IFRS16 & Insurers

The new accounting standard could make you insolvent

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IFRS 16 & lease commitments

Insurers with lease commitments will incur solvency problems under the soon to be released IFRS16. This will affect insurers and also banks.

IFRS16 will take effect from 1 January 2019. However its impact will be felt as soon as it is signed off later this year.

In simple terms, IFRS16 requires that assets and liabilities are to be held on the balance sheet to reflect the contractual requirements from any lease. The balance sheet will therefore be larger than previously shown although the equity position will be unchanged.

Under the regulatory solvency rules, the solvency position applies a risk charge to assets that are held. In this case the new asset relating to the capitalised lease commitment will probably attract a 40% risk charge.

This will reduce the regulatory solvency position of the entity from the effective date (Jan 2019). Although this is over two years away, under Section 24 of the Insurance (Prudential Supervision) Act 2010 ('IPSA'), entities must report to the RBNZ if they consider that they may be unable to satisfy solvency requirements at any time within the next three years.

This is especially an issue if you have any leases to be reviewed over the next few years as you may want to consider how they are structured and the term of the lease.

Regulatory solvency

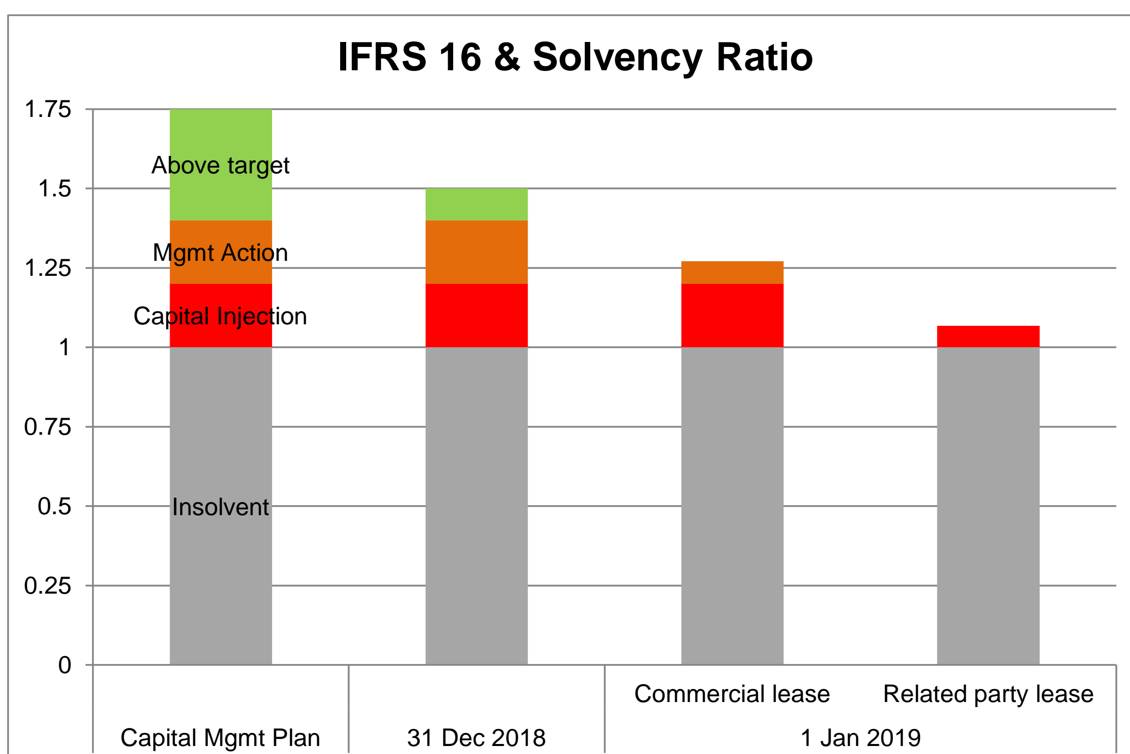
Regulatory solvency for insurers in NZ is assessed by comparing Actual Solvency Capital (effectively Equity less items which are not freely available to cover claims) to a calculated Minimum Solvency Capital.

The Minimum Solvency Capital is a function of the risks of the entity (operations, reinsurance, credit, interest and assets).

In respect of Asset Risk, capital charges are applied based on the security of the investment. Government stock and cash receive a small charge. Equities, property and doubtful debts etc receive much higher charges.

Lease commitments (e.g. property, motor) would probably be classified as 'Other Asset' (40% charge) as long as they were normal commercial, arms lengths agreements. If they could not be classified as this, they would probably be classified as 'Any Other Asset' and incur a 100% charge.

