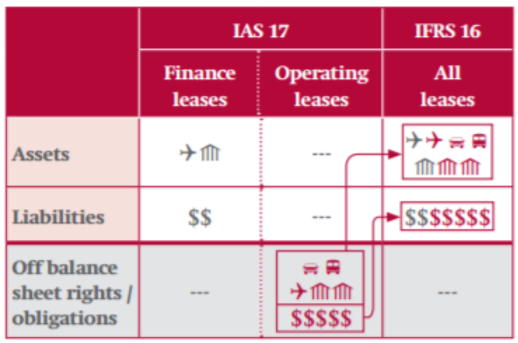
Association for Financial Markets in Europe

AFME Working Paper / Issue Summary

IFRS 16 – Regulatory treatment of Leased assets

Overview

IFRS 16 is an accounting standard, which deals with the accounting treatment of leases and comes into force 1 January 2019. One of the most significant changes in IFRS 16 versus IAS 17 (i.e. the previously applicable accounting standards) is the treatment of Operating Leases (OLs). Whereas under IAS 17 OLs were off-balance sheet and recorded as a single expense, under IFRS 16, the lessee is required to bring OLs on-balance sheet by recognising a right of use (RoU) asset and a corresponding lease liability, as displayed in the chart below.



Capital Treatment

The EBA in its letter to EFRAG[1] stated that the classification of the RoU asset as tangible or intangible for regulatory purposes will follow the accounting designation of the underlying asset. We welcome this helpful clarification and support an amendment tabled by EP MEPs Sander, Lamassoure, Cadec (317) in this regard. Furthermore, the letter states that a risk weight would be applied to those RoU assets which are deemed to be tangible assets, while intangible assets would be deducted from own funds. The EBA suggests a 100% risk weight could be applied to RoU tangible assets, following the same treatment of finance leases under IAS 17.

Therefore, the impact of recognising RoU assets associated with OLs on balance sheet will result in a reduction in capital ratios, as well as a subsequent reduction in leverage ratio. The impact on capital ratios will be material for a number of banking institutions, and in some cases it will be larger than that of implementing IFRS 9.

The current RRM package does not address the potential cliff effect on capital ratios or the impact on leverage ratios from the new IFRS16 leasing standard. While we are supportive of the increased transparency brought by IFRS16, we believe the prudential impact of bringing OLs on balance sheet should be addressed as there has been no change in the risk profile of operating leases and that the lessor bears the investment risk in an operating lease. As such, the impact on capital (and leverage) ratios should be unchanged, which could be achieved by applying a 0% risk weight to operating lease exposures. This would also preserve the current regulatory treatment of operating leases and better

[1](EBA-2017-D-1085) Letter Mr Gauzes, EFRAG re IFRS 16 Leases.pdf

reflect the economic risks. The ongoing CRR review may be the only opportunity to avoid an unintended sudden capital increase due to IFRS 16 before its entry into force (1/01/2019**).**

As an alternative to the 0% risk weight, if it is deemed appropriate to apply a higher risk weight, we ask that consideration be given to phase-in or transitional arrangements to avoid a cliff effect on capital ratios. This would ensure a consistent implementation of IFRS 16 to what was done for IFRS9. It should be noted that as operating leases do not currently attract a capital charge, the transitional solution for capital and leverage purposes could be relatively straightforward e.g. increasing the proportion that is recognised by 20% each year, until the full impact has been phased in over 5 years.

Net Stable Funding Ratio (NSFR)

The EBA's letter to EFRAG sets out two 'contrary impacts' that occur in the calculation of the Net Stable Funding Ratio (NSFR): the rate of depreciation of the RoU asset is faster than the rate of repayment of the lease liability, and the available stable funding (ASF) factor applied to the finance liability in the part of the lease transaction maturing below one year is lower than the required stable funding (RSF) factor applied to the RoU asset. The industry believes that, among these two 'contrary impacts', the lower ASF factor is most significant one and will therefore reduce the NSFR ratio.

The objective of the NSFR is to limit excessive reliance on short-term or unstable funding. A lease of premises, equipment, or other operating assets entered into by a bank does not involve maturity transformation, nor does it create any kind of reliance on short-term funding that would erode a bank's liquidity position in a way that could increase the risk of its failure and potentially lead to broader systemic stress. The crucial fact is that the RoU asset is directly linked contractually and economically to the corresponding liability. Indeed, the IASB has argued that the values of the two components are linked at commencement of the lease[2]. Therefore, if the RoU asset for an OL attracts 0% RSF, the corresponding liability should also carry a 0% ASF.

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[2]IFRS 16.23-24.