solution would be to provide more detailed guidance on the application of the existing standard in response to the G20 requirements rather than introduce an overly complex expected loss basis which does not reflect the underlying economics of the transactions.

(b) No comment provided.

Question 2
(a) Do you agree that recognising a loss allowance (or provision) at an amount equal to 12-month expected credit losses and at an amount equal to lifetime expected credit losses after significant deterioration in credit quality achieves an appropriate balance between the faithful representation of the underlying economics and the costs of implementation? If not, why not? What alternative would you prefer and why?
(b) Do you agree that the approach for accounting for expected credit losses proposed in this Exposure Draft achieves a better balance between the faithful representation of the underlying economics and the cost of implementation than the approaches in the 2009 ED and the SD (without the foreseeable future floor)?
(c) Do you think that recognising a loss allowance at an amount equal to the lifetime expected credit losses from initial recognition, discounted using the original effective interest rate, achieves a better balance between the faithful representation of the underlying economics and the cost of implementation than this Exposure Draft?

(a) As noted above, we are concerned that recognising any provision equal to 12-month credit losses on financial instruments which are investment grade does not fairly represent the economics of these financial instruments.

In theory, all financial instruments have an element of risk therefore a loss allowance will also be required for low risk assets. Failure to recognise a provision for credit loss will imply that the financial instruments are 'risk-free', which in theory they are not.

In practice, incurring credit losses on low risk financial instruments is an extremely rare event (as per S&P default table and borne out by our experience over many years and including during the GFC). The cost to implement systems to comply with the requirements of this ED requiring provisioning for all instruments, could be substantial, and are likely to outweigh perceived benefits.

We consider an appropriate alternative would be to enhance the requirements of the existing IAS 39 to ensure more consistent application of the determination of objective evidence of deterioration in credit quality and requiring provisioning for expected losses from that point.

We consider that financial instruments with objective evidence of significant credit deterioration which are purchased or held by an entity should not be considered as held for expected cash flows or held for expected cash flows and to sell and therefore should be more appropriately categorised as FV through P&L.

(b) No comment provided.
(c) No comment provided.

Question 3
(a) Do you agree with the proposed scope of this Exposure Draft? If not, why not?
(b) Do you agree that, for financial assets that are mandatorily measured at FVOCI in accordance with the Classification and Measurement ED, the accounting for expected credit losses should be as proposed in this Exposure Draft? Why or why not?

(a) No comment provided.
(b) We consider the FVOCI approach has been developed to achieve matching of financial instruments with the treatment of insurance liabilities. The aim appears to be to match the movements in interest rates on debt instruments with the discount rates on insurance liabilities. This approach fails to recognise the natural offset of inflation and interest rates (via discount rates) on the valuation of insurance liabilities which are significant for general insurance. We therefore disagree with the mandatory measuring of investments at FVOCI.

The proposed approach to measuring expected credit losses attempts to remove movements in value due to credit risk from OCI and report it in the profit or loss. Where there is a provision on *initial recognition and this provision subsequently reduces, the initial movement would be a gain – paragraph 27 states "An entity shall present impairment losses (including reversals of impairment losses or impairment gains) determined in accordance with this [draft] IFRS as a separate line item in the statement of profit or loss and other comprehensive income."*

This sentence does not contemplate an initial gain which is possible and ought to be recognised under the proposed model.

Question 4
Is measuring the loss allowance (or a provision) at an amount equal to 12-month expected credit losses operational? If not, why not and how do you believe the portion recognised from initial recognition should be determined?

Recognition of a loss allowance equal to 12-month expected credit losses will have operational issues for many organisations. The approach may work well in some instances (i.e. recognising provisional losses for credit cards, short term trade receivables, loans etc); however, it's much more difficult to apply the same concept to financial instruments. Many organisations will not have this kind of data readily available, and implementing systems to do so could be very costly. The ED emphasises that information should be readily available without undue cost or effort; however, many organisations have different risk, front office and accounting systems which will need to be integrated to comply with the ED. Large financial institutions may hold hundreds or thousands of financial instruments, therefore, an automated system solution for measuring the 12-month loss allowance and subsequent disclosure is a necessity.

Our view is that no loss allowance should be applied at initial recognition for financial instruments which are considered low risk (i.e. investment grade). Recognition of a provisional loss for low risk financial instruments is unlikely to increase the relevance of financial reports, provisional losses will be estimates at best, and would be likely to be vastly different to actual incurred credit losses. We also consider the 12 month window and arbitrary timeframe which does not reflect the commercial reality of managing financial instruments whereby managers would be very unlikely to restrict their risk horizon to a 12 month timeframe.

Question 5
(a) Do you agree with the proposed requirement to recognise a loss allowance (or a provision) at an amount equal to lifetime expected credit losses on the basis of a significant increase in credit risk since initial recognition? If not, why not and what alternative would you prefer?
(b) Do the proposals provide sufficient guidance on when to recognise lifetime expected credit losses? If not, what additional guidance would you suggest?
(c) Do you agree that the assessment of when to recognise lifetime expected credit losses should consider only changes in the probability of a default occurring, rather than changes in expected credit losses (or credit loss given default ('LGD'))? If not, why not and what would you prefer?
(d) Do you agree with the proposed operational simplifications, and do they contribute to an appropriate balance between faithful representation and the cost of implementation?
(e) Do you agree with the proposal that the model shall allow the re-establishment of a loss allowance (or a provision) at an amount equal to 12-month expected credit losses if the criteria for the recognition of lifetime expected credit losses are no longer met? If not, why not, and what would you prefer?

