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APRA

31 May 2018

TO: ALL GENERAL INSURERS, LIFE INSURERS AND PRIVATE HEALTH INSURERS

UPDATE ON NEW ACCOUNTING STANDARDS – AASB 16 AND AASB 17

As you are aware, the Australian Accounting Standards Board (AASB) has issued new standards AASB 16 *Leases* (AASB 16) and AASB 17 *Insurance Contracts* (AASB 17).

In September 2017 APRA wrote to all general insurers, life insurers and private health insurers to inform them that APRA would not be altering its prudential or reporting frameworks until the impacts of the forthcoming changes are better understood. APRA also sent out an information request to the insurance industry to inform APRA's understanding of the impact of the new standards.

AASB 16

AASB 16 introduces a single accounting model under which lessees must recognise all leases (including property and equipment) on the balance sheet as a new 'right of use asset' and lease liability. AASB 16 is effective for annual reporting periods beginning on or after 1 January 2019.

Having assessed the likely impact of AASB 16 on the insurance industry, this letter clarifies the appropriate capital treatment of the right of use asset and associated liability. APRA will consider applications for transitional arrangements from insurers that are significantly impacted on initial adoption of AASB 16 on a case-by-case basis.

Attachment A to this letter sets out APRA's expectations regarding the regulatory capital treatment of assets and liabilities arising under leases.

AASB 17

AASB 17 requires all insurance contracts to be accounted for in a consistent manner, thereby facilitating comparisons across similar insurance companies. The requirements are designed to help users of financial statements better understand an insurer's exposure, profitability and financial position. AASB 17 is effective for annual reporting periods beginning on or after 1 January 2021.

The responses to APRA's survey indicate that the tax treatment of Deferred Acquisition Costs (DAC) is a factor being considered by life insurers when deciding whether to adopt the standard early. The tax treatment for life insurers is presently linked to *Prudential Standard LPS 340 Valuation of Policy Liabilities*. Consistent with its mandate, APRA's focus with AASB 17 is primarily prudential soundness and protecting the interests of policyholders. Treasury has confirmed it will consider the tax treatment for life insurers in consultation with Government, the Australian Tax Office and other stakeholders and that no decisions have been made, either implicitly or explicitly, on the transitional or ongoing tax treatment.

APRA recognises some entities may be considering early adoption of the standard. APRA expects entities would analyse the impacts of the new standard, and contact APRA to discuss their approach to early adoption prior to proceeding.

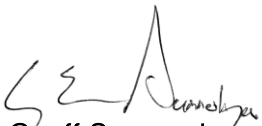
2017 Survey Results

Attachment B to this letter provides the high level observations and results of the 2017 survey of insurers regarding the impacts of AASB 16 and 17. APRA intends to conduct another AASB 17 survey once insurers are more advanced with their implementation, to better understand the quantitative impacts of the changes.

APRA encourages all insurers to review the results of the survey, and consider the impacts of AASB 16 and 17 on their operations. In particular, the survey results demonstrate the complexity of AASB 17; careful planning will be needed to ensure that insurers are appropriately prepared to meet their obligations under the new standard once it is effective.

If you have any questions regarding this letter, please contact Peter Kohlhagen (peter.kohlhagen@apra.gov.au or 02 9210 3363), Robert Sharma (robert.sharma@apra.gov.au or 02 9210 3899) or your responsible supervisor.

Yours sincerely,



Geoff Summerhayes
Member
Australian Prudential Regulation Authority

Attachment A – applying the existing capital standards to the new assets and liabilities arising under AASB 16

For insurers who are lessors of investment property under operating leases, the accounting and prudential treatment will remain largely unchanged under AASB 16.

Under the existing capital framework for general insurers and life insurers who are lessees, the treatment of leases impacts three key aspects of the calculation:

- under *Prudential Standard GPS 112 Capital Adequacy: Measurement of Capital* (GPS 112) and *Prudential Standard LPS 112 Capital Adequacy: Measurement of Capital* (LPS 112) – in relation to whether the right of use asset should be deducted from the capital base;

- under *Prudential Standard GPS 114 Capital Adequacy: Asset Risk Charge* (GPS 114) and *Prudential Standard LPS 114 Capital Adequacy: Asset Risk Charge* (LPS 114) – in relation to how the Asset Risk Charge should be calculated for the right of use asset and the associated lease liability; and

- under *Prudential Standard GPS 117 Capital Adequacy: Asset Concentration Risk Charge* (GPS 117) and *Prudential Standard LPS 117 Capital Adequacy: Asset Concentration Risk Charge* (LPS 117) – in relation to whether asset concentration limits should apply to right of use assets.

GPS 112 and LPS 112

Under GPS 112 and LPS 112, intangible assets must be deducted from the capital base. Where the leased asset is tangible in nature, APRA considers it appropriate that the right of use asset ought to likewise be considered tangible and not deducted.

