RESERVE BANK

OF NEW ZEALAND

TE PŪTEA MATUA

Response to Submissions: Insurance Solvency Standards and NZ IFRS 16 Leases

November 2018

Ref #7807735

Finalised changes to the solvency standards in response to NZ IFRS 16 *Leases*

1. The Reserve Bank consulted[1] on proposed changes to the insurance solvency standards in response to the accounting standard NZ IFRS 16 *Leases.* The consultation closed on 24th August 2018 with 17 organisations providing submissions.

2. The Reserve Bank welcomes the submissions made. Having considered the submissions, this feedback statement sets out the finalised proposals. Appendix A includes a response to the key points raised by submitters.

3. Submissions, excluding any information provided in response to the survey that accompanied the consultation, are available on the Reserve Bank website, unless confidentiality was requested.[1]

Treatment of right-of-use assets and leases liabilities will be as consulted except for the treatment of leases of intangible assets accounted for under NZ IFRS 16

4. Table 1 below sets out the finalised proposals for the treatment of the right-of-use assets and lease liabilities arising for lesees under NZ IFRS 16 *Leases* under the solvency standards.

5. The treatment of the right-of-use assets arising from the lease of intangible items has changed from that originally consulted on in response to comments received. These are shown in bold text in the table. Other aspects remain unchanged. Brief comments on the reasons for this change and other points made by submitters are set out in Appendix A.

[1] Available at: http://www.rbnz.govt.nz/regulation-and-supervision/insurers/consultations-and-policy-development-for-insurers/completed-policy-development/solvency-standards-and-nz-ifrs-16-leases

Table 1 : Changes to the solvency standards for NZ IFRS 16 *Leases*

Component	Requirement
Deductions from capital (Intangible Assets)	A right-of-use asset is not deducted from capital where the underlying asset is tangible. **The deduction from capital where the underlying asset is intangible and the lease is accounted for under NZ IFRS 16 is limited to 100% (value of right-of-use asset – value of corresponding lease liability) with a minimum of zero.**
Asset risk capital charge	Asset risk capital charge of 100% (value of right-of-use asset – value of corresponding lease liability) with a minimum of $0.
Concentration risk capital charge	Right-of-use assets are excluded from the asset concentration risk charge.
Foreign exchange and interest rate risk charge	No changes to the current text, so that right-of-use assets and corresponding lease liabilities are subject to the Foreign Exchange Risk Capital Charge and the Interest Rate Risk Capital Charge if appropriate.
Treatment of related party leases	A right-of-use asset is not subject to a 100% charge due to the counterparty being a related party, provided the lease contract is on a prudent commercial arm's length basis.

Solvency standards shall include some changes that are editorial or already communicated to insurers

6. The Solvency Standard for Non-life Insurance Business 2014 will include the earthquake event loss return period and transition arrangements directly. These have previously been set out in a separate Policy Position Paper. The requirements remain unchanged.

7. The solvency standards will include reference to a "reasonable assurance" audit of the insurer solvency returns.[2] The decision to require a "reasonable assurance" level of audit on the annual solvency return has been consulted on and decisions taken in September 2018.[3]

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[2] "Reasonable assurance" is defined in section 12 of the International Standard on Assurance Engagements (New Zealand) 3000, issued by the External Reporting Board in July 2014.

[3] Available at: http://www.rbnz.govt.nz/regulation-and-supervision/insurers/consultations-and-policy-development-for-insurers/completed-policy-development/audit-requirements-for-insurer-data-returns

Amended standards shall be issued as soon as practical with effective dates aligned to mandatory adoption of NZ IFRS 16 *Leases*

8. The Reserve Bank will issue the amended standards in November 2018. The effective date of the changes will be:

Areas	**Effective Date**
Treatment of right-of-use assets and leases liabilities under NZ IFRS 16	The start of the financial year beginning on or after the 1 January 2019.
Reasonable assurance audit level on solvency returns	From and including the end of the financial year ending in 2019.
Incorporation of return period for catastrophe risk previously in Policy Position Paper	No change in requirements so continues to remain in effect

Survey results confirm expectations

9. The Reserve Bank thanks those submitters that also provided information under the survey that accompanied the consultation.

10. In aggregate the survey results:

- Confirm that the significant lease arrangements are primarily in respect of premises, car fleets and information technology.

- That the expected impact on the net asset position, initially, and over the first year is expected to be small. Of those that provided a quantification expected impact on solvency ratios were under 1% under the proposals.

- A number of insurers anticipate using the available exemptions for low-value items and short-term leases but have not yet fully assessed the options.

Appendix A: Feedback comments on key submissions made

A1. This appendix provides a summary of key points raised in submissions and the Reserve Bank's response.

A2. We received submissions representing 17 organisations. Submissions were broadly supportive of the proposed changes noting that the proposals largely addressed the risks identified, were appropriately pragmatic and took account of prior industry comment.

