25 October 2013

Hans Hoogervorst
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Mr Hoogervorst,

Re: ED/2013/7 'Insurance Contracts'

Australia and New Zealand Banking Group Limited (ANZ) is an AA-rated bank listed on the Australian Securities Exchange. Our operations are predominately based in Australia, New Zealand and the Asia Pacific region. Our most recent annual results reported profits before tax of US$5.9 billion and total assets of US$672 billion.

We acknowledge the progress the International Accounting Standards Board (the Board) has made in relation to the development of an insurance contracts standard. We note that a large number of the issues that we raised in our previous submission have been addressed by the Board and we consider the revised ED to be a significant improvement on the previous ED. In particular, we support the proposals to unlock the contractual service margin and to exclude financial guarantees from the scope of the standard.

However, we do have two areas of concern: the presentation of the financial impacts of changes in discount rates in the Statement of Other Comprehensive Income (OCI); and the contract boundary.

Presentation of the financial impacts of changes in discount rates in OCI

We do not support the proposals in the ED to mandate the presentation of the financial impacts of discount rate changes in OCI because of the complexity of this proposal as well as the potential to create accounting mismatches for some insurers. We propose that insurers are *permitted* (but not required) to present the financial impact of *changes in discount rates in the current period* in OCI, where this presents useful information to users.

The proposal to present the financial impacts of discount rate changes in OCI will require insurers to maintain two measurement bases for each cohort of insurance contracts: one using locked-in discount rates; and one using current discount rates[1]. This will create significant complexity in the actuarial models required to calculate the financial impact and additional burdens for external auditors and those involved in financial governance, including non-executive directors.

ANZ currently presents both statutory profit and cash profit (a non-IFRS measure) in its annual report. One of the adjustments to statutory profit is the financial impact of changes in discount rates in the current period. We believe this is useful information to our users as it disaggregates market-driven impacts (which otherwise drive significant

1 the amount presented in OCI includes two components: the impact of changes in discount rates in the current period (the bulk of the financial impact); and the difference between interest accretion in the period measured using a locked-in rate and interest accretion in the period measured using a current rate

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P&L volatility) from underlying underwriting profit. As it only relates to the current period, it is an adjustment that is relatively simple to determine and to explain to our users. Including the difference between interest accretion in the period measured using a locked-in rate and interest accretion in the period measured using a current rate in the adjustment would add significantly to the complexity of the determination and would substantially reduce the usefulness of the information presented. The movements in this second component do not move in line with market conditions and are difficult to understand and explain. For example, even if discount rates do not change in a particular period, a gain or loss would be recognised in OCI because of the continued use of a locked-in rate for interest accretion. We therefore propose, to reduce complexity and to provide useful information for users, that if changes in discount rates are presented in OCI that it should only be the component that relates to changes in discount rates that arise in the period presented.

Furthermore, we believe that it should be an accounting policy choice to present this impact in OCI, depending upon whether or not, given the asset measurement bases and product mix of the insurer, this would provide useful information for users. For some insurers, presenting the financial impact of discount rate changes in OCI will create accounting mismatches, for example, where the insurer has a large number of assets measured at fair value through profit and loss.

Contract boundary

We are concerned about a lack of clarity in the drafting of the current contract boundary proposals that could result in diversity in the accounting for contracts of a similar nature.

The ED introduces amended requirements to determine the boundary of an insurance contract. These requirements impact whether a contract can be measured using the simplified approach, as the simplified approach can be applied to contracts with coverage periods of twelve months or less. Under the contract boundary proposals, coverage ends: either when the contract can be repriced, or, when the portfolio can be repriced and "when pricing of the premiums for coverage up to the date when the risks are reassessed does not take into account risks that relate to future periods" (para 23(b)(ii)). We understand that paragraph 23(b)(ii) was introduced to prevent certain contracts such as certain level premium contracts from being accounted for as annual contracts as this would result in the recognition of revenue (and hence profit) being accelerated relative to the provision of service (or expiry of risk).

In Australia, yearly renewable terms (YRTs) contracts are common in the life insurance market. At ANZ, they are prevalent in both our Retail and Group life business. For these contracts, the insurer may not cancel the contract, but it may reprice the portfolio of contracts annually. While the insurer, in pricing the contract prior to inception, will reflect expectations of renewal and/or lapse beyond the first twelve months (if all insureds were to lapse after one year the first year's premium would often not cover acquisition costs) it will reprice all risks such as lapse, mortality and disability risk at each annual renewal.

