Qualitative assessment of IFRS 16 Leases from a financial stability perspective

Dear Mr Gauzès,

In July 2016, the European Financial Reporting Advisory Group (EFRAG) approached the ECB with a request to provide a qualitative assessment of the new accounting standard for leases, IFRS 16, from a financial stability perspective. This assessment is meant to form part of EFRAG’s assessment on the European Public Good.

The ECB, as an official observer in the EFRAG Board, is pleased to provide this qualitative assessment with respect to the potential financial stability implications of IFRS 16. The ECB has a keen interest in high quality accounting standards that serve the public interest via a proper reflection of the economic substance of transactions and do not compromise financial stability. High quality accounting standards are also a major prerequisite for effective prudential supervision.

This qualitative analysis is based on the ten high-level principles for assessing accounting standards from a financial stability perspective, as set out in a report of the European System of Central Banks (ESCB), which was published in December 2006¹.

First principle relating to the enhancement of market confidence and corporate governance. The ECB concludes that the requirement of IFRS 16 for lessees to present almost all their leases on the face of the balance sheet (i) constitutes “prudent” accounting and (ii) may enhance market confidence by better

reflecting the actual leverage of lessees and by reducing incentives for arranging lease contracts in such a way as to achieve a particular accounting outcome. However, IFRS 16 does not fully eliminate this possibility, as certain variable lease payments are excluded from the measurement of the lease liability and the corresponding right-of-use asset.

**Second principle relating to the promotion of a forward-looking recognition of risks.** IFRS 16 overall promotes a forward-looking recognition of risks (i) by providing detailed guidance on the reassessment of the lease liability and (ii) by requiring that the right-of-use asset recognised by the lessee is tested for impairment on a regular basis. A more forward-looking approach would have been achieved if variable lease payments that depend on future sales or use of the underlying asset had also been considered in IFRS 16. However, the ECB understands that this was not done because of the difficulty in determining reliable estimates of the related cash outflows.

**Third principle relating to the avoidance of negative and promotion of positive externalities.** The ECB assessed, among other aspects, the implications of IFRS 16 for the leasing market and for the relationship between lessees and their creditors. While the requirement of IFRS 16 to recognise all leases (including those that were previously classified as "operating leases") on the face of the balance sheet may reduce the demand for leases, if this occurs the expected impact would not necessarily be material. This, the assessment reasons, is because companies enter into lease agreements for a number of reasons other than "off balance sheet financing", for example, staying on top of technological advances to maximise productivity via leasing\(^2\). The ECB overall expects no major impact of IFRS 16 on the credit conditions for lessees, since current evidence seems to suggest that the effects of any off-balance sheet financing are already duly taken into account by financial analysts and creditors, i.e. prior to IFRS 16. However, a certain effect on the interest rate charged for credit cannot be excluded, subject to the magnitude of the adjustments that are currently made by analysts to adjust for off-balance-sheet leases.

**Fourth principle relating to the portrayal of the financial situation of banks with respect to profitability, solvency and liquidity.** While the cumulative lease expenses remain the same under IFRS 16, its application may result in an unequal distribution of lease expenses in the income statement of lessees over time, in comparison with the actual payments made under the lease. Overall, the ECB concludes that the specific expense recognition pattern under IFRS 16 provides an appropriate reflection of the expenses incurred by the lessee, and applying the effective interest rate method is consistent with the measurement of financial liabilities in accordance with IFRS 9 *Financial Instruments*. It should be noted that IFRS 16 may increase the capital requirements of banks. However, the ECB supports a better reflection of actual balance sheet risks in prudential requirements.

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\(^2\) Cf. Lenovo Financial Services (2010): Top 5 Reasons to lease
Furthermore, prudential regulators usually analyse the impact of new accounting standards on prudential requirements and, if necessary, may decide to introduce adjustments to the existing prudential requirements.

Fifth principle relating to the reliance on principles-based accounting standards. The ECB concludes that overall IFRS 16 is based on a set of clear principles and introduces an overarching disclosure objective. These two factors are likely to contribute to achieving the objective of capturing the underlying economics of lease transactions. In this context, the ECB agrees with the general principle in IFRS 16 of requiring lessees to present almost all their leases on the face of the balance sheet.

Sixth principle relating to the recognition of the allocation and magnitude of risks. The requirement of IFRS 16 for lessees to present lease liabilities for almost all their leases on the face of the balance sheet provides insights into potential liquidity and solvency risks of lessees, while IAS 17 only required disclosures on operating lease transactions in the notes to the financial statements. The enhanced disclosure requirements for lessors are also expected to provide useful information about the risk exposures of bank lessors.

Seventh principle relating to the alignment of accounting rules and sound risk management practices. The ECB is of the view that IFRS 16 supports sound internal risk management by providing better information on the related risk exposure. For example, sound risk management should take into account any reduction in future cash inflows, and IFRS 16 requires regular impairment testing for all right-of-use assets.

The remaining principles relating to the provision of understandable, comparable, relevant and reliable financial information. The ECB concludes that IFRS 16 overall provides relevant and reliable accounting information, while the options provided under IFRS 16 (e.g. the exemption of short-term and low-value leases) are not expected to significantly hinder the comparability of financial information.

In summary, based on its qualitative analysis, the ECB overall has currently not identified conclusive evidence to indicate that IFRS 16 would pose a significant risk to financial stability in Europe. It should be highlighted again that the above conclusions have been reached on the basis of a qualitative assessment of IFRS 16. Therefore, it is important to monitor the effects of IFRS 16 on financial stability after the new accounting standard has become effective in January 2019.

Yours sincerely,

[Signature]

Encl.
Cc:

Mr Olivier Guersent, Director General of the Directorate General for Financial Stability, Financial Services and Capital Markets Union (FISMA)


Mr Steven Maijoor, Chair of the European Securities and Markets Authority (ESMA)

Mr Gabriel Bernadino, Chair of the European and Occupational Pensions Authority (EIOPA)

Mr Andrea Enria, Chair of the European Banking Authority (EBA)

Mr Andrew Watchman, Chair of the EFRAG Technical Expert Group (TEG)