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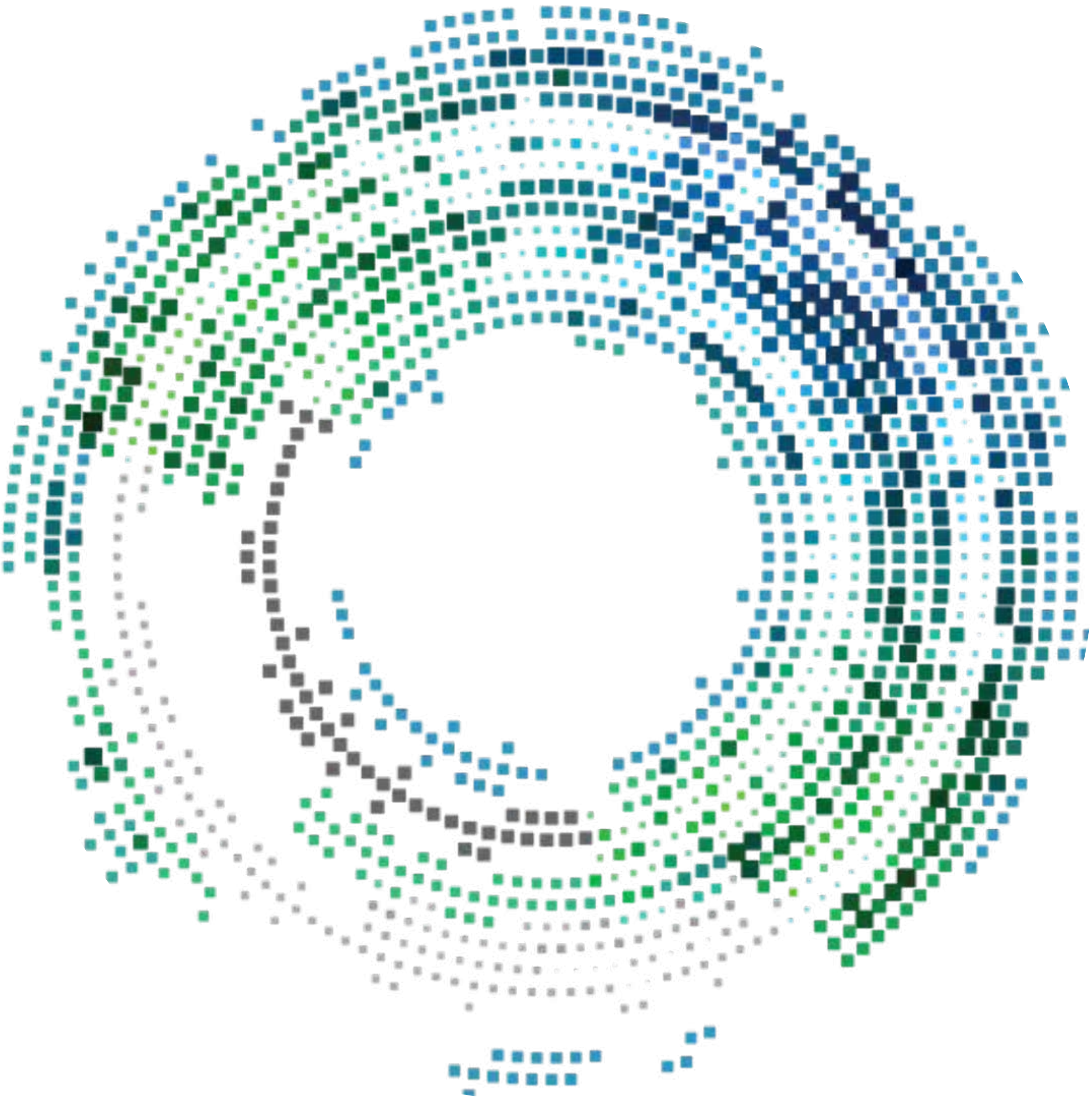


Deloitte Insights

IFRS 16: Leases and the Impact on Credit institutions

Introduction

Leasing is an important financing activity for both corporate and credit institutions with the majority of leased assets not reported on their balance sheet.

