FÉDÉRATION
BANCAIRE
FRANÇAISE

Banking supervision
And Accounting issues Unit

The Director

Paris, March 14th 2017

FBF comments on EFRAG Draft Endorsement Advice on IFRS 16 Leases.

Dear Mr Gauzes,

The French Banking Federation is pleased to have the opportunity to comment on the EFRAG Draft Endorsement Advice on IFRS 16 Leases.

As already highlighted in our comments on the preliminary analysis conducted by the EFRAG regarding IFRS 16, 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.

Once again, we would like to highlight that the interaction of accounting and regulatory framework and the impact of IFRS 16 on capital should be an integral part of the assessment of the impact of the new standard on European public good and European economy.

We fully support the EBF comment letter that is annexed to our letter.

Mr Jean-Paul GAUZES
EFRAG Board President
35 Square de Meeûs
B-1 000 Bruxelles

18 rue La Fayette 75440 Paris cedex 09 – Tel : 01 48 00 52 52 – Fax : 01 42 46 76 40
Internet : www.fbf.fr

As clearly stated in the EBF comment letter, we believe that the EFRAG should explicitly recommend in its advice endorsement paper that necessary changes to safeguard the capital should be introduced within the CRR and remain in place until the time the interaction of IFRS 16 with prudential regulatory framework is duly analyses and addressed both at international and EU level. The changes to the CRR must be introduced in time to be aligned with the IFRS 16 implementation date in the EU.

In conclusion, we would therefore appreciate if the EFRAG could consider our concerns related to the prudential impact of the new lease standard IFRS 16 and would be pleased to provide any further information.

Yours sincerely,

Bertrand Lussigny

Mr Andrew WATCHMAN
EFRAG CEO and TEG Chairman

Brussels, 13 March 2017
EBF_026046

Subject: **EBF response to the EFRAG endorsement advice on IFRS 16**

Dear Mr Watchman,

We understand that the actual effect of FRS 16 on solvency, leverage and liquidity ratios of financial services entities subject to prudential capital requirements were not taken into account in EFRAG assessment as it is regarded to be in the competence of the relevant prudential regulators to respond to the capital consequences off the new accounting standard.

While we appreciate that changes to the capital rules are not in the competences of EFRAG, we view the interaction of the accounting and prudential frameworks as being of increasing importance and that significant accounting change should trigger an assessment of the effect on prudential capital and whether any increase should be viewed as a natural consequence or duplicative in nature and, depending upon this, whether any transitional arrangement is needed. We do not consider it appropriate that CET 1 ratios of banks decrease as a result of change in the accounting standards without any corresponding change in the level of risk, risk appetite, the bank's strategy, management or level of losses.

The regulators have stated in other consultation proposals that they do not intend to significantly increase overall capital requirements. However, the impact on capital ratios resulting from IFRS 16 have not yet been taken into account in the overall calibration of the capital framework. While taking separately, the impact of IFRS 16 on capital may not be itself significant on average (this would need to be properly assessed through a quantitative impact study performed by the EBA based on real figures). The cumulative impact together with other prudential measures, adds pressure on banks' capital levels. Further increases in capital requirements can only further curtail banks' capacity to finance the economy. Increased capital requirements are expected to have an adverse impact on banks' lending practices and pricing. Banks can adjust to higher capital requirements either by raising fresh capital – a scenario that after the earlier considerable efforts by banks in Europe in this regard is not feasible – or by deleveraging.

We do believe that the IASB´s decision to no longer refer to the level of risk being transferred between the lessor and the lessee is not an adequate basis for the prudential treatment.

Under the current leasing standard (IAS 17) lease contracts are recognized on the balance sheet only when the contract transfers substantially all the risks and rewards incident to

ownership to the lessee (Finance Lease). Operating Leases therefore have no impact on the balance sheet of the lessee. IFRS 16 effective (01.01.2019) introduces fundamental changes in accounting for operating lease contracts on lessee`s balance sheet as it no longer differentiates between operating and finance lease and requires to recognize all on the balance sheet as Right of Use Assets.