There are differing views in Australia as to whether YRT contracts would be considered annual contracts or long-term contracts under the ED. Given that lapse risk, for the first twelve months and into the future, is anticipated in the original pricing, does this mean that the pricing takes into account future risk? Given lapse rates can be such a significant contributor to ultimate underwriting profit some believe that YRT contracts would not be considered annual contracts. We believe that as all risks can be repriced annually the contracts should be considered annual contracts. We also believe paragraph 23(b)(ii) would be difficult to substantiate as the insurer would need to be able to demonstrate that it was only incorporating risk, and expectations about changes in that

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risk, for the following twelve months and that it is not reflecting risk, or changes in that risk, beyond the next twelve months.

We would therefore encourage the Board to reconsider the current drafting of 23(b)(ii) to avoid diversity in the accounting for contracts such as YRTs.

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 do not hesitate to contact me at shane.buggle@anz.com.

Yours sincerely

Shane Buggle
Deputy Chief Financial Officer

Copy: Chairman, Australian Accounting Standards Board (AASB)

APPENDIX

Question 1 - Adjusting the contractual 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? Why or why not? If not, what would you recommend and why?

We are supportive of the Board's decision to unlock the service margin as we had significant concerns with the previous ED, which required a locked-in residual margin. 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 over the remaining 15 years, however, the expected profits are reduced. Under the proposed model a loss will be recognised in the profit and loss to reflect a reduction in profits that is expected to emerge over the next 15 years, however the residual margin, which is an indicator of future profits will remain unchanged and will continue to run off as before.

We agree with the different accounting treatment for assumptions relating to future coverage and assumptions relating to coverage that has expired as we believe that this will ensure that profit is recognised as it is earned, which is as the insurer is released from risk.

There are two aspects to the service margin proposals we would like to comment: on the reversal of previous losses and impacts of changes in the risk margin.

Loss reversals
We note that the ED does not allow losses that have been recognised in profit and loss (because the service margin has been exhausted) to be reversed, where there is a subsequent change in estimates (such that the service margin is reinstated). The current life insurance accounting model in Australia (the Margin on Services model, or "MoS") allows for the reversal of losses. Experience in Australia has shown that, for contracts that can continue for 20 years, it is not unusual for losses to be recognised and subsequently reversed. Indeed this is one of the reasons that the planned margin under MoS absorbs changes in estimate and does not recognise them in P&L. We understand that the IASB has not allowed for the reversal of losses in its model because of the additional complexity this brings to the model. While we would regard this as a conceptually better approach, we do support the approach of minimising complexity. We would recommend that the Board reconsider its position on this treatment, as it is the view of some actuaries in Australia that the degree of complexity introduced here is not significant.

Changes in risk margins
Under the ED, changes in the risk margin assumption are recognised immediately in profit and loss; this includes experience gains and losses, as well as changes in assumptions about future risk. This is inconsistent with the accounting treatment proposed for changes in other actuarial assumptions, such as mortality, where experience gains and losses are recognised in profit and loss, but changes in assumptions relating to future periods are adjusted against the service margin.

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Conceptually, changes in the risk margin should affect the current measurement of the service margin in exactly the same way that changes in future cash flows do, as remeasurements of risk impact the expected profit. It is our view that the financial impact of changes in the risk margin assumptions should be recognised in profit and loss, where they relate to the current period, or remeasured through the service margin where they relate to future periods, as this approach is consistent with the treatment for other actuarial assumption changes. Under this approach, the user has visibility of changes in all experience gains and losses (an indicator of how accurate estimates have been) and all changes in assumptions relating 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.

As ANZ does not have a material involvement in participating business, we do not have any comments to make with regard to this question.

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?

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Why or why not? If not, what would you recommend and why?

We support the approach of the IASB to produce a single model for both life and general insurance contracts and a single model for presentation of revenue and expenses. We also support the IASB's intention to bring the insurance contracts standard in line with the revenue standard, and to propose a concept of revenue under an insurance contract that is consistent with the approach that will be applied to all other types of revenue.

ANZ (along with all of the Big 4 Australian banks) is involved in providing banking services, issuing life insurance contracts, general insurance contracts and life investment contracts and a single approach to presentation of revenue and expenses across all of our products will result in financial statements that are of greater use to users, and will reduce the volume of disclosures.

We support the ED's approach on the basis that:

- It is an improvement on the margin analysis proposed in the previous ED;
- It proposes a consistent presentation model for both life and general insurance contracts; and
- While the 'revenue' balance that will be presented is different to that currently presented, the components of that number are readily determined as part of the measurement of the insurance contract.

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? Why or why not? If not, what would you recommend and why?

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We do not support the proposals in the ED to mandate the presentation of the financial impacts of discount rate changes in OCI because of the complexity of this proposal as well as the potential to create accounting mismatches for some insurers. We propose that insurers are *permitted* (but not required) to present the financial impact of *changes in discount rates in the current period* in OCI, where this presents useful information to users.

