

POSITION PAPER



ESBG response to the EFRAG consultation on IFRS 16 LEASES Draft Endorsement Advice

ESBG (European Savings and Retail Banking Group)

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ESBG thanks EFRAG for the opportunity to share its comments on the advice that EFRAG will provide to the European Commission on the endorsement of IFRS 16 Leases.

We would like to attract your attention to the following key points which are of particular importance to ESBG's members:

- We will incur significant one-off and on-going costs in complying with the new standard, bearing in mind that no difference is expected in terms of total impact on equity of lease contracts under IFRS 16 compared to existing IAS 17, except for timing recognition.
- This accounting change should not lead to a reassessment of an entity's overall risk profile, and in particular no negative prudential impact should arise from adopting IFRS 16. As it stands right now, it is uncertain whether the EBA's conclusion that the estimated impact on own funds and leverage ratios will be of limited significance for the vast majority of European banks will occur or not. To ensure this limited impact, we believe that EFRAG's draft endorsement advice should include a suggestion that the European Commission reviews the wording in CRR/CRD IV sufficiently in advance before IFRS 16 is in place.

Potential effects of stakeholders' behaviours:

ESBG agrees with EFRAG's assessment.

Potential impact of IFRS 16 on the leasing industry:

ESBG overall agrees with EFRAG that the new standard does not represent a threat to the overall viability of the leasing industry, however there are certain issues which cannot be ignored:

- The requirement in IFRS 16 by which, if a contract is, or contains, a lease, an entity is required to account for each lease component within the contract as a lease separately from non-lease components (i.e. services) of the contract, entails a significant business risk for lessors. It should be borne in mind that lessees may decide to use the practical expedient which allows them to elect not to separate non-lease from lease components, while lessors will have to develop their systems in order to provide their customers with all the information on these components.

In this sense, it is highly probable that the identification and the independent price allocation for each of the components will result in lessees attempting to contract each one separately, seeking the most competitive and favourable conditions. It may be the case that, in relation to the lease of a car (or any other asset such as a forklift truck, commercial vehicle, computer equipment, machinery,...), the lessee wanted to lease the car or asset with entity A, its maintenance service with entity B and its insurance with entity C, introducing unnecessary business risks in the market, such as the loss of control over the insurance or the appropriate maintenance of the asset.

Therefore, in our opinion the negative effects on the industry would not be derived only from a reduction in the use of leasing or pricing adjustments as commented by EFRAG in Appendix 3, paragraphs 79-88, which could be manageable at some point, but also for a disruption effect on the business itself.

To continue the example above, if lessees contracted the insurance of the car with a different entity, a vast majority of the existing lessors processes should be modified (negotiation



timeframe, administrative processes, individual contract drafting, etc.) and new processes should be also created (ensure that the third party insurance covers the basic risks of the vehicle).

- From an industry perspective, in addition to the introduction of additional complexity for both the lessor and the lessee, this issue runs contrary to one of the main benefits of a lease or renting contract, which is the renewal of the vehicles or other assets to favour an improved environmental behaviour of the vehicle fleet and increased safety for the customer. It has been statistically proven that the level of accidents and fatalities in car operating leases and renting is markedly lower than in other arrangements. Currently, leasing and renting are the preferred types of contracts for SMEs for the renewal of their industrial infrastructure, favouring the competitiveness of the entities at a European and global level. We note that this issue has not been conveniently addressed in the Draft Endorsement Advice.

Potential impact of IFRS 16 on SMEs:

ESBG shares EFRAG's views included in Appendix 3, paragraph 95, that even though the majority of SMEs in Europe are not expected to apply IFRS 16, the absolute number of SMEs that would apply the standard is potentially large.

In this regard, we take the view that once IFRS 16 is in place, the different national standards will change to achieve consistency, as it happened in the past after the publication of other relevant international standards.

As noted by EFRAG in paragraph 97, additional effects may arise based on decisions made by Member States to introduce changes to their local accounting or tax legislation. However, we cannot support EFRAG's approach on this issue whereby all these effects are not considered in its assessment while leaving the responsibility to Member States.

It could be convenient to explain better how an appropriate balance between costs and benefits could be achieved (please see *Costs and benefits* section). In our opinion, the effects of applying IFRS 16 or the "adapted" national standard would be disproportionate for SMEs and thus it is something that cannot be overlooked.

