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The EBA's views on the adoption of International Financial Reporting Standard 16 Leases (IFRS 16)

Dear Mr Jean-Paul Gauzes,

Following the IASB publication in January 2016 of IFRS 16: Leases (IFRS 16), which replaces the current requirements in IAS 17 Leases (IAS 17), the European Commission (Commission) launched the endorsement process of the Standard in the EU in October 2016. To this end, the Commission requested EFRAG to provide its endorsement advice in accordance with the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards.

The EBA, as an observer in the EFRAG Board, is pleased to support the work of EFRAG towards providing endorsement advice to the Commission by providing input, in particular from a prudential supervisory perspective.

The EBA has a strong interest in promoting sound and high quality accounting and disclosure standards for the banking and financial industry, as well as transparent and comparable financial statements that would strengthen market discipline.

The EBA's view on IFRS 16 is based on a qualitative and quantitative analysis of the impact of the new Standard. The views provided in this letter are expressed for the purpose of providing an input for the Preliminary Consultative Document published by EFRAG on 12 October 2016 and the future draft endorsement advice that EFRAG will publish, on the basis of information[1] currently available to the EBA.

As mentioned in the EBA's response during the IASB's consultation on the proposals for the changes in accounting for leases[2], the EBA welcomes the efforts of the IASB to improve financial reporting in the area of leasing and in particular the aim to reflect the substance and the economics of the lease transactions in the financial statements of both lessees and lessors. The

[1] The analysis is based mainly on the information included in the financial statements and Pillar 3 supervisory disclosures, except for a few banks which provided themselves the necessary information to estimate the impact from IFRS 16

[2] https://www.eba.europa.eu/documents/10180/16112/2013+09+13+%28Let+to+Mr+Hoogervorst+on+Draft+ED-2013-6+leases+-+signed%29.pdf

current accounting treatment of leases under IAS 17 allows some assets and liabilities relating to leases to remain off-balance sheet, there is inadequate transparency of information about lease rights and obligations and the leverage position of lessees may not be accurately reflected. The EBA believes that the core principle of IFRS 16 in which a lessee is required to recognise assets and liabilities arising from a lease will improve the transparency of information about lease rights and obligations. For these reasons, the EBA supports the endorsement of IFRS 16 in the EU and agrees with EFRAG's view that IFRS 16 brings a significant improvement to the reporting of leases when compared with IAS 17.

The EBA conducted a qualitative analysis of the interaction of IFRS 16 with the existing prudential requirements and a quantitative analysis of the impact of IFRS 16 on a sample of banks in EU to lessees. The qualitative analysis highlighted the existence of some areas of interaction of IFRS 16 with the prudential requirements, being the nature of the newly recognised assets (so called right-of-use -'RoU'- assets) and the prudential treatment of these assets for capital, leverage and liquidity purposes. This analysis suggests that, overall, IFRS 16 will not raise significant challenges related to bank regulation. In quantitative terms, on the basis of the underlying assumptions used using the available information at the time the exercise was performed, the impact of IFRS 16 on own funds and leverage ratios is estimated to be of limited significance for the vast majority of the banks in the sample.

Overall, the EBA estimates that the impact of IFRS 16 to EU banks is of rather limited significance depending mainly on the materiality of the RoU assets compared to the existing assets of a bank. However, the EBA acknowledges that this analysis includes certain limitations on the basis of the available data at the time the analysis was performed. Therefore, the actual impact of IFRS 16 may differ across different banks and jurisdictions when IFRS 16 is initially applied, depending mainly on the magnitude of the lease obligations that a bank holds and which will need to be recognised on the Balance Sheet when IFRS 16 is initially applied.

Lastly, the EBA will continue analysing the interactions of IFRS 16 with the prudential regulatory framework taking also into consideration any developments at the international level -namely at the Basel Committee of Banking Supervision (BCBS).

The EBA's overall views and supporting analysis on IFRS 16 are set out in the Appendix to this letter.

Yours sincerely

(signed)

Andrea Enria

CC: Andrew Watchman, EFRAG TEG Chairman

Appendix

This Appendix sets out the EBA's main views on IFRS 16. The EBA's view on IFRS 16 is based on a qualitative and quantitative analysis of the impact of the new Standard for lessees. The views provided in this letter are expressed for the purpose of providing an input for the Preliminary Consultative Document published by EFRAG on 12 October 2016 and the future draft endorsement advice that EFRAG will publish, on the basis of the information currently available to the EBA.

