National Australia Bank

National Australia Bank Limited
ABN 12 004 044 937

800 Bourke Street
Melbourne Victoria 3000
AUSTRALIA

25 October 2013

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

Dear Sir

Exposure Draft ED/2013/7 Insurance Contracts

We are pleased to have the opportunity to provide our comments on the draft IFRS for Insurance Contracts, Exposure Draft ED/2013/7.

National Australia Bank (NAB) is one of the four major banks in Australia. Our operations are predominately based in Australia, New Zealand, the United Kingdom, the United States and Asia. Through our wealth management division, MLC, we provide investment, superannuation and insurance solutions to corporate and institutional customers. MLC is a leading provider of life insurance in Australia.

Overall we are supportive of many of the requirements of this Exposure Draft and welcome the improvements from the 2010 ED, including the unlocking of the residual margin and the revised transition requirements.

We support the move towards a uniform IFRS that will apply across many jurisdictions, however we do have a reservations regarding some of the proposals which we believe will inappropriately impact reported results if the draft IFRS is not amended. In our opinion, the major areas to be addressed are as follows:

- The use of other comprehensive income for the impact of changes in the discount rate – we believe this approach is overly complex, particularly the requirement to use interest rates applicable at initial recognition of the contract. The proposal also does not eliminate all accounting mismatches where the assets backing policy liabilities will not be classified as fair value through other comprehensive income. We believe a better approach would be to require all changes in policy liabilities to be recognised in profit or loss, except where the other comprehensive method is more appropriate, based on business model.
- We do not agree with the proposal to measure fulfilment cashflows by reference to the carrying value of underlying items on the basis that the practical application of the approach could result in the decomposition of contractual cashflows into components with multiple accounting treatments. We believe the resulting complexity outweighs potential benefits.

Our detailed response is attached to this letter.

Should you have any queries regarding our comments, please do not hesitate to contact Marc Smit, Head of Group Accounting Policy at marc.smit@nab.com.au.

Yours sincerely

Stephen Gallagher
General Manager, Group Finance

Laura Ribeiro
Manager, Group Accounting Policy

Detailed Answers to Questions

Question 1 – Adjusting the Contract Service Margin
Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial position and performance if differences between the current and previous estimates of the present value of future cash flows if: (a) differences between the current and previous estimates of the present value of future cash flows related to future coverage and other future services are added to, or deducted from, the contractual service margin, subject to the condition that the contractual service margin should not be negative; and (b) differences between the current and previous estimates of the present value of future cash flows that do not relate to future coverage and other future services are recognised immediately in profit or loss?

We agree with the revised approach regarding the contractual service margin set out in this Exposure Draft. We agree that financial statements will provide more relevant information if differences between current and previous estimates of cashflows relating to future coverage are deferred to future periods.

In our view this approach improves the relevance of profit or loss as changes in expected future profitability are excluded from current earnings, and this will allow users of financial statements to better assess the profitability of the business.

We also consider that this approach could be applied to changes in the risk margin which relate to future coverage and future services as these also relate to future profitability and should be excluded from current earnings. We understand that the approach in the Exposure Draft was put forward on the basis of simplicity, however we consider that it would be relatively straightforward to differentiate between differences in the risk margin relating to future periods and differences relating to current and previous periods.

We also recommend that the Exposure Draft be revised to confirm that subsequent changes in assumptions that result in a reversal of previously recognised losses be taken to profit or loss rather than deferred to future periods.

Question 2—Contracts that require the entity to hold underlying items and specify a link to returns on those underlying items

If a contract requires an entity to hold underlying items and specifies a link between the payments to the policyholder and the returns on those underlying items, do you agree that financial statements would provide relevant information that faithfully represents the entity's financial position and performance if the entity:

(a) measures the fulfilment cash flows that are expected to vary directly with returns on underlying items by reference to the carrying amount of the underlying items?

(b) measures the fulfilment cash flows that are not expected to vary directly with returns on underlying items, for example, fixed payments specified by the contract, options embedded in the insurance contract that are not separated and guarantees of minimum payments that are embedded in the contract and that are not separated, in accordance with the other requirements of the [draft] Standard (ie using the expected value of the full range of possible outcomes to measure insurance contracts and taking into account risk and the time value of money)?

(c) recognises changes in the fulfilment cash flows as follows:

  (i) changes in the fulfilment cash flows that are expected to vary directly with returns on the underlying items would be recognised in profit or loss or other comprehensive income on the same basis as the recognition of changes in the value of those underlying items;

  (ii) changes in the fulfilment cash flows that are expected to vary indirectly with the returns on the underlying items would be recognised in profit or loss; and

  (iii) changes in the fulfilment cash flows that are not expected to vary with the returns on the underlying items, including those that are expected to vary with other factors (for example, with mortality rates) and those that are fixed (for example, fixed death benefits), would be recognised in profit or loss and in other comprehensive income in accordance with the general requirements of the [draft] Standard?

Whilst we support the view that accounting mismatches should be eliminated for contracts which require the entity to hold underlying items and specify a link to returns on those underlying investments, in our opinion the proposed approach is unduly complex.