A3. A number of submitters raised potential concerns with some aspects of the proposal or commentary made in the consultation paper. These are summarised below:

Summary of main issues raised by submitters	**Our response and comment**
Intangible asset treatment	
Some submitters consider that right-of-use assets should not be treated as intangible assets and not fully deducted from capital. This is because there is no material increase in the net asset position and no increase in economic risk based on whether the underlying asset is intangible or not. Alternatively, a submitter suggested if the distinction is retained, the deduction should	*Response* **Change the proposal so that the distinction between tangible and intangible assets is kept but limit the deduction to 100% x (value of right-of-use asset – value of lease liability), with a minimum of zero.** *Comment* NZ IFRS 16 *Leases* makes a distinction between leases of tangible or intangible assets. NZ IFRS 16 does not apply for a lessee for the lease of intangible assets within scope of NZ IAS 38 *Intangible Assets* for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights, and may, but is not required to be, used for leases of other intangible assets (NZ IFRS 16 paragraphs 3(e) and 4). Insurers therefore have a choice as to the accounting treatment of some intangible assets that are leased. Rather than override the accounting standards to determine when an asset is intangible or not (i.e. within scope of NZ IAS 38), we have aimed to ensure that the resulting capital outcome is the same regardless

be limited to the net value of the right-of-use asset over the lease liability.	of the choice made. The revised response achieves that outcome.

	Intangible asset that is not leased or leased but choice made to apply NZ IAS 38.	**Intangible asset that is leased and accounted for under NZ IFRS 16**
Intangible Asset	20	
Right-of-use asset		22 << new asset
Other Asset	80	80
Liabilities	60	60
Lease Liability		20 << new liability
Net Assets	40	22
Deduction from capital	(20)	(2) << deduction limited to amount new asset exceeds new liability.
Capital	20	20 << same amount of eligible capital all other things being equal

Market risk sensitivity - Interest rate risks	
The consultation paper indicated that interest rate risk may apply in some circumstances. A number of submitters consider this is not actually the case as the asset and liability, once established, are not normally updated for movements in interest rates. Where revaluations do occur the value of the asset and liability move together.	*Response* **No change** *Comment* The consultation paper noted that interest rate risk (i.e. a change in the net asset position due to movements in interest rates having different valuation impacts on the value of the asset and liability), may apply in some circumstances. We had in mind two situations: - Where the right-of-use asset is valued using valuation approaches related to a fair value model (permitted or required for certain asset classes under NZ IFRS 16 *Leases* paragraphs 34 and 35); - Where a revaluation of the lease-liability may not be able to be matched by a corresponding change in the right-of-use asset e.g. if the liability were to reduce in value and the right-of-use asset has already amortised to a low value or has been written down due to impairment so that the full reduction in liability is not offset. The default accounting model under NZ IFRS 16 would not lead to interest rate sensitivity in respect of right-of-use assets and lease liabilities generally as the liability is not revalued using updated interest rates except in specified circumstances e.g. a change in the lease term or a change in the firm's likely decision under any termination options included within the lease. If right-of-use assets and lease liabilities result in no interest rate sensitivity, the interest rate risk capital charge as currently applies should result in no additional capital. Therefore we do not consider that text that explicitly excludes right-of-use assets and lease liabilities from

The related area of exposure to future inflation is not recognised for accounting purposes until contractual cashflows change. These changes are also reflected in both the asset and liability values.	the calculation is warranted. That the proposed approach does not capture future inflation risk fully (i.e. are not recognised until lease payments are contractually altered) or that the risks that the *fair value* of the right-of-use assets and liabilities may be mismatched is recognised. We consider that any changes to the solvency standards for these types of risk need to be considered more broadly than only in respect of lease assets and liabilities. These areas may be considered in future reviews of the solvency requirements.
The rate of interest used to value the lease liability will involve a degree of judgement and should be specified by the RBNZ.	*Response* **No change**. *Comment* The liability is valued using the interest rate implicit in the lease (if known) or the firm's marginal borrowing rate. This will result in different firms using different rates and may involve a degree of estimation and judgement. In addition, the "marginal borrowing rate" approach may reflect an entity's own credit risk. The issue of appropriate discount rates and the extent they should be prescribed by the Reserve Bank for solvency purposes is broad. We consider that this area should be addressed more holistically in possible future reviews of the solvency requirements.
Other areas	
Have a transition period for inclusion of NZ IFRS 16 values within the 4 year projections required in the	*Response* No change. Insurers should continue to make appropriate estimates, subject to materiality, informed by this paper and other relevant factors and provide commentary on methods used, including material

insurer solvency returns e.g. by not requiring any NZ IFRS 16 related amounts until the first return after the insurer adopts NZ IFRS 16.	approximations, in the commentary included within the Insurer Solvency Returns. The Reserve Bank may develop additional guidance on the intent and purpose of these projections in the context of s24 of the Insurance (Prudential Supervision) Act in due course. *Comment* The Insurer Solvency Return includes a 4 year projection of actual solvency capital, minimum solvency capital, the solvency margin and solvency ratio, and asks for confirmation on whether or not there are "reasonable grounds to believe that a failure to maintain a solvency margin is likely to occur at any time within the next three years" i.e. in support of the requirements of s24 of Insurance (Prudential Supervision) Act. Such projections will necessarily involve a degree of judgement and the estimation of future uncertain amounts, subject to appropriate materiality considerations. This issue extends beyond the treatment of lease related assets and liabilities introduced by NZ IFRS 16.
Treat proposed asset risk charge as a deduction from capital to avoid reduction in solvency ratio	*Response* **No change** *Comment* Some components of the proposed capital charges e.g any foreign exchange risk, should be treated consistently with the existing requirements e.g. foreign exchange risks are currently captured within the minimum capital requirement rather than through a deduction from capital. We therefore consider the proposed approach is appropriate and avoids the alternative complexity in separating out different elements of the total charge and allocating them to deductions from capital or the minimum capital requirement.