Moreover, within the assessment of whether IFRS 16 is proportionate to those SMEs that apply IFRS, EFRAG observes in Appendix 3, paragraph 105, a number of simplifications which may help to reduce the application costs on an on-going basis (i.e. short-term lease exemption, low-value assets, and allocation of all contract payments to the lease component).

However, as noted in Appendix 2, paragraph 36, the fieldwork conducted by the IASB suggested that, in most cases, assets and liabilities arising from leases within the scope of the low-value assets exemption would not be material.

Additionally, as described in paragraph 105, the majority of preparers do not expect that the exemption for short-term leases will provide significant cost relief, due to the fact that relatively few leases have a term of twelve months or less.

Consequently, we do not believe that those exemptions will significantly reduce the administrative burden for SMEs.

Still on the subject of transposition of the standard into national law, we are also concerned about its potential effects, which may result in some European SMEs being at a competitive disadvantage. In



some countries (for example Spain), a more conservative approach, requiring the early application of IFRS 16 together with the application of IFRS 15 Revenue from Contracts with Customers (1 January 2018), is currently being considered. It seems that local SMEs will not be scoped out from its application.

In our view and, in order to ease the transition to IFRS 16, SMEs should apply this standard for annual reporting periods beginning on or after 1 January 2023 and the entities under the scope should be determined based on a homogeneous definition of SME at a European level.

There may be a risk of a lack of level playing field if the current trend in Europe is confirmed (no application or application in 2023 for SMEs), while in certain countries early application is required for all entities. Bearing in mind that SMEs in Europe are a source of job creation, it is not advisable to make their processes more complicated or limit their activity and business model.

IFRS 16 is considered a complex and costly standard, especially for SMEs, which could be impacted by lower competitiveness in terms of funding, ratios, debt position, modification of covenants, etc. It is difficult to understand the need for early application, bearing in mind that still it does not provide clear benefits to them.

Costs and benefits:

Most of ESBG members are not in a position to deliver at this stage concrete estimates for the amounts of the costs.

However ESBG members expect additional costs for the development and implementation of a modified client-/credit rating model for clients applying IFRS. For already-existing contracts with clients applying IFRS there will be additional costs for adapting covenants in their loan contracts to the new situation caused by IFRS 16. In other words, acting as a lessee, the main one-off costs are expected to relate to the analysis of existing contracts, the purchase of additional IT systems, and potential process changes.

In this regard, in some cases, an external consultant should be employed in order to gather the data of the existing contracts, create a database and develop a new IT tool, for which the cost would be for some ESBG members in the range of €300,000. Internal staff will be also dedicated to the implementation of the standard (i.e. accounting and reporting, IT, real estate departments, etc.).

The time required for the IT implementation has been estimated by some ESBG members between 5 and 8 months, approximately, not including the time for the pre-analysis phase, redefinition of processes, approvals, period for testing the new IT tools, etc.

In relation to cost estimates it is important to note that:

- Significant differences may arise depending on the transition approach applied and it will not be possible to decide on the approach until the systems capture all the data necessary to comply with the new requirements, including the creation of an inventory of all leases.
- Given the uncertainties remaining in treatment of the right-of-use assets for prudential purposes, we are concerned that in order to make the most efficient decision we will need to estimate the impacts under each transition approach.



In any case, the different accounting policy choices provided by the standard or the choice of transition will not prevent entities from having considerable one-off costs. We do not consider, as noted in Appendix 3, paragraph 166, that using the low-value and short-term lease exemptions would help to mitigate both one-off and ongoing costs significantly.

Additionally, we do not agree that part of the cost may be 'shifted' to lessors (Appendix 3, paragraph 19) if lessees rely on lessors to provide some of the information needed to implement the requirements. For example, financial institutions which enter into rental agreements for their branch network, with multiple counterparties both natural and legal persons, will not be able to shift part of these costs to lessors in any way.

Currently, we do not have clarity on the potential internal benefits which could be obtained from the new systems. We believe that the benefit of this information would not outweigh costs. From a business management perspective, for example, the financial performance of the branch network is measured in an analytical manner. We expect changes in the way performance is measured; current lease expense will be replaced by the interest expense relating to the lease liability and the depreciation expense for the right-of-use asset, but we are not sure whether this new information incorporated will lead to improvements in strategic management decisions.