IAS 17 "Leases", the previous leasing standard, categorised leases as either 'finance leases', which were reported on the balance sheet, or 'operating leases', which were only recognised in the income statement as a straight line expense with the outstanding commitment disclosed in the Notes to the financial statements. The classification in each of the two categories was driven by the exposure of the entity to the risks and rewards incidental to the ownership of the asset:

- **Finance Lease** – the lease was economically similar to purchasing the underlying asset. This resulted in the entity recognising an asset and a corresponding liability on balance sheet.
- **Operating Lease** – the lease was a contract that allowed for the use of an asset but did not convey rights of ownership of the asset. This represented an off-balance sheet financing of assets, and thus a leased asset and associated liabilities of future rent payments were not included on the balance sheet. The lease payments were recognised on straight line basis over the lease term.

This distinction made it difficult for investors to compare companies. There was criticism from investors that reported balance sheets provide a misleading picture about leverage and leased assets used.

Investors (and others stakeholders) had to estimate the effects of a company's off balance sheet lease obligations, based on lease commitments for operating leases disclosed in the notes of the financial statements, which in practice often led to overestimating the liabilities arising from those obligations.

To manage the criticism received for IAS 17 accounting treatment of leases, the International Accounting Standards Board (IASB) introduced a new Leasing standard: **IFRS 16: Leases.**

Timing

Effective date

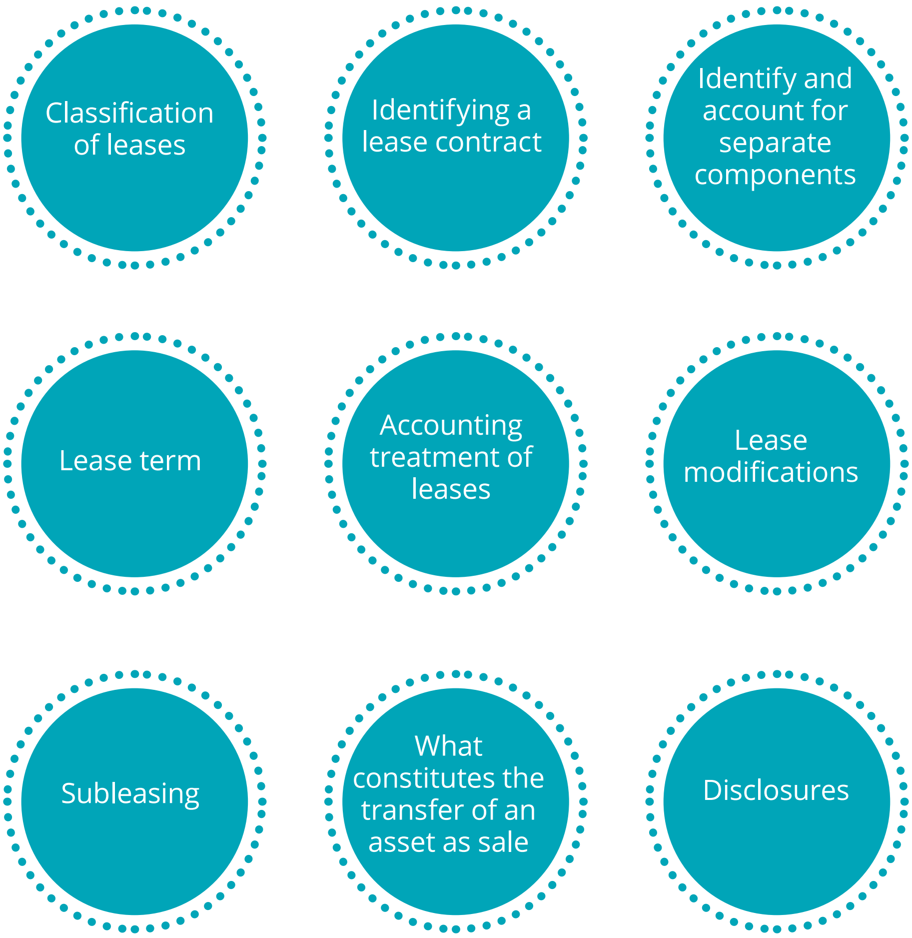
As of 1 January 2019, an entity shall apply IFRS 16 retrospectively for annual periods beginning on or after this date.