(a) The Fair value through P&L (FVP&L) classification basis captures all investment risks, including credit risk. Where there is objective evidence of impairment and it is probable that a default will occur, FVP&L measurement should be mandatory. This will remove the complexity of trying to recognise life time expected losses and complying with the disclosure requirements in this ED which will require significant judgement and inconsistent and possibly unreliable outcomes.

The market price reflects any significant increase or decrease in credit risk, and this observable evidence of price may contradict the subjective impairment assessments made by companies on these securities. FVP&L will be a more objective and observable measurement in most cases, and will result in much more relevant information to users of financial statements.

(b) The stages on page 6 of the ED are clear – no further information required.

(c) No comment provided.

(d) The operational aspect is unlikely to be as simple as set out in the ED. Large financial institutions which hold significant volumes of debt financial instruments will need to invest large amounts of time and money to implement systems which will provide the information necessary to comply with ED requirements.

(e) As noted above, we do not agree with the recognition of 12-month expected credit losses for financial instruments which are considered low risk. This information will not be meaningful in most circumstances and will further reduce comparability of financial statements.

Question 6

(a) Do you agree that there are circumstances when interest revenue calculated on a net carrying amount (amortised cost) rather than on a gross carrying amount can provide more useful information? If not, why not, and what would you prefer?

(b) Do you agree with the proposal to change how interest revenue is calculated for assets that have objective evidence of impairment subsequent to initial recognition? Why or why not? If not, for what population of assets should the interest revenue calculation change?

(c) Do you agree with the proposal that the interest revenue approach shall be symmetrical (ie that the calculation can revert back to a calculation on the gross carrying amount)? Why or why not? If not, what approach would you prefer?

(a) We do not believe there is merit in changing the accrual process for financial instruments. Interest accruals for financial instruments are system generated based on the appropriate market conventions. Most systems will not have an option to modify the interest accrual calculation between the net and gross carrying amount. This process would also be contrary to the economics of market practices, i.e. securities which have a higher degree of credit risk must offer higher interest rates to entice investors. Investors would have a reasonable expectation that they will be appropriately compensated for the additional risk they are taking, hence, reducing the interest revenue on higher risk financial instruments goes against fundamental economic principles.

(b) If there are instances whereby there is objective evidence that interest income is impaired due to the deterioration of credit risk, a better process of accounting for this is to "write off" interest income, rather than modifying the basis of the accrual.

(c) No comment provided.

Question 7

(a) Do you agree with the proposed disclosure requirements? Why or why not? If not, what changes do you recommend and why?

(b) Do you foresee any specific operational challenges when implementing the proposed disclosure requirements? If so, please explain.

(c) What other disclosures do you believe would provide useful information (whether in addition to, or instead of, the proposed disclosures) and why?

Refer comments above – no additional comments on disclosure provided.

Question 8

Do you agree with the proposed treatment of financial assets on which contractual cash flows are modified, and do you believe that it provides useful information? If not, why not and what alternative would you prefer?

Any financial instruments which have modified contractual cash flows due to increased credit risk should be mandatorily measured at fair value through profit and loss.

Question 9
(a) Do you agree with the proposals on the application of the general model to loan commitment and financial guarantee contracts? Why or why not? If not, what approach would you prefer?
(b) Do you foresee any significant operational challenges that may arise from the proposal to present expected credit losses on financial guarantee contracts or loan commitments as a provision in the statement of financial position? If yes, please explain.

No comment provided.

Question 10
(a) Do you agree with the proposed simplified approach for trade receivables and lease receivables? Why or why not? If not, what changes do you recommend and why?
(b) Do you agree with the proposed amendments to the measurement on initial recognition of trade receivables with no significant financing component? If not, why not and what would you propose instead?

No comment provided.

Question 11
Do you agree with the proposals for financial assets that are credit-impaired on initial recognition? Why or why not? If not, what approach would you prefer?

Financial instruments which have objective evidence of being credit impaired should be mandatorily measured at fair value through profit and loss. Amortised cost and FVOCI measurement should be strictly limited to financial instruments which have no objective evidence of impairment and are expected to fulfil their obligations in respect to contractual cash flows.

Question 12
(a) What lead time would you require to implement the proposed requirements? Please explain the assumptions that you have used in making this assessment. As a consequence, what do you believe is an appropriate mandatory effective date for IFRS 9? Please explain.
(b) Do you agree with the proposed transition requirements? Why or why not? If not, what changes do you recommend and why?
(c) Do you agree with the proposed relief from restating comparative information on transition? If not, why?

A 3 year effective date from issue of the final standard would appear sensible given the scale of systems changes needed in many organisations.

Question 13
Do you agree with the IASB's assessment of the effects of the proposals? Why or why not?

We do not believe that the proposals as outlined in the ED will achieve the desired outcome of the IASB. The proposed model of the IASB to recognise credit losses earlier may work effectively for organisations dealing with lease contracts, loan commitments, credit card debt and trade receivables; however, applying the same concept to financial instruments is too simplistic in its approach and results in overly complex requirements which do not reflect the underlying economics of the financial instruments or the commercial practice of managing financial instruments.

The overall aim is for early recognition of credit losses and this can be achieved by improving the guidance in IAS 39 as to the circumstances that give rise to credit losses and therefore require provisioning and the circumstances which would trigger a move to FVP&L as a more appropriate classification.