

# IFRS 16 Leases

## Discount Rates

25 March 2019



01

Overview



02

Defining the discount rates



03

Transition approach



04

Determining the IBR and worked examples



05

Questions

# Overview



# Overview

---

Discount rates are used to determine the lessee's lease liability.

IFRS 16 provides for the use of two discount rates:

- ▶ Rate implicit in the lease, if readily determinable, otherwise,
- ▶ Incremental borrowing rate (IBR)

*IFRS 16:27 “The lease payments shall be discounted using the interest rate implicit in the lease, if that rate can be readily determined. If that rate cannot be readily determined, the lessee shall use the lessee’s incremental borrowing rate.”*



# Defining the discount rates



# Defining the discount rates

## Rate implicit in the lease

---

The rate implicit in the lease causes:

- ▶ The present value of (a) the lease payments and (b) the unguaranteed residual value to equal
- ▶ The sum of (i) the fair value of the underlying asset and (ii) any initial direct costs of the lessor

The interest rate implicit in the lease is not necessarily the rate stated in the contract and reflects, among other things, the lessor's initial direct costs and estimates of residual value.

# Defining the discount rates

## Incremental borrowing rate ('IBR')

The rate an **entity** would



**Pay** to borrow



In a similar **economic** environment



With a similar **security**



Over a similar **term**



IBR is:

1. Specific to **each** entity
2. Specific to the **jurisdiction** in which the entity operates



Lessee considers borrowings:

1. With a similar term
2. For a similar security

*To the right-of-use asset, **not** the underlying asset*

# Transition approach





# Transition approach

---

## 1. Fully retrospective

- Determine IBR as at the date of commencement of each lease
- IBR for full term of the lease

## 2. Modified retrospective

- Determine IBR for existing leases as at date of initial application (e.g. 1 January 2019)
- IBR for remaining term of the lease

# Determining the IBR and worked examples



# IBR composition

## Maximize the use of observable inputs

### Base Rate Component

- Risk-free rate:
  - Interbank borrowing rate
  - Gilt rates
- Reflective of economic environment
- Aligned to appropriate tenor



### Financing Component

- Borrower specific considerations:
  - Credit rating
  - Industry in which it operates
  - Parental guarantees/letters of comfort
- Aligned to appropriate tenor



### Security Component

- Generally only relate to:
  - Property
  - Land
- Aligned to appropriate tenor

# Security component

---

Existence of security **reduces** the IBR

Appropriate for longer term leases (e.g. Property/land leases extending beyond +/-75 years)

Lack of observable data and subjectivity related to the security component, adjustments have not been recommended

# Base rate component

## Risk-free rate – UK lease





# Base rate component

## Risk-free rate – German lease



# Financing component

## Approaches

---

### Potential sources:

1. Entity's listed CDS or close proxy's listed CDS
2. Indicative spread using borrower's credit rating
  - Bond yield curves
  - Quotes from bank counterparties