Regarding the cost for lessors, we do not agree with EFRAG's view included in Appendix 3, paragraph 162, that it is expected that any incremental costs for lessors will be low because the changes in IFRS 16 to lessor accounting have a relatively minor impact.

Contrary to lessees, all lessors will need to adapt their IT systems and applications to be able to provide the breakdown of each concept included in the receipt to lessees. Further to these IT changes, lessors may need to reassess their analytical accounting methodologies and applications.

We support the opinion indicated by other lessors and lessor organisations (Appendix 3, paragraph 163) that one-off costs could be significant.

Considering that IFRS 16 carries forward substantially all of the lessor accounting requirements in IAS 17 and no other benefits expected, except for enhanced disclosures, we cannot hide the fact that the application of this standard may have an adverse impact on lessors.

In conclusion, for the one who acts both as a lessor and lessee in several lease transactions, we still see room for striking an appropriate balance between costs and benefits for the European financial industry. ESRG members believe that they will incur significant one-off and on-going costs and effort in complying with the new standard (IT systems, controls, databases, etc.) which could be even higher if some of them are outsourced. More specifically, we are concerned with the requirements for the assessment of leases which will be extremely costly in terms of effort for preparers. A contract-by-contract analysis will have to be carried out in order to verify if the three conditions included in IFRS 16 are met.

Lastly some countries already apply IFRS-similar GAAP and thus will probably also implement IFRS 16 similarly and so the above mentioned will be the case even for all clients of those countries.



Other comments:

Prudential treatment of right-of-use asset:

One of the main concerns of ESBG's members is the lack of clarity on the prudential treatment of the right-of-use asset at the date of this response.

Depending on the volume of leases leading to right-of-use assets it could have a relevant effect on the own funds and the leverage ratio, possibly having a negative influence on the decisions of stakeholders. As mentioned in paragraph 134 of Appendix 3, there are two alternatives (i) a specific risk weight is applied if the right-of-use asset is considered as a tangible asset; (ii) a deduction from own funds is applied if considered as an intangible asset.

We cannot support EFRAG's decision explained in Appendix 3, paragraph 136, whereby all these effects are not considered in its assessment.

Accordingly, we would support a proposal to amend article 36 of the Capital Requirements Regulation (CRR) in order to avoid deductions of new intangible assets arising from the application of IFRS 16 (right-of-use assets linked to lease transactions).

Other prudential issues:

Moreover, we do not share EFRAG's approach, as included in its cover letter and in paragraphs 137-140 of Appendix 3, which solely relies on the input given by the European Banking Authority (EBA) during the preliminary consultation period (please see details below) to conclude that IFRS 16 would not raise significant challenges related to bank regulation and the impact of IFRS 16 on own funds and leverage ratios of banks is estimated to be of rather limited significance.

In this sense, we would like to draw EFRAG's attention to the following issues:

- A potential disadvantage for IFRS 16 preparers compared to US-GAAP can be identified in the possibly complete deduction of the right-of-use asset from own funds, provided the right-of-use asset is regarded as an intangible asset. On this topic we would like to underline the view mentioned by the EBA in its letter to EFRAG on 11 January 2017 with the title "The EBA's views on the adoption of International Financial Reporting Standard 16 Leases (IFRS 16)": *"The EBA considers that the same treatment as for finance leases under LAS 17 could be followed under IFRS 16 for ROU assets and therefore considers for prudential purposes all leased assets (ROU and those similar ones to finance leased assets under LAS 17) as tangibles – If the underlying asset is tangible."* Consideration as tangible or intangible is still unclear in the end and should be clarified by the regulators as soon as possible. Any analysis in this regard should be treated with caution and could not be considered as a key factor to conclude the possible impact of the standard.
- It should be highlighted in the endorsement advice document that the baseline scenario of the EBA analysis included a risk weight of 100% for the right-of-use assets and 3% discount rate to estimate the present value of the future lease obligations. We understand that this reference is essential in order to understand the conclusion reached.
- The EBA quantitative analysis does not show the estimated impact due to a deduction of right-of-use assets from own funds (if considered intangible assets), being one of the alternatives discussed to date.