The EBA's main view on the endorsement of IFRS 16

The EBA welcomes the efforts of the IASB to improve financial reporting in the area of leasing and in particular the aim to reflect the substance and the economics of the lease transactions in the financial statements of both lessees and lessors[3]. The current accounting treatment of leases under IAS 17 allows some assets and liabilities relating to leases to remain off-balance sheet, there is inadequate disclosure of operating leases and the leverage position of lessees may not be accurately reflected.

The EBA supports the recognition of assets and liabilities arising from lease transactions on the balance sheet. Overall, compared to the current requirements, IFRS 16 should improve the transparency of information, result in a wider recognition of financial liabilities for all types of leases for lessees and should reduce the room for structuring leases in order to achieve beneficial accounting treatment. For these reasons, the EBA supports the endorsement of IFRS 16 in the EU and agrees with EFRAG's view that IFRS 16 brings a significant improvement to the reporting of leases by lessees when compared with IAS 17.

On the basis of the EBA qualitative and quantitative analysis performed, the overall impact of IFRS 16 to EU banks is estimated to be of limited significance, but will depend on the magnitude of the lease obligations that a bank holds and which will need to be recognised on the balance sheet when IFRS 16 is applied initially and subsequently. The estimated impact of IFRS 16 to lessors is considered to be of limited significance as the changes introduced in IFRS 16 are relevant mainly to lessees accounting. The analysis suggests also that overall IFRS 16 will not raise significant challenges related to bank regulation. However, the final impact from the application of IFRS 16 may be different than the estimated impact by the EBA.

[3] https://www.eba.europa.eu/documents/10180/16112/2013+09+13+%28Let+to+Mr+Hoogervorst+on+Draft+ED-2013-6+leases+-+signed%29.pdf

Qualitative analysis

The EBA has analysed the interaction of IFRS 16 with the existing prudential requirements and will continue its analysis taking also into consideration any developments at the international level - namely at the Basel Committee of Banking Supervision (BCBS).

a. Prudential treatment of RoU asset as tangible or intangible

Under IAS 17, for a finance lease, when the underlying asset is a tangible asset (for example property), lessees may present the leased assets as part of the Property, Plant and Equipment on the balance sheet (together with owned assets), which are tangible assets. For prudential purposes, a risk weight is applied to these (tangible) assets. When the underlying asset is an intangible, a deduction from own funds shall be applied. Hence depending on the nature of the newly recognised RoU assets under IFRS 16, the relevant prudential treatment would be applied (a risk weight could be applied to the RoU asset – if it is a tangible asset – or a deduction from own funds – if it is an intangible asset). The EBA considers that the same treatment as for finance leases under IAS 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 IAS 17) as tangibles - if the underlying asset is tangible. As the RoU asset is classified as an asset, it is a resource controlled by the entity as a result of past events and from which benefits are expected to flow to the entity. The control of this resource could be obtained through different legal forms; that is, a purchase agreement is not the only way to obtain control of a tangible asset as this control could be also obtained through a lease agreement.

Having said that, an additional overall consideration is that the CRR refers to leases (without any differentiation between finance and operating leases) and the CRD refers to financial leasing in Annex I with the list of activities subject to mutual recognition. Therefore, an additional review of the CRD/ CRR texts would be useful to ensure that the scope of application of the relevant CRD/ CRR requirements is also appropriate under IFRS 16.

b. Impact on RWA from RoU assets

As there will be no distinction between finance and operating leases under IFRS 16, the newly recognised RoU assets under IFRS 16 could follow the same treatment as finance leases under IAS 17. Therefore, a 100% risk-weight could be applied to these assets which could be seen as simpler and consistent with the current treatment for prudential purposes and at the same time it avoids creating any incentives for banks to choose either ownership[4] or leasing of assets. Alternative options for the appropriate risk weight to be considered would need to be assessed against the need to ensure that any risk of unexpected losses arising from a leasing contract is covered by regulatory capital and the possible inconsistency which will be introduced if a distinction between finance and operating leases exists only for prudential purposes.