The purpose of this publication is to:

- Provide an overview of the definition and scope of IFRS 16 and a comparison against IAS 17,
- Explain IFRS 16 impact on banks and credit institutions,
- Inform clients how they can best prepare themselves for the new classification requirements under IFRS 16 and what information with regards to classification of lease contracts they will need to prepare for audit purposes,
- Provide an overview of how Deloitte can help clients in Cyprus address the challenges of IFRS 16.

Comparing IAS 17 and IFRS 16 – Overview

What changed?



Lessees

- The new leasing standard removes the distinction between finance and operating leases for lessees.
- A completely new lease accounting model for lessees is introduced that requires lessees to recognise all leases on balance sheet, except for short term leases and leases of low value assets.
- The measurement requirements for lessees, include estimates and judgements around the lease term, lease payments and discount rates.

Lessors

- Lessor accounting will not change significantly as the operating and finance lease distinction remains for lessors.

Other

- New requirements are introduced for subleases, sale and leaseback transactions and lease modifications.
- Additional disclosure requirements are introduced.
- Enhanced guidance is introduced on identifying whether a contract contains a lease.
- The new standard clarifies how to deal with contracts with multiple lease and non-lease components.

Comparing IAS 17 and IFRS 16 – Key changes

Definition of a lease

IFRS 16 defines a lease as:

> a contract, or part of a contract, that conveys to the customer ("lessee") the right to control the use of an identified asset for a period of time in exchange for consideration. Fulfilment of the contract depends on the use of an identified asset and control of the use of the asset during the lease period.

A Lease involves the use of an identified asset:
- The asset may be explicitly or implicitly specified (can also be a physically defined smaller part of bigger asset).
- No identified asset exists if supplier has a substantive right to substitute the asset.
- A supplier's right to substitute an asset is substantive if both:
  - The supplier has the practical ability to substitute the asset, and
  - The supplier can benefit from substituting the asset.

A Lease exists when a customer controls the identified asset:
- The customer has the ability to direct the use of the asset.
- The customer has the right to obtain substantially all of the economic benefit from the use of the asset.
- The customer can direct the use of an asset, that is, the customer can decide how and for what purpose an asset is used throughout the period of use.

The majority of property leases, which are frequently observed in credit institutions, are expected to remain in scope of the new lease standard. Judgement may be required for more complex contracts.

Lessee accounting

Lessee accounting represents the most significant change from the new standard with the accounting for almost all leases impacting the balance sheet:

Balance sheet	• The lessee initially recognises lease liabilities on the balance sheet at present value of future lease payments. • Lease assets (commonly referred to as Right of Use Assets ("ROU")) are recognised at cost, with part of the cost being the amount of the lease liability.
Income statement	• Rent expense will no longer be recognised. • Companies will instead recognise depreciation of the right of use asset and interest expense on the lease liability over the lease term. • The unwinding of the interest expense on the liability would result in a higher interest expense at the beginning on the lease and a lower interest expense as the rents are paid. • The amortisation is recognised on a straight line basis in most cases.
Cash flow statement	• The lessee will need to separate the total amount of cash paid into a principal portion (presented within financing activities) and interest (presented within either operating or financing activities).

Operating leases of properties, machinery, cars and other assets may now need to be accounted differently. Exemptions may be available for short term leases and leases of low value assets.

Transition

At the date of initial application, as a practical expedient, an entity is not required to reassess whether a contract is, or contains, a lease. This is, however, subject to conditions.

A lessee shall either apply IFRS 16 with full retrospective effect (" full retrospective approach") or alternatively not restate comparative information but recognise the cumulative effect of initially applying IFRS 16 as an adjustment to opening equity at the date of initial application ("modified retrospective approach").

The modified retrospective approach may be applied in two ways when measuring the ROU asset:

- The ROU asset may be measured at an amount equal to the lease liability;
- The ROU asset may be measured at its carrying amount as if the standard had been applied since the commencement date;

The standard provides for various practical expedients on transition on the measurement of the lease liability and the right of use asset.

