

Temporary working group under the Solvency II task force of the CFO Forum on SII implications of IFRS 16

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1. Introduction

In IFRS there currently is IAS 17 that deals with lease arrangements.

IAS 17 will be superseded by IFRS 16 *Leases* and applies to annual reporting periods beginning on or after 1 January 2019.

Where IAS 17 required leases to be classified as either finance lease or operating lease, under IFRS 16 all leases are treated the same.

Under IAS 17

- a finance lease would transfer substantially all risks and rewards, giving rise to asset and liability recognition by the lessee and a receivable by the lessor;
- whereas in an operating lease the asset would remain on the balance sheet of the lessor and the lessee would only recognize expenses (lease payments) when they incur.

Under IFRS 16

- lessees are required to recognise assets and liabilities for all leases unless the lease term is 12 months or less or the underlying asset has a low value. And;
- lessors still classify the lease as operating or finance lease, with an approach similar to IAS 17.

Solvency II

Currently (with IAS 17 still being in place), in respect of the SII treatment the following from the Delegated Regulation and (final report on) guidelines are relevant:

Delegated Regulation, article 16 paragraph 4 says:

“

4. Insurance and reinsurance undertakings which are lessees in a financial lease or lessors shall comply with all of the following when valuing assets and liabilities in a lease arrangement:

(a) lease assets shall be valued at fair value;

(b) for the purposes of determining the present value of the minimum lease payments market consistent inputs shall be used and no subsequent adjustments to take account of the own credit standing of the undertaking shall be made;

(c) valuation at depreciated cost shall not be applied.

“

EIOPA confirmed the following, in the final report on guidelines on valuation of assets and liabilities other than Technical Provisions¹, in respect of to what extent current IFRS principles apply under SII:

- Operating Leases
 - o *“Operating leases measurement principles are considered to be consistent with Article 75 of Directive 2009/138/EC, having in mind that the lease items in the lessors balance sheet are valued according to the general valuation principles applicable for those assets and liabilities.”*
- Finance Leases
 - o *“undertakings which are lessees in a finance lease, shall value lease assets and liabilities at fair value. Undertakings shall not make subsequent adjustments to take account of the own credit standing of the undertakings”*
 - o *“For lessors in finance leases, the receivable measured at an amount equal to the net investment in the lease, with the income allocation based on the pattern reflecting a constant periodic return on the lessor’s net investment in the finance lease is considered to be consistent with Article 75 of Directive 2009/138/EC.”*

For the purpose of this discussion paper, we do not provide an in depth discussion of IAS 17 and IFRS 16 from an IFRS accounting perspective. The summarizing texts above are regarded sufficient. We will focus on identification of the SII discussion on IFRS 16.

Nevertheless it has to be pointed out, that the above mentioned EIOPA guidance¹ has to be kept updated for the valid underlying – and endorsed – IFRS-framework. In case certain operating lease contracts give rise for capitalization of “right of use “ assets, it should be clearly pointed out, that the involved risk for SCR-pruposes cannot be higher than owning the relevant assets. Consequently the maximum SCR-shock to be applied references to the relevant asset category of the item under lease.

2. Identification of SII attention point in respect of IFRS 16

From the perspective of being a lessee, the fact that IFRS 16 does treat all lease contracts the same means that operating leases need to be interpreted within the context of Solvency II again, and the above conclusion from the final report on operating leases will not be valid anymore.

More specifically, currently the lessee will recognize expenses in own funds when they are incurred. That will change after IFRS 16 comes into effect.

Furthermore it is assumed for the purpose of this position paper that members of the Solvency II task force primarily are looking for the lessee perspective within what currently would be classified as an operating lease, where leasing property is assumed to be the base case.

¹ https://eiopa.europa.eu/Publications/Reports/EIOPA-BoS-15-113_Final%20report_GL_Valuation.pdf

3. Recognition and valuation under Solvency II

Recognition

In line with article 9 of the delegated regulation, recognition of lease assets (right to use asset) and lease liabilities will follow IFRS, unless EC will adopt regulations that define a special case for leases with other treatment. But the latter is currently not expected.