[4] According to Article 134 of the CRR, tangible assets are subject to a 100% risk-weight.

c. Impact on leverage from RoU assets

Currently, in contrast to finance leases, operating leases under IAS 17 are not considered in the calculation of the leverage ratio for regulatory purposes. The recognition of RoU assets in the denominator of the leverage ratio would be consistent with EBA's view as it will lead to a more accurate reflection of the economics of leasing transactions. In addition, it would lead to more transparency of rights and obligations from leases. Therefore, for lessees that currently have material operating leases under IAS 17, there may be an impact on the leverage ratio, as these assets will be recognised on the balance sheet and in the leverage exposure respectively.

d. Impact on liquidity from RoU asset and lease liability

Operational expenses do not trigger any outflow in the short-term metric of liquidity which is the liquidity coverage ratio (LCR). The outflows (payments) for these types of contracts respond to operational costs which may be seen conceptually outside the scope of the stressed outflows covered under the LCR. However, it should be noted that the distinction between finance and operating leases will not exist under IFRS 16 and one may question whether banks will still be able to differentiate most of these types of contracts under IFRS 16.

Regarding the impact on the longer-term metric of liquidity, the net stable funding ratio (NSFR), there are mainly two contrary impacts taking place being the faster rate of depreciation of the RoU asset (than the rate of amortisation of the lease liability) and the lower factor applied in the finance liability in the part of the lease transaction maturing below one year (than the factor applied to the RoU asset). The treatment of RoU assets from operating leases in NSFR would be similar to the treatment of finance leases since the accounting treatment of all leases would be the same.

e. Impact on capital requirements for operational risk

For the calculation of the own funds requirements for operational risk (under the Basic Indicator Approach), the annual gross income should be used as defined in Article 316 of CRR. The annual gross income does not include expenses from operating leases according to IAS 17. The annual gross income used for the calculation of capital requirements for operational risk will be reduced as under IFRS 16, the total expenses will be split between depreciation expense for the RoU asset (operating expense) and interest expenses for the lease liability. Consequently, the interest expense will reduce the annual gross income for the calculation of the own funds requirements for operational risk, which will lead to a decrease in the minimum requirements for operational risk.

Quantitative analysis

The EBA performed also a quantitative analysis of the impact of IFRS 16 on a sample of banks in EU to understand the impact on IFRS 16 on Common Equity Tier Capital, Total Capital and Leverage ratio. The analysis is based mainly on the information included in the financial statements and Pillar 3 supervisory disclosures[5]. The sample used for the analysis includes 65 banks across 19 countries in the European Economic Area (EEA). Each country in the sample is represented by at least 3 banks. The sample consists of different banks in terms of size, business model and risk profile and across most of the EU Member States.

This analysis is focused on the impact of the newly recognised RoU assets for lessees and it does not include the possible impact on own funds via the profit or loss account where the expenses recognised may be different under IFRS 16. However, this impact is considered as less likely to be material. In summary, the analysis included an estimation of the present value of lease obligations based on the current disclosures of the future obligations for operating leases[6]. The baseline scenario of the analysis included a risk weight of 100% for the RoU assets and 3% discount rate to estimate the present value of the future lease obligations. The analysis was performed also using different scenarios regarding the underlying assumptions for the discount rate applied to the lease obligations and the risk weights which could be applied to the RoU assets.

On the basis of the underlying assumptions, the estimated impact from IFRS 16 on own funds and leverage ratios of the banks in the sample is of limited significance. In a few cases, the impact could be higher depending on the materiality of RoU assets compared to a bank's RWA (for the impact on own funds) and to the leverage ratio exposure (for the impact on leverage ratio). The table at the end of this letter includes aggregated data of the estimated impact based on the analysis performed.