Implications for Credit institutions

Overview

The IASB expects credit institutions that have material off balance sheet leases to report higher assets and lower equity when applying IFRS 16 [1].

This is driven mainly by the fact that IFRS 16 requires a company to now recognise right of use assets arising from leases of property, plant and equipment as tangible assets, if they are not presented within their own line item on the balance sheet. The asset will be then amortised over a straight line basis.

At the same time, the unwinding of the interest rate on the lease liability will result in a higher interest expense at the beginning of the lease and thus a higher liability, compared to the end of the lease, when interest expense will be reduced the as the rents are paid.

The mismatch between interest expense and the amortisation charge in a period, as compared to the straight line recognition under IAS 17 will change the operating results of a group compared to the past.

Banking and other financial services entities that have extensive branch networks, large administration and call centres, contracts over ATM networks and the related space occupied by such machines, data storage facilities and arrangements with such providers will, therefore, be significantly affected by IFRS 16.

Capital requirements for Credit institutions

Under EU regulations, credit institutions are required to hold a certain amount of capital as part of their licensing conditions. One of the key measures of the capital requirements for a credit institution is the Total Capital Ratio. This is the ratio of credit institutions' capital to risk and it is used by regulatory authorities to ensure that it can absorb a reasonable amount of loss and ensure viability of the institution.

Under the requirements of Capital Requirements Regulation (CRR) and the Capital Requirements Directive (CRD IV), banks must have top quality capital equivalent to **at least** 10.5 per cent (10.5%) of their risk-weighted assets which is defined as the total capital ratio of 8% plus 2,5% countercyclical buffer plus any additional Pillar 2 Capital Requirements. Failing to meet the Capital Ratios would have significant implications for credit institutions: for viability concerns to restrictions on their ability to pay bonuses and dividends. .

The Total Capital Ratio ("TCR") is defined as TCR = Total Capital / Risk Weighted Assets:

- **Total Capital** is the total of the Bank's eligible Capital and Reserves;
- **Risk Weighted Assets** are the credit institution's assets or off-balance sheet exposures weighted according to risk.

IFRS 16 is expected to have an impact on both the numerator and the denominator of the TCR.

The effect of any new accounting requirements on regulatory capital depends on the actions of prudential regulators which is yet unclear both locally, in Cyprus, and across Europe as no transitional rules have been announced by the ECB or the EBA.

1 IFRS 16 Leases – Section 7.3—Effects on regulatory capital requirements
https://www.ifrs.org/-/media/project/leases/ifrs/published-documents/ifrs16-effects-analysis.pdf

Impact on Total Capital

Banks commonly enter into **long-term operating leases,** especially for the use of branches or call centres.

Under IAS 17, operating lease assets were not recognised on the bank's balance sheet. Instead, an expense was recognised on the Income Statement.

Under IFRS 16, the expense, recognised in the Income Statement, for the rental of the assets will be replaced with the depreciation and interest expense. As a result, Retained Earnings, are expected to remain broadly unchanged pre and post IFRS 16 adoption. Thus the overall impact on Total Capital for the total lease period will be the same under IFRS 16 and IAS 17. However, during the first years of the total lease period, capital may suffer a negative impact resulting from the higher interest expense on the Lease liability recognised under IFRS 16.