- By inferring the calculation made by the EBA (*RW 100%; discount rate +3.00%; average impact in total capital ratio = 11 bps*), the deduction from own funds (which would equal to a 1,250% risk weight) could have an average impact of more than 135 bps in the total capital ratio, which we believe is material.

The changes in the accounting standards do not reflect any change in the risk profiles, the cash flows of banks or the real economics of lease transactions, but rather the decisions of accounting standard setters on how to present leasing assets and liabilities in lessee balance sheets. The change in the accounting framework did not arise out of a concern related to bank's financial situation and therefore their regulatory capital position should remain essentially unchanged.

We share the view that the current status quo should be kept so that companies are not prudentially affected by an accounting change being all other economic conditions equal. We would like to take the opportunity to set out a possible regulatory approach aligned with what has just been pointed out.

- The IASB has argued that the values of both the asset and lease liability are linked at commencement of the lease and that they have the same contractual origin: one cannot exist without the other and their values are intrinsically linked.
- Therefore, it would be appropriate for prudential purposes to look at the net lease i.e. the net of the right-of-use asset and the corresponding lease liability, if it has a positive value.

This approach would provide an exposure value at lease commencement and at each reporting date for regulatory capital purposes that would be consistent with the lessee's risk profile. A risk weight of 100% would be applied to the net exposure.

- Finally, the prudential framework should not distinguish between finance leases which are currently recognised on the entities balance sheets (risks and rewards not transferred) and the new contracts to be recognised from January 2019.

Other issues:

A particularly significant issue is how to properly estimate the lease term in cases of lease contracts comprising an indefinite lease term or options to prolong. This should be better clarified - depending for example on how far in advance an entity is able to plan, the longer the term, the higher the uncertainty gets, and how long is it then still "reasonably certain"? The effect, especially for office leases, can be considerable.

Another topic, which is already mentioned in Appendix 3 (39 and 206 – 207), is particularly relevant for complex group structures: the lack of symmetry between lessor and lessee accounting for intragroup leases increases complexity for group financial statements significantly. There are often no or not the same amounts covering certain lease expenses/revenue respectively assets in one entity covering respective liabilities in the other entity. This can happen for only intragroup leases and also for external leases leading to further subleases within the group, and also if the duration of head lease and sublease are materially different. In the end it may be challenging or impossible to depict all of this in the consolidation tool and manual consolidation recordings would be the result with all the associated potential for mistakes.

We also take the opportunity to comment on Appendix 3: Assessing whether IFRS 16 is conducive to the European public good, and to reply to the question "*Is the financial reporting required by IFRS 16 an improvement over that required by IAS 17?*".



Regarding paragraph 29, Appendix 3, we do not consider that the consolidated cash flow statement of a bank provides useful information. Therefore, any changes affecting the statement of cash flows are not relevant for us in this regard.

In our opinion, the current disclosures required by both IAS 17 and IFRS 7 *Financial Instruments: Disclosures*, are sufficient to give a good understanding on the lessee's liquidity risk.

Moreover, it should be highlighted that a significant proportion of users do not anticipate that IFRS 16 will lead to a reduction in the effort they currently expend in understanding the effects of operating leases in their analysis of lessees' financial statements, as stated in Appendix 3, paragraph 20.

We believe that the main effect for the financial industry would be the change in the presentation of the statement of profit or loss for leases that are classified as operating under IAS 17. As per IFRS 16 the lease expense will be separated into interest expense (on the lease liability) within financing costs and depreciation expense (on the right-of-use asset) within operating costs, while under IAS 17, a single line expense is included within operating costs.

Consequently, we may question the improvement of IFRS 16 over IAS 17, considering also the significant one-off and ongoing costs to be incurred.



About ESBG (European Savings and Retail Banking Group)

ESBG – The Voice of Savings and Retail Banking in Europe

ESBG brings together nearly 1000 savings and retail banks in 20 European countries that believe in a common identity for European policies. ESBG members represent one of the largest European retail banking networks, comprising one-third of the retail banking market in Europe, with 190 million customers, more than 60,000 outlets, total assets of €7.1 trillion, non-bank deposits of €3.5 trillion, and non-bank loans of €3.7 trillion. ESBG members come together to agree on and promote common positions on relevant regulatory or supervisory matters.



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