Update on How Banks Will Fare re: the Lease Accounting Project
The News is still good for US Banks
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Bank lessors are the major players in the leasing industry both in the US and in IFRS countries. They are both lessors and lessees. The news out of the Lease project is very good for US bank lessors but not so good for IFRS bank lessors. The FASB and IASB are going to issue separate lease accounting standards because of key differences in lessee accounting. The differences are serious and the IASB approach is negative for bank lessee customers as well as banks as lessees. The FASB approach more closely reflects the economic reality that operating leases are not financings so the impact on business for US bank lessors will be minor.

The timing of the project is imminent. The new rules should be signed by the end of this year. It is expected the transition year will be 2018 when all lessees and lessors will have to convert to the new rules and report financials reflecting those rules.

We know the basics of what the rules will be from following the meetings and the posted project outline. Also, there are no major open issues left on the FASB and IASB agendas. Recent meetings have been dealing with minor issues that the staff has found as they continue to finish drafting the new rules. The two boards do continue to hold joint meetings where the issues are common to both approaches.

One issue looming for the IASB is that EFRAG (the European Financial Reporting Advisory Group) has formally requested that the IASB expose the new draft for public comment. EFRAG's position is the IASB has made significant changes since the last exposure draft such that the public should be allowed to comment. EFRAG was established by the European Commission to provide input into the development of accounting standards issued by the IASB and to provide the European Commission with technical expertise and advice on accounting matters. The European Commission must formally endorse the IASB's new leasing standard for it to become law. This is contrary to the US process where the SEC has delegated accounting standard setting to the FASB so that it is independent of the political process. As a result, the European Union has the power to reject the IASB's proposed lease accounting standard. It is quite possible that the European Union will reject the IASB standard it is not re-exposed for public comment.

Banks as Lessors:

Both the FASB and IASB have agreed that lessor accounting rules do not need major changes. There will be minor changes like the definition of the lease term and lease payments but these will be more in the nature of tweaks. The decision not to change lessor accounting means that there will still be two accounting methods – direct finance lease ("DFL") accounting and operating lease accounting. That means that bank lessors will not have to make major systems changes.

The lease classification tests to determine if a lease is a DFL or operating lease for lessors will be continue to employ a risks and rewards approach. The FASB has tentatively agreed to change the classification tests to be in line with the current IAS 17 tests by eliminating the "bright lines" – the 75% of useful life and 90% present value vs. the fair value. ***BUT*** there is reason to believe that they may just keep the current FAS 13/ASC 840 classification tests as they have asked me for feedback on this. The reason for keeping the bright lines are that it would be simpler to implement and would mean less judgment so there would be more assurance that lessee accounting would be consistently applied.

Sales type lease accounting will change too, but banks normally don't qualify for sales type lease accounting. Leveraged lease accounting has been dropped from the US rules ***BUT*** the good news is that existing leveraged leases will be grandfathered in transition. This means bank lessors can continue to do new leveraged leases until the transition year which is expected to be 2018. It should also mean that

leveraged leases can continue to be traded after transition and not lose their initial classification as a leveraged lease.

Most importantly, new business for US bank lessors and lessors in general should be as robust as ever as the Boards have made some key decisions that will simplify the lessee accounting rules. They loosened the definition of a short term lease (they are exempt from capitalization) so that the lease term includes only renewals that represent a significant economic incentive to exercise. They minimized instances requiring rebooking leases for changes in variable payments. These changes will significantly ease the compliance burden that had concerned lessees.

The other reason that lease business volume should remain robust is the reasons for leasing will still remain strong. Even though operating leases will be capitalized it should still be better that borrowing to buy (for more detailed analysis see my article http://www.monitordaily.com/article-posts/customer-education-is-key-during-fasb-implementations/) to the extent that lower amounts for the asset and liability will be reported on balance sheet and the lease costs will be straight lined. Borrowing to buy means the full asset goes on the balance sheet, the borrowing is classified as debt and the combination of depreciation and interest expense front ends lease costs. All this adds up to lower returns on assets and equity for the lessee. Additionally, the lessee may not be able to borrow or might be forced to agree to terms in a loan that are less favorable than the lease terms – examples being less than 100% financing or higher after-tax cost to name two common issues.

Specifically, the good news for our lessee customers is the FASB decided current lessee accounting should be retained for operating leases except for the capitalization of the lease. As a result, lessees will continue to report straight line average rent as the reported cost in the income statement. They also decided that the lease asset and liability arising from operating leases be separately reported from capital lease assets and liabilities on the balance sheet. The key benefits here are that operating lease liabilities will not be labeled as debt so lessee debt limit covenants will not be impacted. This was a huge concern for small and medium sized and non-publicly traded companies that have debt limit covenants in other debt agreements. These companies often lease equipment as they have limited sources of capital. It is true that lessees will have to capitalize operating leases but only at the present value of the lease payments so one could say that operating leases will only be partially on balance sheet while all the other aspects of operating lease accounting remain in place.

Banks as Lessees – The Capital Issues

Banks are heavy users of operating leases, primarily real estate leases, due to their branch network and office space needs. The accounting treatment for the capitalized operating leases under the proposed standards will impact IFRS banks adversely while US banks will fare much better. The key is the IASB decision to treat all leases the same versus the FASB decision to retain current GAAP two lease regime. In my opinion the IASB is fixated on the fact that lease payments are made over time so operating leases must be a financing like any other financing. They do not seem to care that some leases are rental contracts (executory contracts) and should reflect that substance on the income statement and balance sheet. The substance defines when capital is needed to support an asset and when a liability impacts leverage.

The one lease lessee model means that IFRS banks will have front loaded costs that reduce equity capital and create deferred tax assets that are generally deducted from regulatory capital. The loss of capital

and new deferred tax asset are permanent capital problems as they will never reverse until a bank stops all leasing – not a realistic scenario. At the same time US banks will see no changes to regulatory capital as the lease P&L cost will be the straight line average rent as under current GAAP.

On the balance sheet IFRS banks will report the combined capital and operating lease assets and liabilities as one number. The new capitalized operating lease asset will attract capital for banks at the new Basel III requirement of as high as 10.5%. Under current rules operating leases need no capital as the leased asset is returned to the lessor in the event of a bank liquidation so any so called lease assets and liabilities cease to exist for capital consideration. The IFRS banks will have a difficult time getting regulatory relief without unwinding the accounting and re doing the classification tests and accounting on all leases to determine which have no capital impact in a bankruptcy liquidation. The capitalization of operating leases will impact Basel III liquidity standards and leverage ratios for IFRS banks. US banks should see no such issues as the capitalized operating lease asset will be reported separately so that regulators can give relief on that asset for capital and liquidity measures. In my opinion the US regulators continue to treat operating leases as they do today despite the accounting rules changes.

The US bank leasing environment will see little change

The FASB approach will reflect economic reality for lessees. The FASB has listened to feedback and retained the best (meaning most sound) parts of current lease accounting GAAP while the IASB is back to its "one lease" lessee model. The IASB still has to deal with the negative aspects of its approach.

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