The chart below is explained over the page.



Simpl House 40 Mercer Street
PO Box 11330 Wellington 6142 New Zealand
T: 64 4 499 0277
wgtn@mjw.co.nz

www.mjw.co.nz

MELVILLE JESSUP WEAVER LIMITED

57 Fort Street
PO Box 4014 Auckland 1140 New Zealand
T: 64 9 300 7155
akld@mjw.co.nz

Solvency example

Consider an entity at 31 December 2018 with $20m assets, $14m liabilities and a minimum required solvency capital of $4m. Assuming all the equity is freely available to meet obligations, the solvency margin is $2m (ratio of 1.5). The entity has a capital management plan which targets a minimum solvency ratio of 1.4 with various required actions if the ratio falls below this.

Consider also that the company is about to renew a six year lease on its premises where its annual rent is $250,000. It also has a small fleet of cars with rolling three year leases. The annual lease commitment in total is $350,000.

On 1 January 2019, it is estimated that the capitalised value of these leases is $1.8m. The balance sheet would now have $21.8 assets, $15.8m liabilities and a solvency position that has deteriorated by approximately $0.7m (40%x$1.8m). The company will still be regulatory solvent but may feel obliged to hold higher levels of capital to support this extra charge.

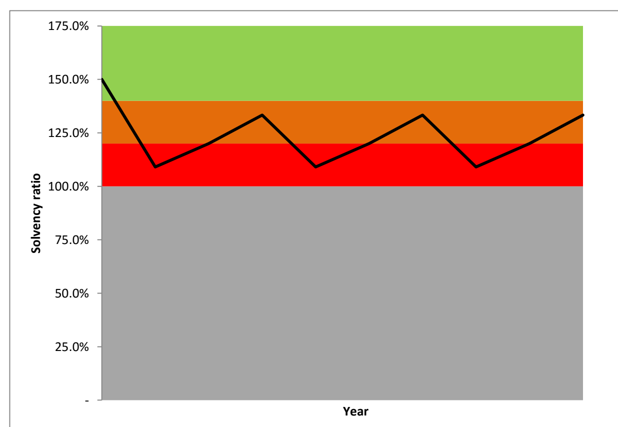
If the property was leased from a parent entity, the asset may attract a 100% charge. This would reduce the solvency margin by $1.8m. At this point, the RBNZ may start taking an interest in how the company intends to respond.

From the chart on the previous page, it is clear that this entity needs to be thinking now about what its solvency position might be in a little over two years.

Lease - time to go

A peculiar consequence of IFRS16 is that the balance sheet of the entity will grow as leases are renewed and then contract as the lease unwinds.

This will also flow through to the solvency margin of the entity and this will have consequences for capital modelling, dividend payments etc. The chart below illustrates how the solvency ratio may be affected from a three year property lease.



Leases and solvency

It is true that lease commitments impose a cost on the business and this should be considered in determining solvency. Certainly the impact is felt through the ability to generate a profit and therefore increase Actual Solvency Capital.

RBNZ response

However, it seems incongruous that the solvency strength of a company would change without a fundamental change in the entity's operations.

The IFRS16 accounting rules will have a regulatory solvency impact unless there is a response from the RBNZ (regulator) to recognise this anomaly.

The RBNZ is aware of the issue and discussions have been held between the NZ Society of Actuaries and the RBNZ. However, there is yet to be a response and it may be several months before anything formal will be released.

If IFRS16 comes into force before then, it will be incumbent upon entities to consider how their three year solvency projection will be affected on 1 January 2019, when IFRS16 comes into effect.

Lease vs Purchase

The discussion above focuses on the solvency implications of lease commitments under IFRS 16.

It is worth noting that the capital implications of this may encourage a review of the reasons for leasing vs purchasing and / or how lease commitments should be structured.

Further reading

There is a detailed analysis of the impacts of IFRS 16, which can be found on the International Accounting Standards Board (IASB) website.

ABOUT MELVILLE JESSUP WEAVER

Melville Jessup Weaver is a New Zealand firm of consulting actuaries providing advice on superannuation, insurance and asset consulting. The firm, established in 1992, has offices in Auckland and Wellington and is an alliance partner of Willis Towers Watson, a leading global services company and is located on the web at willistowerswatson.com.

For further information please contact:

Jeremy Holmes 09 300 7318
jeremy.holmes@mjw.co.nz

Craig Lough 09 300 7151
craig.lough@mjw.co.nz