

*Banking supervision
And Accounting issues Unit*

The Director

Paris, December 12th 2016

FBF comments on EFRAG preliminary consultation document regarding the endorsement of IFRS 16 leases.

Dear Mr Gauzes,

The French Banking Federation is pleased to have the opportunity to comment on the EFRAG preliminary Consultation Document regarding the endorsement of IFRS 16 Leases.

We appreciate the preliminary analysis conducted by the EFRAG regarding IFRS 16 in order to consider technical criteria for endorsement and whether IFRS 16 could be conducive to European public good and the additional work that EFRAG undertakes considering the impact of IFRS 16 on SMEs and an economic study.

Regarding the accounting side, IFRS 16 is expected having a significant impact for entities having operating leases as it will imply a gross-up of balance sheet resulting from recognition of operating leases as assets and liabilities.

However, the major concern for banks as lessees is the prudential impact of the changes in the lease accounting, whereas there are no changes of the risk profiles or the real economics of lease transactions. Indeed, as banking institutions, the interaction between IFRS 16 and the financial stability in Europe should be analysed in terms of impacts on our prudential ratios. The regulatory implications of the new lease standard raise several issues as follows:

- how the right-of-use (ROU) assets will be classified under regulatory capital requirements, i.e. as intangible assets or tangible assets depending on the underlying assets. This will influence the risk-weighted assets and with it, the capital ratios used for calculation of the regulatory capital.
- how international regulation would treat the “new Right to use assets” notably regarding the calculation of leverage ratios and the solvency ratio (leased risk-weighted assets) given that the changes in the accounting standards do not reflect any change in the risk profiles .

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- how the level playing field between jurisdictions and banks would be achieved. Indeed, the value of the right-of-use of the same types of leased assets may vary between jurisdictions because the term of the lease contracts may be different due to different contractual and legal practices on that matter. As a consequence, the impact on prudential capital requirements may vary from one jurisdiction to another, creating a distortion of competition among banks operating in different jurisdictions.

Therefore, we advocate for and support an impact assessment conducted by EFRAG or European agencies as an integral part of the endorsement process so that the European authorities could be duly informed of the consequences of the new standard when taking a decision about IFRS 16 endorsement. Such impact study should encompass an analysis of prudential impacts of IFRS 16 and beyond the assessment, we think it is fundamental that any ambiguity and regulatory uncertainty is removed well in advance of the application of this new standard.

We also believe that potential regulatory amendments that would be taken by regulators under the new accounting standards should be carefully assessed in order to avoid that capital ratios would be negatively impacted by accounting changes and this should be acknowledged in the EFRAG advice endorsement paper.

Finally, concerning disclosure related to expenses relating to short-term leases, we question the benefits of the extensive disclosure compared to the costs occurred in order to provide the information.

Following are answers to some of the questions of the EFRAG preliminary consultation document. We hope the EFRAG find these comments useful and would be pleased to provide any further information. We would therefore appreciate if the EFRAG could consider our concerns related to the prudential impact of the new lease standard IFRS 16, and notably the need of an analysis on that matter.

Yours sincerely,



Bertrand Lussigny

Appendix 1 Summary of IFRS 16 Leases

Q2 - If you are a preparer, which approach to transition do you expect to take? Please explain your reasons for this decision.

As a substantial preparatory work is necessary to meet the transition requirements, i.e. track lease arrangements individually, reassess historical conditions of lease contracts up to the initial date, apply discount rates that were valid as at the date of the initial lease contract, the full retrospective approach will undoubtedly be costly and burdensome for preparers. Indeed, entities would be required to make all the assumption and estimates that are necessary to apply the lessee accounting model and to account for leases as if the new leases standard has always been applied.

Under a modified approach, entities are not required to restate the comparative information. They only have to present the cumulative effect of initially applying the lease standard as an adjustment to the opening balance sheet.

Final decisions depend on the scale of the processes and IT developments to be made to meet the transition requirements, the available information and the impact on the presentation of the financial information. Entities will have to make a trade-off between costs involved for implementation of the transition requirements regardless of the option chosen and the impact on balance sheet - carrying amounts of assets and liabilities – and profit and loss account – profit trends – until the last lease in place on transition has expired.

Appendix 3 Assessing whether IFRS 16 is conducive to the European public good

Q6 - Do you have any views or information on how IFRS 16 can be expected to affect the behaviour of investors and/or lenders? If so, do you have any views or information on whether and how IFRS 16 could, for European companies that apply IFRS, positively or negatively affect: (i) the overall cost of capital; (ii) access to finance and cost of credit? Please provide any available evidence.

As the new lease standard will change radically the lease accounting - leases are accounted for as assets and debts in the balance sheet - lessees may change the way they consider entering into a lease contract. Lessees could potentially have to balance – even more than before - the advantages and disadvantages of purchased assets and leased assets in order to respond to their business needs within the constraints of the new accounting treatment.

As mentioned by the EFRAG, long term leases will be less attractive and, thus, the demand for shorter term leases may increase. Therefore, lessees will probably try to renegotiate the term or the inclusion of options to extend or break clauses of the lease contracts before implementing IFRS 16.

Offers of services will change as well. Lessees are likely to ask the lessors to separate service charges in the lease contracts to reduce the impact of the standard on their balance sheet.