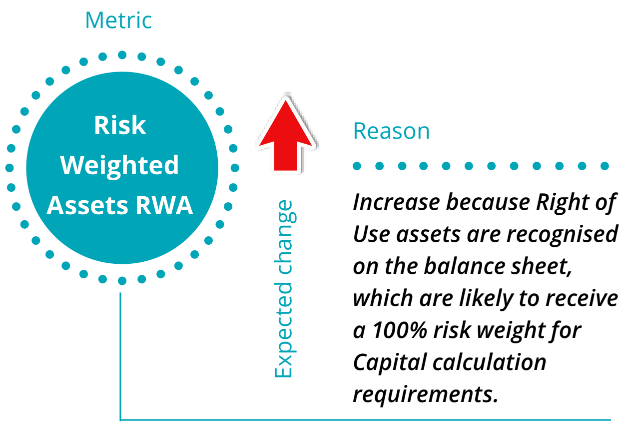
Impact on Risk Weighted Assets

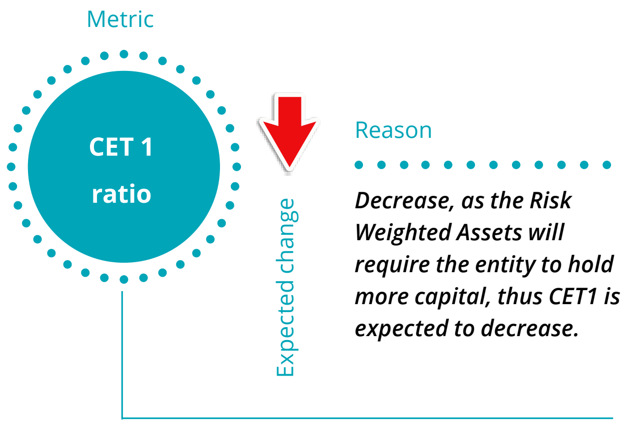
The starting point for the calculation of Risk Weighted Assets for a credit institution is the asset position it reflects on its Balance Sheet.

Under IAS 17, banks did not report any Operating lease assets on their Balance sheets (off balance sheet items). As a result, such assets received no risk weighting for the purposes of capital calculations.

Under IFRS 16, the Right-of-Use Assets are expected to be recorded on Balance sheet and be classified as non-counterparty related assets, similar to Property, Plant and Equipment. This is expected to drive the risk-weighted asset treatment of these as assets and, as a result, the capital ratios used for the calculation of the regulatory equity.

This is because under Article 134 of CRR, such assets are expected to be treated as Tangible Assets and are expected receive a full risk weighting of 100%. This means that for every EUR 100 of new asset the Bank recognises on its Balance sheet, it would have to hold EUR 10,5 of Total Capital making it quite expensive and capital depletive for the Banks upon adoption of IFRS 16.





Putting things into perspective

The IASB has estimated the effect of IFRS 16 on reported TCR by considering a sample of twenty (20) European banks [2].

At the time of IASB's Quantitative Impact Study (QIS), the estimated decrease in reported TCR was less than 0.5 per cent (0,5%) of reported equity for all banks included in the sample, and less than 0.2 per cent (0,2%) of reported equity for almost half of the sample.

On the basis of the QIS, the IASB did not expect the changes to lessee accounting to have a significant effect on the regulatory capital of most credit institutions.

Separately, the EBA performed a quantitative analysis[3] of the impact of IFRS 16 on a sample of banks in EU to understand the impact on Common Equity Tier Capital, Total Capital and Leverage ratio. Sample used for the analysis, included 65 banks across 19 countries in the European Economic Area (EEA), varying in terms of size, business model and risk profile.

The resulting estimated impact from IFRS 16 on own funds and leverage ratios of the banks in the sample, was found to be of limited significance.

[2] *IFRS 16 Leases – Section 7.3—Effects on regulatory capital requirements https://www.ifrs.org/-/media/project/leases/ifrs/published-documents/ifrs16-effects-analysis.pdf*
[3] *The EBA's views on the adoption of International Financial Reporting Standard 16 Leases(IFRS 16) https://eba.europa.eu/documents/10180/1713902/%28EBA-2017-D-1085%29%20Letter+Mr+Gauzes%2C%20EFRAG+re+IFRS+16+Leases.pdf*

