

POSITION PAPER



ESBG comments on EFRAG's Preliminary Consultation Document regarding the endorsement of IFRS 16 *Leases*

ESBG (European Savings and Retail Banking Group)

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ESBG Transparency Register ID 8765978796-80

08 December 2016



European Savings and Retail Banking Group (ESBG) members are most appreciative of the opportunity afforded to them by the European Financial Reporting Advisory Group (EFRAG) to comment on the Preliminary Consultation Document regarding the endorsement of IFRS 16 *Leases*.

We are confident that the below feedback will prove useful in this process.

ESBG Position:

Concerns have been raised by some members regarding the lack of clarity in the new requirements and the possible extra burden they will cause. While the general consensus of the members is that the accounting side of this standard is relatively acceptable, there are major concerns regarding the prudential impact.

General Comments

In advance of responding to the questions posed in the consultation, ESBG would like to draw EFRAG's attention to a number of points that have sparked discussion and concern amongst our membership:

- Given the business model implemented by financial institutions, and in particular the standard strategy they employ to facilitate clients (combination of branches, mobiles and internet) lease arrangements are often necessary. At times leasing may be the only option available, even though the lessee has adequate funding to purchase, the owner of the property is unwilling to sell and they have no choice but to enter into a lease agreement.
- While it is accepted that the more comprehensive information on the lessee side will provide an improved overall picture of the entity, increasing investor protection and market confidence, whether or not the endorsement of IFRS 16 strikes an appropriate balance between costs and benefits for the banking industry remains uncertain, as the significant benefits from the application of the standard are not obvious to many of our members.
- Compliance with the new standard will lead to significant one-off and on-going costs, 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 entity's overall risk profile, and in particular no negative prudential impact should arise from adopting IFRS 16.

The current uncertainty regarding the prudential impact of right-of-use assets makes it difficult for preparers to decide on the transition approach.

- Members are concerned about the impacts of adopting IFRS 16 in activity levels of lessors; in particular if companies within the scope of the new requirements are different across Europe based on how IFRS 16 is adopted into local accounting frameworks.

Appendix 1: Summary of IFRS 16 Leases

Question for constituents

Question 1: *Do you have any information or evidence on the extent to which leases (that you are party to or otherwise aware of) will be eligible for the short-term and low value exceptions identified in paragraph 24 above? If so, please provide details.*

If you are a preparer, do you expect to use the exceptions? If so, please:

(i) Quantify the number and annual lease payments for each category;

(ii) Indicate the proportion of your leases (by volume and/or value) you estimate to be covered by each of the exceptions.



Leases on electronic devices such as computers, tablets, printers, some office equipment and mobile phones could be some of the most common types of contracts to be eligible for the low value exception. However, for some of our members, these assets are owned and, consequently, the exception will not be used.

Question 2: *If you are a preparer, which approach to transition do you expect to take? Please explain your reasons for this decision.*

Regarding the different transition methods, members are of the view that it is premature to answer this question at this stage. Their reasoning for this is as follows:

- Preparers and auditors may have different understandings of the principle-based standard and its transition, and it is expected that both of them will work together with greater intensity as the effective date gets closer (and the first years of application).
- We are concerned about the differences which may arise depending on the transition approach applied. Based on first rough estimations, those differences could be material, thus reducing comparability. One important driver of these differences is the discounting rate to be used: depending on the date an entity entered into an arrangement, the incremental rate may have been reduced significantly, having a direct impact when estimating the lease liability at the transition date. At the same time, it would also impact the statement of comprehensive income.
- 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 regarding how the right-of-use assets will be treated for prudential purposes (please refer to Appendix 3, question 1), we are concerned that in order to make the most efficient decision we will need to estimate the impacts under each transition approach. Under the full retrospective approach, preparers will need to incur significant costs to gather all historical data for lease contracts.

Appendix 2: EFRAG's technical assessment of IFRS 16 against the endorsement criteria

Comments on relevance:

Based on a preliminary analysis, the impact on equity of the existing contracts over their entire life under IFRS 16 would not differ from the impact under the current IAS 17. As mentioned previously, the benefit of this standard can be seen in a clearer overall picture of the lessee position, however, the relevance of this standard could be questioned as it might be considered that the introduction of additional disclosures, or improvements over those included in IAS 17, could have been sufficient in order to influence the economic decisions of users, considering the required costs and complexity of the new standard.

Question to constituents

Question 3: *Are you aware of:*

(i) any contracts that you consider to be leases that would not be classified as leases under IFRS 16; or

(ii) any contracts that you consider to be service contracts (or other non-lease contracts) that would be classified as leases under IFRS 16?

Members are not in a position to conclude whether their existing lease contracts will still be classified as leases under IFRS 16 or if the existing service contracts will be reclassified as leases under IFRS 16. However, it is expected that most current lease contracts will be recognised under IFRS 16 and a part of the new service contracts (or renegotiations) will also be recognised under this new standard. These are contracts where there is an identifiable asset for which use is controlled.



We are concerned about 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.