The proposal to present the financial impacts of discount rate changes in OCI will require insurers to maintain two measurement bases for each cohort of insurance contracts: one using locked-in discount rates; and one using current discount rates. This will create significant complexity in the actuarial models required to calculate the financial impact and additional burdens for external auditors and those involved in financial governance, including non-executive directors. We note that the amount presented in OCI includes two components: the impact of changes in discount rates in the current period (the bulk of the financial impact) and the difference between interest accretion in the period measured using a locked-in rate and interest accretion in the period measured using a current rate.

ANZ currently presents both statutory profit and cash profit (a non-IFRS measure) in its annual report. One of the adjustments to statutory profit is the financial impact of changes in discount rates in the current period. We believe this is useful information to our users, as it disaggregates market-driven impacts (which otherwise drive significant P&L volatility) from underlying underwriting profit. As it only relates to the current period, it is an adjustment that is relatively simple to determine and, therefore, explain to our users. Including the difference between interest accretion in the period measured using a locked-in rate and interest accretion in the period measured using a current rate in the adjustment would add significantly to the complexity of the determination and would reduce the usefulness of the information presented. The movements in this second component do not move in line with market conditions and are difficult to understand and explain. For example, even if discount rates do not change in a particular period, a gain or loss would be recognised in OCI because of the continued use of a locked-in rate for interest accretion. We therefore propose, to reduce complexity, and to provide useful information for users, that if changes in discount rates are presented in OCI that it should only be the component that relates to changes in discount rates in the current period.

Furthermore, we believe that it should be an accounting policy choice to present this impact in OCI, depending upon whether or not, given the asset measurement bases and product mix of the insurer, this would provide useful information for users. For some insurers, presenting the financial impact of discount rate changes in OCI will create accounting mismatches, for example, where the insurer has a large number of assets measured at fair value through profit and loss. Within the ANZ Group, for example, our insurers are impacted differently by changes in discount rates. For one, changes in discount rates introduce significant volatility into the profit and loss, for the other, because of the measurement bases of assets backing the liabilities and because of an inherent hedge within the portfolio (with discount rates impacting annuity and risk portfolios in opposite directions) the impact is less significant.

Question 5 - Effective date and transition
Do you agree that the proposed approach to transition appropriately balances comparability with verifiability? Why or why not? If not, what do you suggest and why?

We support the changes made to the transition proposals since the previous ED.

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Given that the MoS model requires the recognition of a planned margin (which is similar in nature to the service margin under the ED); we were not supportive of the proposals in the previous ED, which required existing planned margins to be derecognised on implementation of the new insurance standard.

Question 6 - The likely effects of a Standard for insurance contracts
Considering the proposed Standard as a whole, do you think that the costs 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.

For Australian entities the impact of the proposed ED is less significant than for entities in many other jurisdictions, and therefore, for ANZ, the benefits of the proposals, in particular the increased consistency it will bring to global accounting practices for insurance contracts, justify the costs of implementing the proposals.

One area where believe transparency may not be achieved is in relation to implementation of the contract boundary proposals. Note our comments in response to Question 7 below. We believe that contracts that are in substance the same could either be accounted for as long-term contracts using the full building blocks approach, or could be measured using the simplified approach.

One area where we believe the costs of implementation do not justify the benefits is the presentation of the financial impact of discount rate changes in OCI (see our response to Question 4).

The ED lists extensive disclosures, but allows the disclosures not considered relevant to be omitted from the financial statements. While we welcome this ability to omit certain disclosures, we would nevertheless encourage the Board to take a more principles based approach to disclosure. Including very extensive disclosures in a standard, but allowing entities to omit certain disclosures, may still lead to unnecessary levels of disclosure as entities include disclosures to bring disclosure in line with peers and external auditor views.

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?

There is one significant area where we believe the proposals are not clearly drafted.

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We are concerned about a lack of clarity in the drafting of the current contract boundary proposals that could result in diversity in the accounting for contracts of a similar nature.

The ED introduces amended requirements to determine the boundary of an insurance contract. These requirements impact whether a contract can be measured using the simplified approach, as the simplified approach can be applied to contracts with coverage periods of twelve months or less. Under the contract boundary proposals, coverage ends: either when the contract can be repriced, or, when the portfolio can be repriced and "when pricing of the premiums for coverage up to the date when the risks are reassessed does not take into account risks that relate to future periods" (para 23(b)(ii)). We understand that paragraph 23(b)(ii) was introduced to prevent certain contracts such as certain level premium contracts from being accounted for as annual contracts, as this would result in the recognition of revenue (and hence profit) being accelerated relative to the provision of service (or expiry of risk).

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We would therefore encourage the Board to reconsider the current drafting of 23(b)(ii) to avoid diversity in the accounting for contracts such as YRTs.

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