Classification

Under (IFRS) accounting, the right to use asset is treated as follows by a lessee (paragraphs 47 and 48 of IFRS 16):

47. A lessee shall either present in the statement of financial position, or disclose in the notes:

- a. right-of-use assets separately from other assets. If a lessee does not present right-of-use assets separately in the statement of financial position, the lessee shall:
 - i. include right-of-use assets within the same line item as that within which the corresponding underlying assets would be presented if they were owned; and*
 - ii. disclose which line items in the statement of financial position include those right-of-use assets.**
- b. lease liabilities separately from other liabilities. If the lessee does not present lease liabilities separately in the statement of financial position, the lessee shall disclose which line items in the statement of financial position include those liabilities.*

48. The requirement in paragraph 47 (a) does not apply to right-of-use assets that meet the definition of investment property, which shall be presented in the statement of financial position as investment property.

Under Solvency II, the (current) s.02.01 balance sheet QRT does not have a separate line item for right of use assets and lease liabilities.

From the assumption in this paper that we focus on case of leasing property, it is expected that under Solvency II the right-of-use assets will be classified in the s.02.01 balance sheet QRT under “Property, plant and equipment held for own use”, in line with the possibility that IFRS 16 offers in paragraph 47.a.i as given above.

The lease liability is expected to be recognized in the s.02.01 balance sheet under “Financial liabilities other than debts owed to credit institutions”.

Valuation

Under IFRS 16, lessees value the right-of-use asset at cost, but have the option to apply the fair value model to investment property and to apply the revaluation model to PP&E.

For initial measurement the right-of-use asset under Solvency II will be valued equal to the requirements under IFRS 16, albeit that the present value of lease payments needs to be a fair value (similar to what EIOPA now demands for finance leases while IAS17 is still in place).

For subsequent measurement, EIOPA confirmed in the final report on guidelines on valuation of assets and liabilities other than Technical Provisions¹ that the revaluation model under IAS 16 (Property, plant and equipment held for own use) is consistent with Article 75 of Directive 2009/138/EC.

Under IFRS 16 the revaluation model is an electable choice as well. Paragraph 35 of IFRS 16 says:

35. If right-of-use assets relate to a class of property, plant and equipment to which the lessee applies the revaluation model in IAS 16, a lessee may elect to apply that revaluation model to all of the right-of-use assets that relate to that class of property, plant and equipment.

From this we conclude that the revaluation model (again, assuming we are focusing on leasing property) will be the applicable valuation methodology for subsequent measurement of the right-of-use asset.

There is a view that the carrying value of right-of-use asset at a given point may be taken as a proxy for its fair value. However, this should be done on an asset by asset basis and any significant

change in economics (for example – significant movement in the property rental market) should be taken into consideration when taking this approach. Also, consideration should be given to materiality.

The subsequent measurement of the lease liability will always be based on the present value of the remaining lease payments against the current risk free rate and the own credit standing as at the initial measurement date.

This means that in the course of time the values of the lease liability and the right of use asset will evolve differently, where for the right-of-use asset a look-through to the (fair) value development of the actual property is required.

4. SCR under Solvency II for right of use assets and lease liabilities

Under Solvency II, when recognizing the right-of-use asset under PPE, it might be subject to the Standard Formula (SF) property shock (assuming there is no internal model and the leased asset represents property). This could be interpreted as if the lease would have been cheaper to enter into, after the property shock.

The use of the property stress in the standard formula may not be entirely appropriate as the lease terms may not give the lessee any exposure to the underlying value of the building.

The lease liability will be subject to mismatch risk. Note that own credit standing (if applied) is to be kept constant (i.e. at the value initially applied), based on delegated regulation article 14.1 and article 16.4.b

5. Transition to IFRS 16 and expected SII impact

IFRS 16 allows two transition options – full retrospective and modified retrospective approach.

Under full retrospective approach, leases are recorded as if IFRS 16 was always applied and uses historic discount rate (i.e., from lease start date) to calculate right-of-use asset and lease liability. The prior year comparative of the IFRS financial is restated and any difference between the right-of-use asset and lease liability is recorded in P&L reserves.

Under modified retrospective approach, right-of-use asset and lease liability is recorded based on the remaining lease liability on the date of transition using the current discount rates. This transition approach also allows (on a lease-by-lease basis) the right-of-use asset to be recorded as if IFRS 16 has always been applied from lease commencement using current discount rate.

The two transition approaches will result in different amounts recorded for right-of-use asset and lease

liability for the IFRS financial statements.

However, we believe that the choice of adopting one transition approach over other will not impact the SII value of right-of-use asset and lease liability that will initially be recorded on transition (i.e., when IFRS 16 was first applied). This is because the right-of-use asset and lease liability under SII will be recorded at fair value which may be different to the values determined under the two transition options.