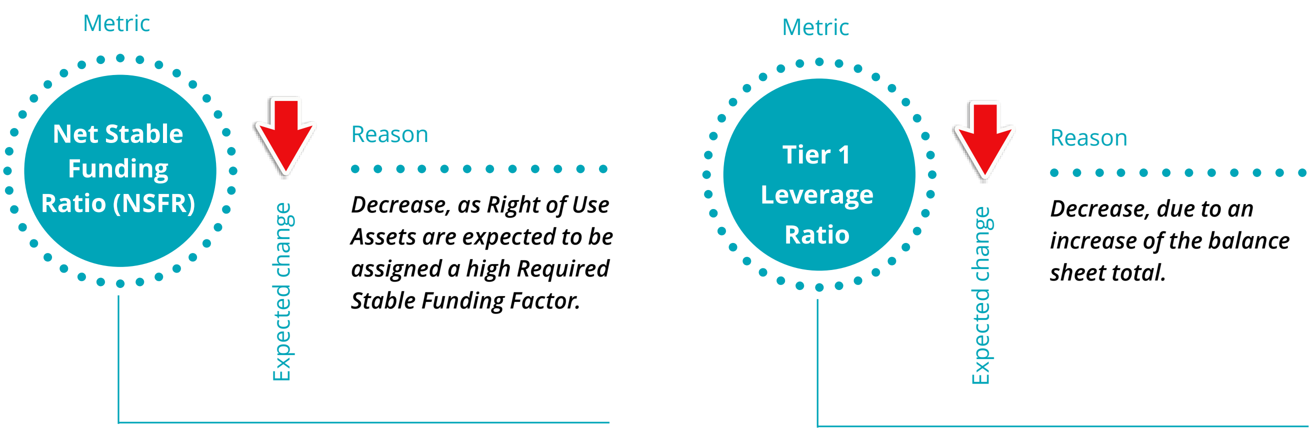
Major Banking Institutions like HSBC, Barclays and RBS announced the adoption of the standard by using the modified retrospective approach. The abovementioned banks have reported the impact of adopting IFRS 16 on their Annual Report 2018 being as follows:

- **HSBC:** "Increase of assets by approximately $5bn and increase of financial liabilities by the same amount with no effect on net assets or retained earnings" [and a corresponding decrease in CET1 ratio]
- **Barclays:** "Increase in assets of £1.6bn, an increase in liabilities of £1.6bn with no material impact on retained earnings" " [and a corresponding decrease in CET1 ratio]
- **RBS Group:** "The opening balance sheet at 1 January 2019 will be adjusted to create a right of use asset of approximately £1.3bn. A lease liability will also be recognised of £1.9bn. Retained Earnings will decrease by £0.2bn after tax. This will have an estimated **impact of 21 basis points on the CET1 ratio**."

Other impact on Credit Institutions

Key metrics

In addition to the TCR, a number of other key financial metrics for credit institutions' are expected to be affected by the adoption of IFRS 16:

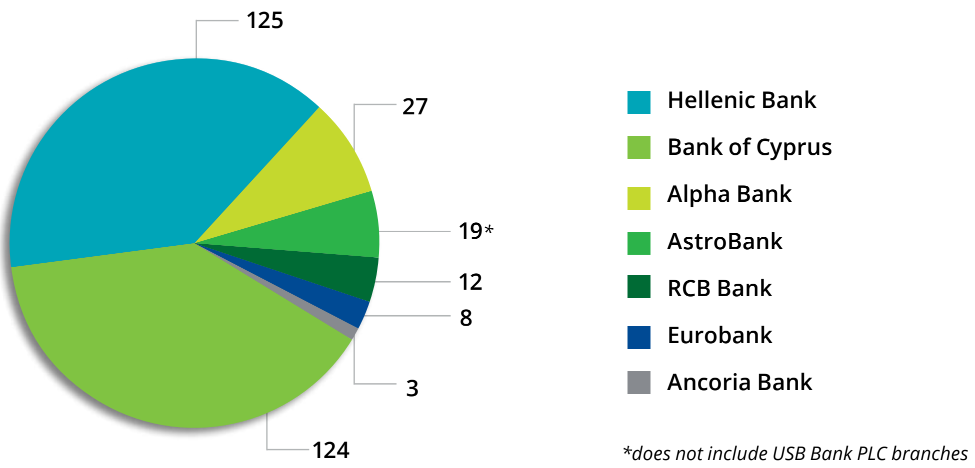


Cyprus Banking sector

Further to the EBA's Quantitative Impact Study (noted earlier in our note), the EBA estimates that the impact of IFRS 16 to EU banks depends mainly on the materiality of the RoU assets compared to the existing assets of a bank.