Question 4: *EFRAG is interested in understanding whether leases of intangible assets (other than rights held by a lessee under licensing agreements within the scope of LAS 38) are common. Do you have any information or evidence as to how frequently such leases of intangible assets arise in practice? If so, please provide information about the types of intangible assets that are subject to leases and the significance in operating and monetary terms.*

Bearing in mind the uncertainty about the classification of a significant number of transactions as leases or service contracts, members have been able to identify frequent examples of contracts on intangible assets, such as computer software and licences, which might be material in some cases. We note that, if the standard is applied on a standalone basis (i.e. separate financial statements), intragroup leases of intangible assets may have a relevant effect on those financial statements. It must be considered that in certain jurisdictions the requirements of IFRS 16 will be adopted at an individual level as a consequence of the modification of the local accounting framework.

Comments on reliability:

As noted by EFRAG, measurement of the right-of-use asset and the lease liability requires judgement in areas such as the length of the lease term and whether payments are variable or in-substance fixed. In our opinion, it adds complexity and may result in similar lease agreements being accounted for differently depending on judgments made.

Comments on comparability:

Members agree with EFRAG that the use of exemptions, practical expedients and different transition requirements limit comparability. It is presumed that the majority of the entities will analyse the pros and cons of each option at the early stages of their implementation projects. It may require significant resources (gathering and validating data, making estimates, etc.), therefore, we do not believe that providing those options will help reduce costs significantly.

Furthermore, it can be argued that comparability may be impaired if the requirements in IFRS 16 are transposed into national accounting frameworks and applied to separate financial statements given that from a standalone point of view contracts over licensing rights and other intangible assets are common and may represent significant amounts. Comparability between companies will depend on whether these contracts are recognised under IFRS 16 or not.

In addition to the limitations to comparability identified by EFRAG, it remains to be seen whether the changes in behaviour of lessees could reduce comparability. New lease contracts may include innovations in terms of the form of payment or the length of the lease term, which could result in information that is not comparable with that derived from the existing contracts.

Finally, members recommend broadening the analysis contained in Appendix 3 to further develop any impacts on comparability between the alternative of using IFRS 16 and other applicable standards to the contracts referred to above.

Understandability:

Members assert that allowing different transition methods to be applied by different entities for similar contracts will reduce transparency and understandability in the market as a whole.

In addition to this, the optional practical expedient allowing lessees not to separate lease and non-lease components impairs understandability. Users will find difficulties in understanding the impact of the use of this practical expedient by a lessee and the resulting effect on the financial statements. For some lease contracts, in which the non-lease component is expected to be material, this is

particularly important (i.e. cars leases, where the insurance service may represent circa 30% of the monthly payment).

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

Question to Constituents

Question 6: *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?*

Concerns have been voiced regarding the potential regulatory implications of IFRS 16 on lessees. Due to the lack of a clear definition by the IASB on the type of asset that represents the right of use under IFRS 16 (i.e. whether the right of use is an intangible asset or not), there could be a very significant impact on CET1 capital, and to a lesser extent on leverage and NSFR ratios depending on the final interpretation of the new type of assets to be recognized in the lessees' balance sheets.

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. However, the change in the accounting framework did not arise out of a concern related to banks' financial situation, their regulatory capital position should therefore 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 all other economic conditions being equal.

In this regard, we would support any 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).

Question 8: *Do you have any additional information or views on how the endorsement of IFRS 16 can be expected to affect the leasing industry in Europe? EFRAG is particularly looking for views from the leasing industry.*

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 of them 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 forklift trucks, commercial vehicle, computer equipment, machinery,...), the lessee wanted to lease the car or asset with the entity A, its maintenance service with entity B and its insurance with entity C, introducing unnecessary business risks in the market, like the loss of control over the insurance or the appropriate maintenance of the asset.

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.

Question 9: *Do you have any information or views on how the endorsement of IFRS 16 can be expected to affect SMEs in Europe?*

We are concerned about the potential effects of the transposition of the standard into national law which may result in some European SMEs being at a competitive disadvantage. In some countries, like in 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, 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.

IFRS 16 is considered a complex and costly standard, especially for SMEs, which could be impacted in terms of 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.

Question 12: *What is your view on the one-off and ongoing costs for preparers? (Please indicate whether you are (a) a lessee; (b) a lessor; (c) both a lessee and a lessor or (d) neither a lessee nor a lessor).*

It is the opinion of our members (acting both as a lessor and lessee in several lease transactions), that it remains uncertain if an appropriate balance between costs and benefits derived from the endorsement of IFRS 16 has been achieved as of today. Besides the already mentioned clearer view of a lessee's position, the other significant benefits from the application of the standard are not obvious. IFRS 16 will result in significant one-off and on-going costs and effort in complying with the new standard (IT systems, controls, databases, etc.). These costs could be even higher if services are outsourced.

As lessors, our members do not share the view in paragraph 70 that costs for lessors of applying IFRS 16 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 so as 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.

Question 14: *If a lessee has to develop new systems to support the accounting for leases, to what extent do you, as a lessee, expect internal benefits from the information provided by the new information? Please quantify to the extent possible.*

Currently, we do not have clarity on the potential internal benefits which could be obtained from the new systems. We believe that costs would outweigh the benefit of this information. 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.



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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Published by ESBG. 08 December 2016