GPS 114 and LPS 114

APRA advises that it is appropriate to treat leases as a form of financing arrangement (akin to a bond) under GPS 114 and LPS 114 for lessees. That is, both the right of use asset and the corresponding lease liability should be subject to the real interest rate stress, the expected inflation stress and the foreign exchange stress (where relevant). It is not necessary to apply the credit spread stress to the right of use asset as, if that asset is removed from the balance sheet, the corresponding liability would be removed simultaneously.

GPS 117 and LPS 117

On similar grounds to the treatment of the credit spreads stress outlined above (i.e. that the asset and liability both cease simultaneously if the right of use asset is no longer on the balance sheet), APRA advises that it is not necessary for an Asset Concentration Risk Charge to be held against the right of use asset.

Private health insurers

For private health insurers, APRA expects that both the right of use asset and associated lease liability would be considered in determining the prudent liabilities amount and stress test amount for the fund. APRA anticipates that the relevant assets and liabilities would be treated consistently in determining the capital impact.

Attachment B – Summary of 2017 survey results

AASB 16

Observations

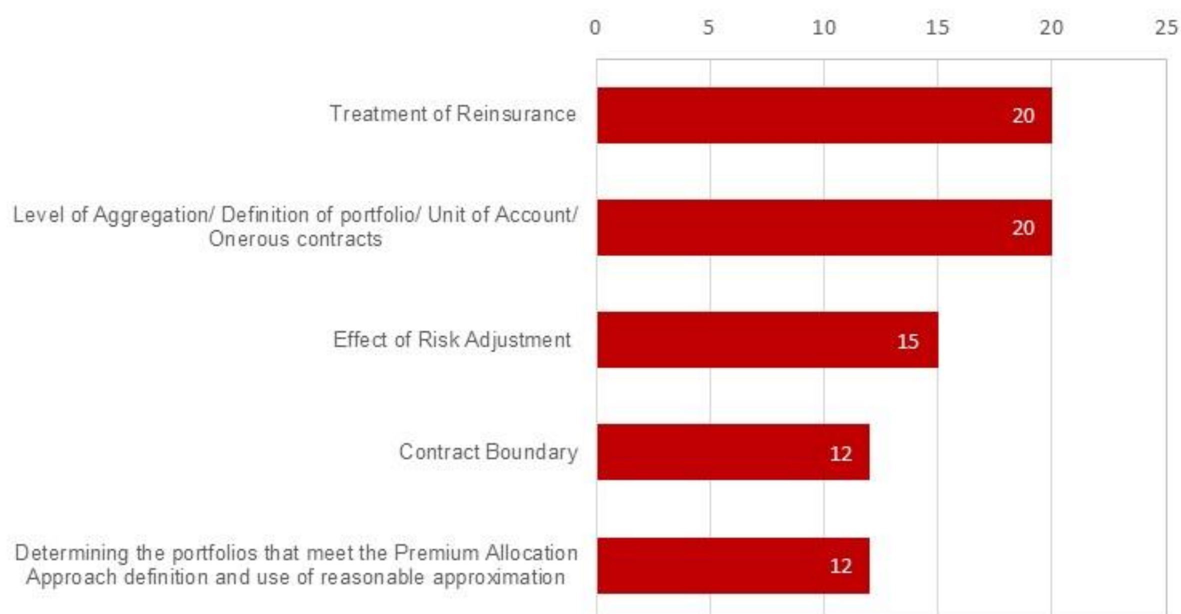
- General insurers appear most affected by the new leasing standard. This is due to leases over property (and to a lesser extent equipment) coming onto the Statement of Financial Position as both right of use assets and corresponding lease liabilities.
- Life insurers are appear to be minimally impacted, as the licenced entity is generally not party to any lease agreements (lease arrangements are entered into by other group entities).
- None of the surveyed entities intend to early adopt the standard.

AASB 17

Observations

- The majority of respondents are in the early stages of AASB 17 implementation, and as such were unable to quantify the impact on adoption.
- Most insurers do not intend to early adopt the standard.
- The cross industry challenges are illustrated by the following chart:

Chart: Most challenging issues for all insurers



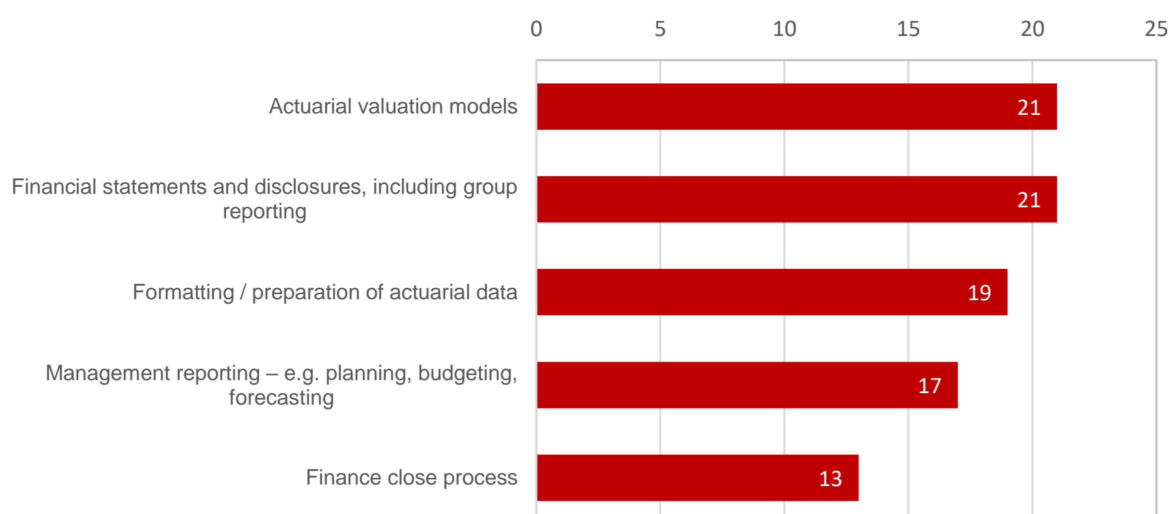
Please note: The number for each bar (above) represents the number of insurers out of a total of 23 respondent insurers who ranked that issue as one of their top 5 challenging issues.

- Total implementation cost estimates vary widely across entities and sectors, and are material investments in the context of many entities. Many entities are reliant on external consultants (rather than in-house resources) to execute the project.

- The impact on the capital base on transition can be largely attributed to the transition approach adopted (i.e. whether the full retrospective, modified retrospective or fair value approach is adopted). The transition approach selected will depend on the availability (or otherwise) of ‘reasonable and supportable’ information, and will likely vary across portfolios and products. The fair value approach will need to be used where ‘reasonable and supportable’ information proves unavailable, and is more likely to be applicable to legacy products.

- The survey requested insurers’ views on the impact of the new standard on various data, systems and processes. As expected, the actuarial, management and financial reporting areas were identified as most impacted (outlined in the following chart):

Chart: Top 5 high impact data/ systems/ processes for all insurers



Please note: The number for each bar (above) represents the number of insurers out of a total of 23 respondent insurers who ranked that data/ system/ process as one of their top 5 most impacted by the new standard.

Industry specific observations

<table>
<tr><td>LI</td><td>Unbundling

There is uncertainty as to whether two contracts issued together (such as a unit linked investment product and an insurance rider) will be considered as two separate contracts or together as a single contract. This could determine whether a significant number of investment contracts fall within or outside the scope of AASB 17.

Effect of Contractual Service Margin (CSM) on Statutory Funds

The operation of the CSM is very different from the current Margin on Services (MoS), and has to be tracked at a much lower level than the existing Related Product Group level.

Risk adjustment and CSM calculation methodology need to be formulated, and models need to be developed to implement. Additionally, impacts on profitability measures and business planning need to be assessed.</td></tr>
<tr><td>GI</td><td>Setting discount rates

Insurers tend to use a risk free discount rate to align the discount rate used between financial and regulatory reporting. A top down or a bottom up approach will now be required to determine the discount rate that meets the requirements of the standard.</td></tr>
<tr><td>Reinsurance</td><td>Contract Boundary

Changes in contract boundaries will require continuous assessment on contract wordings, especially when the entity has ability to reprice or cancel the contract in notice periods, e.g. endorsements that may impact contract boundaries such as extensions.

Effect of CSM on businesses greater than 12 months not meeting the reasonableness test (e.g. Lenders Mortgage Insurance)

Changes in actuarial models are foreseen to calculate CSM, once the technical accounting issues such as unit of account and discount rate have been bedded down.</td></tr>
<tr><td>PHI</td><td>Unbundling

There are several features of the current PHI offering that may constitute components that need to be accounted for under AASB 15 Revenue from Contracts with Customers (AASB 15). For example, discounts offered to members on other services, Wellness benefits etc. These features need to be identified and assessed periodically, and if these features are material and not a marketing offer, a portion of the insurance premium price will need to be accounted for under AASB 15.

Accounting for these features under AASB 15 may prove challenging.</td></tr>
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Friendly Societies	**Effect of risk adjustment** The risk adjustment causes significant complexity for a relatively simple business. Friendly societies are exploring whether this can be addressed by applying Premium Allocation Approach (PAA) (subject to the simplified approach generating a result that would not differ materially from the Building Block Approach).