Considering debt covenants, IFRS 16 may modify financial ratios included in debt covenant contracts for clients subject to IFRS. Thus, the impact of IFRS 16, in isolation, on behaviour of lenders will depend on the features of the loan agreements that may include either automatic renegotiation clauses in the case of accounting principle changes or “frozen” GAAP disposals. In the absence of such clauses and in the case of breaches in covenants ratio due to the change in accounting standards, some waivers or contracts renegotiations could be expected.

As a financial institution, the overall cost of capital of this standard can be assessed through the impacts on our prudential ratios. The extent of the impacts depends on the size of bank agency network subject to leases. The requirement to recognise a ROU and a lease liability will affect banks' solvency ratio, banks' leverage ratio and banks' NSFR ratio based on the current prudential framework.

Q - 10 - Do you have any information or views on whether IFRS 16 is likely to endanger financial stability in Europe? Please provide any available evidence.

The basic effect of IFRS 16 will be an accounting effect. Lessees will be recognised to the balance sheet an increase in lease assets and financial liabilities. For most banks that rent property and equipment as operating leases, the new standard will result in a gross-up of their balance sheet, i.e. an increase in reported assets and liabilities.

Having said that, the major significant impacts of IFRS 16 will be prudential impacts resulting from a change in the accounting standard without reflecting any change of the risk profiles or the real economics of lease transactions. Three aspects of the regulatory implications of the new standard on Leases should be considered.

The first point for banks is how the right-of-use (ROU) assets will be classified under regulatory capital requirements. This will influence the risk-weighted assets and with it, the capital ratios used for the calculation of the regulatory capital. Thus, as the ROU assets might be treated as intangible assets for prudential purposes even if the underlying assets are tangible, written confirmation from the regulators is needed that the prudential treatment of the ROU assets will follow the characteristics of the underlying assets, in order to avoid any intended capital deduction. Indeed, if the ROU asset was considered as an intangible asset by the regulator, the impacts on prudential ratios would be material and could represent an issue in terms of financial stability in Europe.

The second point will be how international regulation would treat the "new assets" that risk profiles have not change or the real economics of lease transactions under the capital prudential regime. Considering leverage ratios, the gross-up of the asset side of the balance sheet will increase the leverage exposure measure and therefore decrease the leverage ratio as the leverage ratio calculation includes the leased asset side without considering the corresponding lease liability. Leased assets will be risk-weighted depending on the class of assets of the underlying assets and, thus, they will impact capital ratios.

The third point relates to the amounts at stake and differences which could arise between jurisdictions and banks. Within different jurisdictions, the term of the lease contracts may vary for the same type of leased assets due to different contractual and legal practices on that matter. Therefore, the extent of the value of the right-of-use assets will be affected by the legal environment and by the judgment required in assessing the termination or extension options included in the contracts. It shall be noted however that property lease in France are "baux 3/6/9" and would probably be considered as having a 9 years term. As a consequence, the impact on prudential capital may be different between jurisdictions.

Therefore, we advocate for and support an impact assessment conducted by EFRAG or European agencies as an integral part of the endorsement process so that the European authorities could be duly informed of the consequences of the new standard when taking a decision about IFRS 16 endorsement. Such impact study should encompass an analysis of prudential impacts of IFRS 16.

We also believe that potential regulatory amendments that would be taken by regulators under the new accounting standards should be carefully assessed in order to avoid that capital ratios would be negatively impacted by accounting changes and this should be acknowledged in the EFRAG advice endorsement paper.

Q - 11 - What is your view on the relative costs of applying IFRS 16 and US GAAP? Do you have any other views as to the advantages or disadvantages of IFRS 16 compared to US GAAP? Please provide any available evidence.

The costs incurred to implement and to apply IFRS 16 are mainly costs related to tracking all the lease arrangements and gathering lease contract data that, in some cases, are available manually. Entities will need to carefully review and assess the attributes of the contracts in order to identify lease and non-lease components, the lease period, payment terms and other options. Implementation of IFRS 16 also results in costs due to changes to processes, controls and IT systems that support lease accounting, but also lease management. Ongoing processes and controls should also be reviewed in order to capture changes in the contractual terms as this might impact the carrying values of lease assets and liabilities.

For the lessors, there are a number of differences between IFRS 16 and ASU 2016-02 (the US Gaap Lease standard), however, as mentioned in the BC 203, these differences are coming from previous gaaps which have been carried forwards in the new lease standards (both the FASB and the IASB decided to substantially carry forward the previous lessor accounting requirements in IAS 17 and topic 840 respectively).

Considering IFRS 16 compared to the US GAAP, the main difference between the two standards relates to the presentation in P&L of operating lease contracts for lessees. Under US GAAP, lease costs related to operating leases, allocated on a straight-line basis over the lease term, are presented as part of the operating costs in the income statement, whereas similar costs under IFRS 16 are split between interests on the lease liability that are recognized as finance costs in the income statement and the amortization of the right-of-use asset. We would be in favour of the revision of the accounting principle for the recognition of operating lease expense in order to enable a linear recognition.

At least there is also a difference between US Gaaps and IFRS regarding leases of low asset value which could have an impact on disclosures requirements and their related costs. Indeed, as there is no exemption under US Gaaps for leases of low-value assets, no specific disclosures might be requested, subject to materiality. We understand that the FASB believes that an entity will be able to adopt a reasonable capitalization policy under which the entity will not recognize certain lease assets and liabilities that are below a certain threshold. As such, no specific disclosures could be expected in US Gaaps contrary to IFRS which explicitly requires some burdensome disclosures for leases of low asset value.