IAG New Zealand submission

to the

Reserve Bank of New Zealand

on the

Consultation Paper: Insurance Solvency Standards and NZ IFRS 16 Leases

24 August 2018

1. Introduction

1.1 This submission is a response by IAG New Zealand Ltd (IAG, we) to the Reserve Bank of New Zealand's (the Bank) consultation paper: Insurance Solvency Standards and NZ IFRS 16 Leases (the Paper).

1.2 IAG is New Zealand's leading general insurer. We insure more than 1.8 million New Zealanders and protect over $650 billion of commercial and domestic assets across New Zealand. We receive more than 650,000 claims a year and pay $1.365b in settling them.

1.3 In this submission we have responded to each of the proposed changes and the specific questions raised. We have also responded to the Bank's Survey at Appendix A of the Paper on a 'best endeavours' basis.

1.4 All our comments relate to Solvency Standard for Non-Life Business (Solvency Standard). Our comments do not relate to re-insurers or life-insurers unless specifically stated as doing so.

1.5 We would welcome the opportunity to discuss our submission with the Bank.

1.6 IAG's contact for matters relating to this submission are:

Bryce Davies, [redacted]

Scott Barkman, [redacted]

Martin Stott, [redacted]

2. General comments

2.1 IAG welcomes the opportunity to comment on the Paper and appreciates the RBNZ's willingness to consult the industry when proposing changes to the regulatory framework.

2.2 We are pleased to see that the Bank has taken into consideration the industry's previous comments on Lease Commitments and more recent comments on NZ IFRS 16 Leases. Accordingly, IAG's view is that the proposals are pragmatic and satisfactory, although we have posed some clarifying questions further below.

2.3 IAG would be pleased to participate in any further dialogue should the Bank deem that necessary.

3. Specific Comments

Deductions from capital

3.1 The Paper proposes that ‘a right-of-use asset is not deducted from capital where the underlying asset is tangible’ and that this is given effect by adding paragraph 28A to the Solvency Standard stating “A right-of-use asset arising from lease contracts accounted for under NZ IFRS 16 where the underlying asset is tangible shall not be deducted from capital”

3.2 **We agree with this proposal**.

3.3 **We recommend that this approach is also applied when the underlying asset is an intangible asset**.

3.4 The current proposal would result in a reduction of Actual Solvency Capital (ASC) and a corresponding reduction in Solvency Margin held where the underlying asset is an intangible asset and that is not appropriate because:

- the net asset value of the insurer will not materially change; and therefore
- the ASC of the insurer will not materially change in the first instance; and
- the “underlying economic risks are not directly impacted by accounting methodologies” (as stated at paragraph 38 of the Paper).

Asset risk capital charge

3.5 The Paper proposes that an asset risk capital charge should be applied as 100% of the net of the value of the right-of-use asset and the value of the corresponding lease liability. And that this charge should be subject to a minimum of zero.

3.6 **We agree with this proposal**.

3.7 Appendix B of the Paper presents two options for the wording of a paragraph 62A in the Solvency Standard for Non-Life Business. **We recommend that the Bank adopts the first option**, being:

> “Right-of-use assets arising from NZ IFRS 16 Leases are excluded from the calculation in 62. The Risk Weighted Exposure Charge under paragraph 62 is increased in respect of right-of-use assets and lease liabilities under NZ IFRS 16 by:
> 100% * (Value of the right-of-use asset less the value of the corresponding lease liability) subject to a minimum of zero.”

3.8 This option more explicitly describes what is intended than the alternative option noted at Appendix B of the Paper.

Concentration risk charge

3.9 The Paper proposes that right-of-use assets are excluded from the asset concentration risk charge and that this is given effect by inserting the words "(excluding right-of-use assets arising from lease contracts accounted for under NZ IFRS 16)" into paragraph 72 of the Solvency Standard.

3.10 The paper further proposes that the right-of-use asset is excluded from the measurement of total assets for the purposes of applying concentration limits and that this is given affected by amending the heading of the 2nd column of Table 3 of the Solvency Standard by inserting the words "and right-of-use assets arising from lease contracts accounted for under NZ IFRS 16".

3.11 **We agree with these proposals**.

Interest rate risk capital charge

3.12 We would like to clarity on how the Bank believes that the calculation of interest rate risk capital charge might apply given NZ IFRS 16 does not introduce interest rate sensitivity into the measurement of the right of use asset and the corresponding lease liability.

3.13 Paragraphs 26 and 37 of NZ IFRS 16 effectively lock in the interest / discount rate at the commencement of a lease and so the subsequent measurement of the right of use asset and the corresponding lease liability is not interest rate sensitive, notwithstanding that the initial measurement is based on a discounted present value measurement.

3.14 We note that the Bank is not proposing any specific changes to the interest rate risk capital charge in the Solvency Standard and that at Part 2 of the Paper the Bank's commentary is:

- "Right of use assets and corresponding lease liabilities are subject to the … Interest Rate Risk Capital Charge *where appropriate*"; and
- "Recognises that right of use assets and lease liabilities *may be* subject to interest rate … risks in some circumstances." [Emphasis added.]

3.15 It is IAG's view that the interest rate risk capital charge will not apply to either the right of use asset or the corresponding lease liability.

Related party risk capital charge

3.16 The paper proposes that a right-of-use asset is not subject to a 100% charge due to the counterparty being a related party, provided that the lease contract is on a prudent commercial arm's length basis and that this is given effect by amending the definition of exposure class 14 in Table 2 of the Solvency Standard to include the words "and right-of-use assets under NZ IFRS 16 where the lease is entered in to on prudent commercial terms on an arm's length basis"

3.17 **We agree with this proposal**.

4. Answers to specific questions

Transition to NZ IFRS 16

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.

4.1 Yes, except at paragraph 23 as there will continue to be a distinction between operating leases and finance leases for small value items and leases of 12 months or less.

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?

4.2 None that we are aware of, although we have not yet fully considered the application detail of NZ IFRS 16.

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

4.3 We have not yet considered the transitional application detail of NZ IFRS 16.

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

4.4 None that we are aware of, although we have not yet fully considered the application detail of NZ IFRS 16.

Risks associated with the new assets and liabilities

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?

4.5 We do not believe that NZ IFRS lease accounting introduces interest rate sensitivity into the measurement of the right of use asset and corresponding lease liability and so do not believe that an interest rate risk capital charge will apply.

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

4.6 None that we are aware of, although we have not yet fully considered the application detail of NZ IFRS 16.

Proposed approach to the Solvency Standards

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.

4.7 We do not believe that NZ IFRS lease accounting introduces interest rate sensitivity into the measurement of the right of use asset and corresponding lease liability and so do not believe that an interest rate risk capital charge will apply.

4.8 We believe that the right of use asset should not be deducted from capital where the underlying asset is an intangible asset. See our comments at 3.3 and 3.4 above.

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

4.9 Yes. See the preferred option of wording for new paragraph 62A of the solvency Standard noted at 3.7 above.

Do you have any further points about NZ IFRS 16 Leases you would like to bring to the Reserve Bank's attention?

4.10 None that we are aware of, although we have not yet fully considered the application detail of NZ IFRS 16.

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]