A few banks in the sample may have a higher impact from IFRS 16 on own funds, when the estimated present value of their existing operating leases compared to their risk weighted assets (RWA) is higher than the respective metric for the vast majority of the sample. Therefore, on the basis of the underlying assumptions of the exercise, banks with higher present value of

[5] 6 banks (in 1 Member State) provided themselves the necessary information to estimate the impact from IFRS 16 instead of publicly available information

[6] When publicly available information was used, some simplifying assumptions have been made:

- All lease payments which are due after 2020 in publically available information are assumed to be due at the end of 2021, and are thus not subject to further discounting.
- Lease payments are not adjusted for the amount of payment attributable to services, which may be excluded from RoU assets, at election of the lessee.
- No adjustments were made for "short term" leases (leases less than 1 year), which may be excluded from RoU assets at the election of the lessee.
- No adjustments were made for leases of "low value" assets, which may be excluded from the RoU assets at the option of the lessee.
- The assumption is that RoU assets are initially measured at the amount of the lease liability and subsequently measured using a cost model.

obligations for operating leases compared to their RWA, in most cases, will have a higher estimated impact on own funds from IFRS 16.

Regarding the estimated impact on the leverage ratio, a few banks in the sample may have a higher impact from IFRS 16 on leverage ratio, when the estimated present value of their existing operating leases compared to their leverage ratio exposure is higher than the respective metric for the vast majority of the sample. Therefore, on the basis of the underlying assumptions of the exercise, banks with higher present value of obligations for operating leases compared to their leverage ratio exposure, in most cases, will have a higher estimated impact on leverage ratio from IFRS 16.

In addition, the analysis did not indicate that there is a concentration of the estimated impact of IFRS 16 to larger or smaller banks of the sample.

Finally, a sensitivity analysis of the underlying assumptions for the discount rate and the risk weight indicated that a change in the discount rate would lead to similar estimated impact as mentioned above. In the case of a lower risk weight applied, the estimated impact is reduced proportionately, whereas a deduction of RoU assets from own funds (if considered intangible assets) would lead to a higher impact on own funds and leverage ratios.

Estimated impact of IFRS 16 Leases

Risk weight of RoU asset = 100%

Discount rate = +3.00%

Banks in sample	65
Countries in sample	19

	Estimated impact (in bps)				Analysis of impact on Own funds ratios	Analysis of impact on Leverage ratio
	Leverage ratio	CET 1 ratio	Tier 1 ratio	Total capital ratio	Materiality of RoU asset to current RWA: RoU/ RWA	Materiality of RoU asset to current LR exposure: RoU/ LRexposure
min	0	0	0	0	0.0%	0.0%
Q1	0	-2	-2	-2	0.1%	0.1%
median	-1	-6	-7	-8	0.5%	0.2%
average	-2	-9	-9	-11	0.6%	0.2%
Q3	-2	-13	-14	-17	1.0%	0.4%
max	-11	-46	-46	-46	2.8%	0.9%

Estimated impact of IFRS 16 Leases - discount rate 0%

Risk weight of RoU asset = 100%

Discount rate = 0.00%

Banks in sample	65
Countries in sample	19

	Estimated impact in bps				Analysis of impact on Own funds	Analysis of impact on Leverage ratio
	Leverage ratio	CET 1 ratio	Tier 1 ratio	Total capital ratio	Materiality of RoU asset to current RWA: RoU/ RWA	Materiality of RoU asset to current LR exposure: RoU/ LRexposure
min	0	0	0	0	0.0%	0.0%
Q1	0	-2	-2	-2	0.1%	0.1%
median	-1	-7	-8	-9	0.5%	0.2%
average	-2	-10	-10	-12	0.7%	0.3%
Q3	-3	-15	-16	-19	1.1%	0.4%
max	-13	-51	-51	-51	2.8%	0.9%

Estimated impact of IFRS 16 Leases - risk weight 50%

Risk weight of RoU asset = 50%

Discount rate = +3.00%

Banks in sample	65
Countries in sample	19

	Estimated impact in bps				Analysis of impact on Own funds	Analysis of impact on Leverage ratio
	Leverage ratio	CET 1 ratio	Tier 1 ratio	Total capital ratio	Materiality of RoU asset to current RWA: RoU/ RWA	Materiality of RoU asset to current LR exposure: RoU/ LRexposure
min	0	0	0	0	0.0%	0.0%
Q1	0	-1	-1	-1	0.1%	0.1%
median	-1	-3	-3	-4	0.5%	0.2%
average	-2	-4	-5	-6	0.6%	0.2%
Q3	-2	-7	-7	-8	1.0%	0.4%
max	-11	-23	-23	-23	2.8%	0.9%