For institutions that rent property and equipment (currently classified as Operating-Lease), these changes will negatively impact:

- Capital ratio (assuming the RoU-Asset would be assigned to other noncredit-obligation assets with a RW of 100%);
- Leverage ratio (due to an increase of the balance sheet total);
- Net stable funding ratio (due to an increase in the required stable funding).

The risk distribution between the lessee and the lessor shall be taken into account for regulatory purposes (for RWA and LR) to achieve a risk adequate, appropriate and proportionate treatment.
Based on the definitions for Operating-Lease and Finance-Lease in IFRS 16 (which have been carried over unchanged from IAS 17) a lease is classified as a:

- "Finance-Lease if it *transfers substantially all the risks and rewards* incidental to ownership of an underlying asset" and
- "Operating-Lease if it *does not transfer substantially all the risks and rewards* incidental to ownership of an underlying asset."

Following this differentiation, the lessee bears the investment risk in a Finance-Lease and the lessor bears the investment risk in an Operating-Lease.

The prudential treatment should be based on:

1) The nature of the RoU assets under IFRS 16. A risk weight should be applied to the RoU asset if it is a tangible asset or a deduction from own funds should apply in case when the underlying asset is an intangible.
2) Differentiation of leases that present a significant transfer of risks and rewards related to the underlying assets to an institution as a lessee and those that do not instead of solely referring to the accounting treatment which intends to make lease transactions transparent on the balance sheet irrespective of the underlying risk distribution.

The inclusion of these criteria into the CRR would preserve consistency of RWA reporting for operating leases (no change in risk), better reflect economic risk exposure, enhance legal certainty, avoid introduction of non-level playing field between IFRS and US GAAPs while it could be adopted consistently for regulatory purposes across institutions using both IFRS and national GAAP.

Assuming the adoption of the boundary criteria into the CRR (Article 4), leases which do meet the criteria of an operating-lease would be assigned **an exposure value of 0**

resulting in an RWA of €0. This would be a more appropriate treatment given that the lessor bears the investment risk.

A distinction of Operating-Lease and Finance-Leases (Article 4 of the CRR) is also necessary **for leverage ratio** purposes in order to achieve the appropriate treatment. Institutions with leased assets for operating purposes has a Right of Use Asset on-balance sheet and a corresponding lease obligation as a liability. It does not create a meaningful leverage.

According to the objective of the **Net Stable Funding Ratio** (NSFR) limiting excessive reliance on short-term or unstable funding, a lease of operating assets entered into by a bank does not involve the kind of maturity transformation, which is intended to be contained by the NSFR. The Right of Use Asset is directly linked contractually and economically to the corresponding liability. Therefore, the Right of Use Asset and the corresponding liability should be categorized as interdependent and get 0% RSF and 0% ASF as per Art. 428k (2) (b) CRR II.

The proposed changes would preserve the current capital treatment of leases for own funds requirements, leverage ratio and NSFR at least until the time the analysis of the interaction of IFRS 16 with prudential regulatory framework is concluded both at international and EU level.

Given that the actual effects of IFRS 16 on solvency, leverage and liquidity ratios of financial services entities subject to prudential capital requirements were not considered by EFRAG in its assessment and that EBA indicated it will continue analyzing the interaction of IFRS 16 with the regulatory frameworks, we believe it would be helpful if EFRAG could make explicit reference for the European lawmakers to consider whether the CRR needs to be amended in order to safeguard the existing capital position until such time the interaction of IFRS 16 with prudential regulatory framework is duly analyzed and addressed both at international and EU level. The changes to the CRR must be introduced in time to be aligned with the IFRS 16 implementation date in the EU.

Yours sincerely,

Wim MIJS

About EBF

The European Banking Federation is the voice of the European banking sector, uniting 32 national banking associations in Europe that together represent some 4,500 banks - large and small, wholesale and retail, local and international - employing about 2.1 million people. EBF members represent banks that make available loans to the European economy in excess of €20 trillion and that securely handle more than 300 million payment transactions per day. Launched in 1960, The EBF is committed to creating a single market for financial services in the European Union and to supporting policies that foster economic growth.

www.ebf.eu @EBFeu

For more information contact:

Denisa Mularova
Senior Adviser
d.mularova@ebf.eu
+32 2 508 37 11