Insurance Solvency Standards and NZ IFRS 16 Leases

Reserve Bank of New Zealand Consultation Paper

SUBMISSION

From

ICNZ Insurance Council of New Zealand

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INTRODUCTION

The Insurance Council of New Zealand (ICNZ) thanks you for the opportunity to provide a submission on this consultation paper on Insurance Solvency Standards and NZ IFRS 16.

This ICNZ submission has been prepared after consultation with ICNZ members and represents a general insurance industry consensus. Individual ICNZ members may be making their own submissions and providing their company information.

INSURANCE COUNCIL OF NEW ZEALAND

ICNZ is the industry representative of general insurers in New Zealand. We aim to assist our members in the key areas that affect their business through effective advocacy and communication.

ICNZ currently has 27 members who collectively write more than 95 percent of all fire and general insurance in New Zealand. ICNZ members, both insurers and reinsurers, make up a significant part of the New Zealand financial services system. ICNZ members currently protect more than three quarters of a trillion dollars' worth of New Zealanders' assets.

ICNZ plays an active role in representing the insurance industry. Our members are licensed under the Insurance (Prudential Supervision) Act 2010 and are signatories to the Fair Insurance Code, which sets high standards for our members in all their dealings with customers. We also perform an important role in informing and educating consumers about key insurance issues and risks.

HIGH LEVEL COMMENTS

ICNZ wrote to the Reserve Bank (RBNZ) on 16 February 2018 outlining some thoughts on the solvency treatment of leases under NZ IFRS 16, when this comes into effect on 1 January 2019. Insurers were concerned about the potential impact an ultra-conservative approach could have on their capital requirements.

We are pleased to see that the proposals in the consultation paper appear to have taken insurers' perspectives into account and the industry is not facing a punitive interpretation of NZ IFRS 16 in relation to capital. We believe this is a technically accurate approach and is a pragmatic solution to what could have been a material issue for some insurers. The approach recognises that there is no fundamental change in the economic reality of an organisation, pre and post NZ IFRS 16.

The table below paragraph 12 of the consultation paper proposes an asset risk capital charge of 100% of the value of the Right of Use (ROU) Asset minus the value of the corresponding lease liability. Insurers expectations are that in the majority of cases the ROU asset and lease liabilities will follow the progression outlined in figure one of paragraph 29 of the consultation paper. The expectation is that the ROU asset will be greater than the lease liability in the very early stages of most leases because of upfront costs and advance payments. However, because of the front loading of interest expenses, the liability will then exceed the asset for the rest of the lease.

In these cases, initially there will be a 100% asset risk capital charge on the net asset position, but after that, the effect will be zero. This means there will be no change from the current solvency position because insurers don't currently gain a solvency advantage from the lease expense.

Insurers accordingly support the solvency treatment of leases under NZ IFRS 16 proposed in the consultation paper, subject to the treatment of intangible assets.

RESPONSES TO SPECIFIC QUESTIONS

The following comments are made in relation to the questions in the indicated sections of the consultation paper. In addressing this section, RBNZ should be aware that insurers have not yet had to apply NZ IFRS 16 and their knowledge is therefore more academic than practical. At this stage answers are given in this context.

Transition to NZ IFRS 16 (section 3.1.4 of the consultation paper)

Is the description of the accounting approaches discussed in Part 3 consistent with your understanding of the current and new accounting approaches for lease contracts? If not, please provide an explanation of the differences.

The paper's description of the accounting approaches aligns with insurers' understanding of the current and future proposals for accounting for leases.

Are there any requirements of NZ IFRS 16 that you consider the Reserve Bank needs to make specific provision for in the Solvency Standard in addition to or instead of those set out in Part 2?

At this stage we are not aware of any additional requirements.

Are there any elements of NZ IFRS 16 transition proposals that you consider the Reserve Bank needs to consider?

The Solvency Standard requires four-year forecasts to be included within solvency returns. ICNZ considers the solvency standard should have transitional provisions in respect of the forecast period to provide insurers with certainty of application of NZ IFRS 16 and to allow insurers to prepare the required transitional calculations.

ICNZ recommends that NZ IFRS 16 be reflected in forecasts included within solvency returns from the first return in which the insurer transitions to NZ IFRS 16, i.e. for an insurer with a June balance date then the standard will become mandatory for the financial year ending 30 June 2020. In this case, it is proposed that the first solvency return which would take into account NZ IFRS 16 for both actuals and forecast would be the return in respect of the half-year ended 31 December 2019.

Are there any other specific lease related transactions that the Reserve Bank should consider from a Solvency Standard perspective?

At this stage we are not aware of any specific lease transactions that RBNZ needs to consider. The same principles apply for leases of property, vehicles, IT, office equipment, etc.

Risks associated with the new assets and liabilities (section 4.1 of the consultation paper)

Do you consider that the nature of the potential risks of lease contracts and the accounting treatment of NZ IFRS 16 set out in Table 2 are reasonable?

At this stage we believe the nature of the potential risks of lease contracts in Table 2 and the accounting treatment of NZ IFRS 16 are reasonable.

Are there any risks that have been ignored or inappropriately characterised?

We believe the risk where a ROU asset is an intangible asset has not been appropriately characterised. The wording under the proposed Solvency Standard suggests that where a ROU asset is intangible, this shall be deducted from capital. We do not believe this should be the case. The underlying economic fundamentals of the insurer is not changed when the subject of a lease is intangible as compared to a tangible ROU asset. The net asset value of the insurer will be similar and an exception for intangible assets, which will be a very small portion of lease assets, does not appear justified when there has only been a change in accounting methodology.

Proposed approach to the Solvency Standards (section 4.2 of the consultation paper)

Do you consider that the proposed approach appropriately addresses the key risks identified in Table 2? If not, please provide an explanation and recommend an alternative approach.

We believe the proposed approach appropriately addresses the key risks in Table 2. The matching of lease assets and lease liabilities leaves a relatively minor surplus or deficit which would not be expected to be material in the insurer's financial position. RBNZ has taken a pragmatic view of these risks, except in relation to where leases are for intangible assets and we have outlined our thoughts on this under 4.5 above.

Do you consider that the draft text set out in Appendix B, would effectively implement the proposed changes?

We believe the following changes/selections should be made:

- **2.5 Intangible Asset Deductions**: in the new paragraph 28A take out the wording:

  "where the underlying asset is tangible"

- **3.3 Risk Weighted Exposures Charge**: in the new paragraph 62A use the first option:

  *100% *(Value of the right-of-use asset less the value of the corresponding lease liability)* subject *to a minimum of zero.*

  We believe this option describes more accurately what is the intention.

ICNZ supports the remainder of the changes to the Solvency Standard for Non-Life Insurance Business under Appendix B.

CONCLUSION

Thank you for consulting on this issue with the industry. If you wish to discuss these comments further, please contact the writer. (terry@icnz.org.nz)

Yours faithfully

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