Banks in Cyprus have, historically, operated through extensive networks of branches. A number of those branches have, historically, been leased by the Banks, and were reported under IAS 17 as Operating leases.

The pie graph on the next page shows the number of branches that Banks in Cyprus currently operate through:



Banks will now be required to recognise a Right of Use assets on their Balance Sheets for the leasing of branches and a corresponding lease liability, as a result of the application of IFRS 16.

The pressure on the Capital Requirements resulting from the recognition of leased assets on the Balance sheet of the Banks requires the holistic assessment of the Banks' branch network model. With the application of IFRS 16, it will be more than necessary for Banks to develop branch optimization strategies.

Using market research and taking into consideration the location and demographical statistics of the branch networking area, Banks should move to a more digitalised environment and through the use of technology, re-engineer the branch operations to serve the needs of the modern customer.

Banks can also consider consolidating branches, to reduce the number of leased assets that put pressure on capital requirements. They may be also required to review the contracts for the leased branches and renegotiate the terms where possible in order to minimise the effect on their financial statements.

Debt Covenants

Separate (and in addition) to the direct impact on key metrics, IFRS 16 is expected to have an indirect impact Credit Institutions in the form of affecting debt covenants within credit granting facilities. As is customary with the granting of credit facilities to corporates and project finance, lending facilities are subject to debt covenants. Some of the most common ones being: Gearing Ratio, EBIT and EBITDA.

Most debt covenants include restrictions and conditions on how much additional debt a company can raise. These are estimated and monitored based on the financial statements of the Borrower.

For those corporates with substantial off balance sheet items the expected implications include:

- ·The assets and liabilities on their balance sheets will increase significantly, with a potentially material impact on covenant calculations.
- The cost profile of their income statements will change, with costs skewed towards the early years of leases and greater volatility due to the frequency of recalculation.
- The nature of costs in the income statements will change, with a positive impact on EBITDA, but a greater weighting to finance costs and depreciation, again potentially impacting calculations of covenants. Depending on the wording of finance documents, this could also have an impact on cash sweeps, management bonuses etc.

With the adoption of IFRS 16, leases that were formerly treated as operating expenses are now brought on-balance sheet as right of use assets and corresponding lease liabilities of financing nature. Debt covenants conditions may be, inadvertently, breached, leaving the Borrower in "technical default" as a result.

This will depend on whether the loan agreements clearly define the Terms used in covenants to include or exclude liabilities relating to leases.

Loan agreements may have provisions for the re-negotiation of the covenants when they are affected by new accounting principles. In those cases, Borrowers will need to demonstrate covenant compliance by restating their financial accounts to reflect the accounting principles that existed at the time of the loan negotiation.

Metric

Gearing Ratio

Expected change

Reason

Increase because lease liabilities will increase total liabilities on an entity's balance sheet, thereby increasing the reported debt load.

Metric

Earnings Before Interest and Tax (EBIT)

Expected change

Reason

Rent expense will be replaced with depreciation and interest expenses. As rent is currently reported as an operating expense, whilst neither depreciation nor interest are taken into account when measuring EBITDA, reported levels of EBITDA could be materially increased. EBIT will increase because the operating lease expense will be eliminated and replaced by a smaller amortisation expense.

This will have a bearing on banking covenants (both absolute measures of EBITDA/EBIT, and also ratios such as gearing and interest cover), and also any other items such as bonuses, which may be linked to these measures of profitability.

In the initial years of a lease, the new standard will result in an income statement expense which is higher than the straight-line rent expense typically recognised under the current standards, falling to a lower cost mid-way through the lease as the interest cost reduces. On implementation, existing leases will be treated in a similar fashion, resulting in increases in assets and liabilities of lessees of large estates.

Institutions should monitor their customers and consider whether they need to renegotiate any loan or other agreements due to changes in their financial metrics used as debt covenants and either amend these provisions to reflect the impact of IFRS 16 or carve out former operating leases from the covenant calculations, after IFRS 16 implementation.