Issues would arise on products which are backed by a mixture of instruments with diverse accounting treatments. The requirement to decompose cashflows on the basis of underlying assets could result in the valuation of a single portfolio of insurance contracts reflecting multiple accounting treatments, including fair value through other comprehensive income, fair value through profit or loss, and historical cost for example. This is in addition to any component which is not linked to returns on underlying items.

It is expected that for some products the valuation of the policy liability resulting from such an approach would not be representative of actual fulfilment cashflows. For this reason, the expected complexity is not justified by expected benefits.

In order to eliminate accounting mismatches without introducing significant complexity, it is our view that a better approach would be to allow the assets underlying the contract to be valued at fair value through profit or loss.

Question 3—Presentation of insurance contract revenue and expenses

Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial performance if, for all insurance contracts, an entity presents, in profit or loss, insurance contract revenue and expenses, rather than information about the changes in the components of the insurance contracts?

We agree with the proposal to present insurance contract revenues and expenses in profit or loss.

Question 4—Interest expense in profit or loss

Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial performance if an entity is required to segregate the effects of the underwriting performance from the effects of the changes in the discount rates by:

(a) recognising, in profit or loss, the interest expense determined using the discount rates that applied at the date that the contract was initially recognised. For cash flows that are expected to vary directly with returns on underlying items, the entity shall update those discount rates when the entity expects any changes in those returns to affect the amount of those cash flows; and

(b) recognising, in other comprehensive income, the difference between:

  (i) the carrying amount of the insurance contract measured using the discount rates that applied at the reporting date; and

  (ii) the carrying amount of the insurance contract measured using the discount rates that applied at the date that the contract was initially recognised. For cash flows that are expected to vary directly with returns on underlying items, the entity shall update those discount rates when the entity expects any changes in those returns to affect the amount of those cash flows?

We do not agree that an entity should be required to recognise the difference between the carrying amount of the insurance contract measured at the discount rate at reporting date and the carrying amount of the insurance contract measured at the discount rate at first recognition through other comprehensive income.

Our specific concerns are as follows:

- The requirement to use interest rates applicable at the initial recognition date of the insurance contract will be difficult to apply in practice and does not provide relevant information to users of financial statements. It will be particularly difficult for insurers to identify and apply the interest rates at inception on older insurance contracts and we consider this to be a costly requirement for no real benefit.
- Many insurance contracts are backed by assets which will not be designated as fair value through other comprehensive income under IFRS 9. These include equities and complex debt instruments and often represent a significant component of the pool of assets used by insurers to back policy liabilities. Accounting mismatches will continue to exist if the entity is required to present the impact to policy liabilities of changes in discount rates through other comprehensive income, and the impact of changes in discount rates on the underlying asset is presented through profit or loss (where the asset is fair value through profit or loss).

We note that the IASB has not developed its conceptual framework with regards to other comprehensive income and it is our view that this should be finalised before additional items are allocated to other comprehensive income.

We propose the following alternative to this approach:

- The ED should require changes to the carrying amount of insurance contract liabilities to be recognised through profit or loss, with an option to allow for the use of other comprehensive income based on the insurer's business model or other circumstances;
- Under the current drafting of IFRS 9, this approach would allow for financial instruments backing policy liabilities to be designated as fair value through profit or loss as it would eliminate an accounting mismatch;
- In our view this would allow for those who had a business model which would be better represented by adopting the other comprehensive income approach to do so;
- We would also recommend that any amounts that are recognised in other comprehensive income represent the difference between interest rates at the start of the period and interest rates at the reporting date, removing the requirement to report using interest rates applicable at the initial recognition of a contract.

Question 5—Effective date and transition
Do you agree that the proposed approach to transition appropriately balances comparability with verifiability?

We agree with the current approach to transition and see it as a significant improvement to the previous Exposure Draft.

We do recommend that the IASB align the mandatory application dates of IFRS 4 and IFRS 9.

Question 6 – the likely effects of a standard for insurance contracts
Considering the proposed standard as a whole, do you think the cost of complying with the proposed requirements are justified by the benefits that the information will provide? How are those costs and benefits affected by the proposals in Questions 1-5? How do the costs and benefits compare with any alternative approach that you propose and with the proposals in the 2010 Exposure Draft? Please describe the likely effect of the proposed Standard as a whole on: a. The transparency in the financial statements of the effects of insurance contracts and the comparability between financial statements of different entities that issue insurance contracts; and b. The compliance costs for preparers and the costs for users of financial statements to understand the information produced, both on initial application and on an ongoing basis.

In our view the costs associated with transitioning to the new standard will be substantial. Whilst we support of the requirement to implement a global accounting standard for insurance contracts and recognise that certain costs must be incurred in achieving this result, we believe there are areas where the associated cost is not justified by the benefits provided.

One particular area of concern is the requirement to use interest rates applicable at the initial recognition date of an insurance contract. In our view this does not provide meaningful information to users of financial statements and is expected to be costly to implement. In this case we do not consider the costs associated with the particular requirement to be justified by the benefits provided.

The proposed approach for contracts which require the entity to hold underlying items and specify a link to those underlying items is considered to be overly complex and in our view the cost of implementing this approach is not justified by the benefits provided.

Question 7 – Clarity of Drafting
Do you agree that the proposals are drafted clearly and reflect the decisions made by the IASB? If not, please describe any proposal that is not clear. How would you clarify it?

We have no comments in relation to the drafting of the Exposure Draft.