Preparing for IFRS 16 – things to focus on

- **Assessing and Preparing** information to analyse the impact of IFRS 16, analysing the data and preparing for the longer term actions and decisions required
- **Mitigating and strategising** impacts on treasury, remuneration targets, covenants, regulatory matters and responding to changing tax requirements
- **Implementing** and embedding system changes and making necessary changes to related processes and controls; developing in house tools to implement the calculations necessary for IFRS 16

Key adoption considerations

Accounting

- Transition approach: Elect to use practical expedients for classification and measurement?
- Classifying contracts: Identify contracts not previously assessed in accordance with IAS 17 and IFRIC 4
- Identify key contract features: Determine lease terms, value of lease payments, the implicit interest rate
- Contracts with multiple components: Identify stand-alone selling prices and determine whether to apply the practical expedients
- Disclosures: Determine the required disclosures and to what extent the disclosures aggregated
- Review accounting and operating systems: data extractions and compliance with new requirements
- Documentation: New accounting policies. Documentation for key judgments applied
- Application of exemptions: Determine the threshold for low-value assets and whether to apply low-value assets and short-term leases exemption
- Justification of the low asset value threshold
- Deferred tax: Impact on deferred tax

Regulatory

- Assess and quantify the increase in risk-weighted assets and impact on TCR as a result
- Assess impact on key regulatory metrics: net stable funding ratio and leverage ratio

Operational

- Identify available and accessible information
- Review of IT systems and adoption of more sophisticated tools that analyse contract terms
- Review of the completeness and accuracy of the contract data
- Review control procedures and lease approval processes
- Internal controls over lease processes and accounting
- Training of finance teams and other relevant departments
- Communication of changes and ensure project plan in place

Commercial

- Impact on future financing: Greater financial transparency
- Impact on tax payments and deferred tax: Timing of profit recognition
- Changes to KPIs
- Compensation arrangements
- Compliance with customer loan covenants
- Procurement strategy: Lease or buy

How can Deloitte help?

Data collection and review of key terms of lease contracts

- Taking inventory of all lease agreements and gathering the necessary data, including, among others, lease terms, renewal options and payment terms.
- Provision of data collection tools to summarise the key data necessary for proper management of the lease contracts.
- Prioritising the analysis of those lease arrangements that are significant and/or have complex elements.
- Support in extracting, reviewing and validating data collection and inputs to a lease accounting model either as a whole or on a sample basis.
- Identification of internal stakeholders - discussing changes with relevant stakeholders, such as the company's board of directors, creditors, analysts, key management personnel, etc.
- Provision of advisory work on the interpretation of judgmental areas.
- Determining whether any changes need to be made to debt covenants, loan agreements, bonus or compensation agreements.

Business, accounting and regulatory advice

- Identifying "data gaps" including information required from subsidiaries and affiliates operating in foreign jurisdictions.
- Provision of accounting lease tools, or assistance with internally developed or purchased accounting tools on the implementation of IFRS 16.
- Assistance in assessing the impact on transition and ongoing impact analysis by considering impact on budgets and forecasts.
- Assistance in understanding the impact of the various transition options and practical expedients.
- Assistance in changes in internal control and processes.
- Advisory work on the significant areas arising of IFRS 16, review and assistance on preparation of accounting policies and position papers, advise on the appropriateness of accounting treatments.
- Advisory work on asset procurement (lease or buy) and analysis of the accounting and business implications of each decisions.
- Preparing pro-forma financial information to assess the impact of the changes to the financial statements.
- Perform capital implication reviews and capital gap analysis for Credit institutions applying IFRS 16.
- Review Capital and other Key regulatory Ratios and ensure compliance with regulatory requirements or plan development for continued compliance
- Review debt covenants included in contracts offered to customers by credit institutions and assess impact on capital and provisioning.

IT systems and data

- Advising on existing accounting and operating systems
- Assessing the accuracy, relevance and completeness of databases
- Assisting with installation and maintenance of software

Training

- Role specific training
- Finance or non-finance staff
- Business or accounting oriented

Contacts

If you require any further information on any of the issues mentioned in this material and on how Deloitte can help you address the challenges ahead, please do not hesitate to contact.

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