# Financing component – approach 1

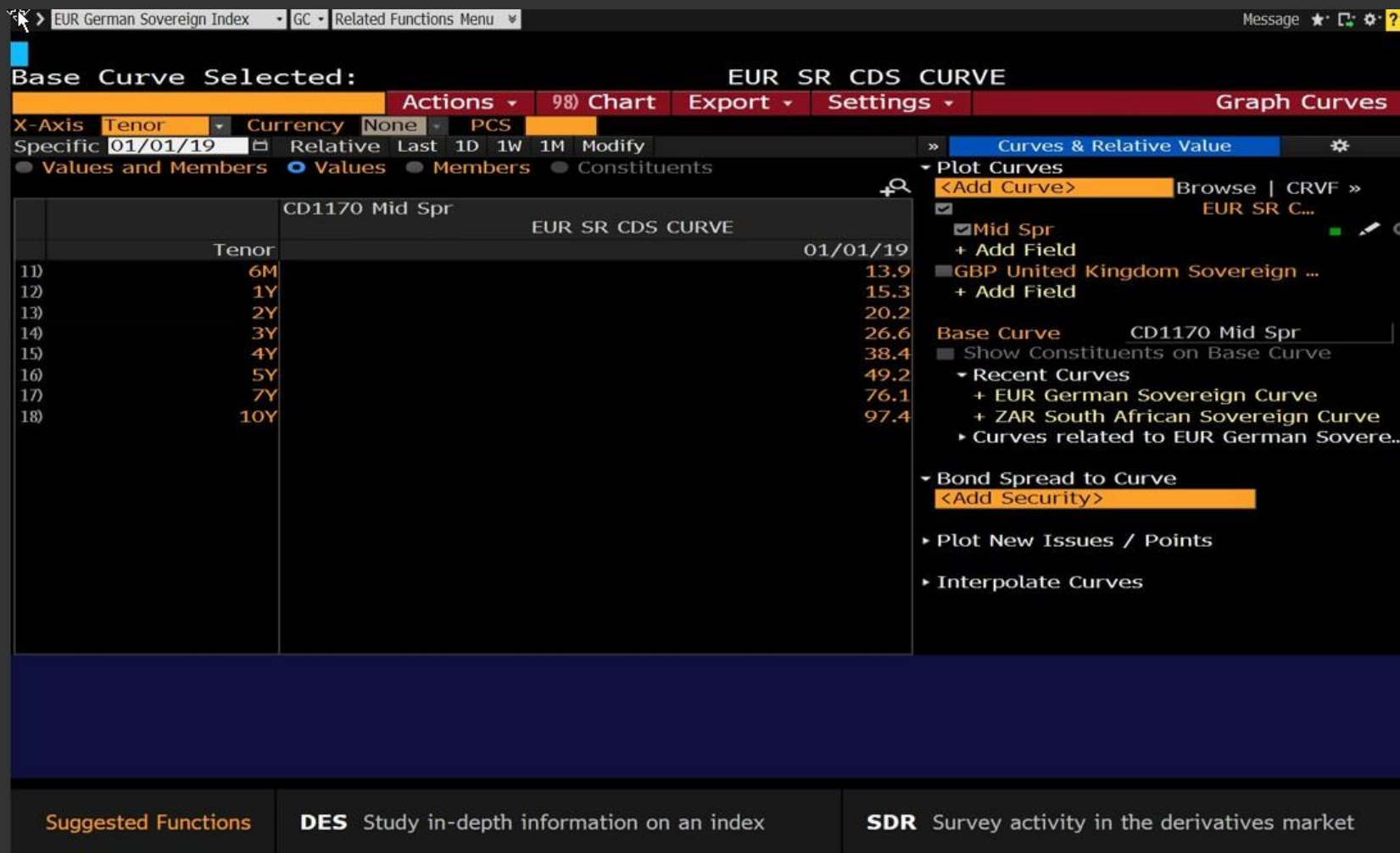
## Entity's listed CDS or close proxy's listed CDS

---

- ▶ Factors to consider
  - ▶ Guarantees or letters of comfort from parent
  - ▶ Level of subordination of the leasing entity to the Group
- ▶ For entities not covered by parental guarantees:
  - ▶ Group CDS needs to be adjusted to account for the additional credit risk of the subsidiary
  - ▶ This adjustment is very subjective due to a lack of observable inputs
  - ▶ Recommendation is to follow Approach 2 instead

# Financing component – approach 1 (...continued)

## Listed CDS



# Financing component – approach 1 (...continued)

## Discount rate matrix – UK lease

Date	Tenor	Base Rate (GBP Sovereign Curve)	Financing Component (CDS)	Discount Rate (%)
		A	B	A + B = C
01/01/2019	1Y	0.76	0.15	0.91
01/01/2020	2Y	0.74	0.20	0.95
01/01/2021	3Y	0.74	0.27	1.00
01/01/2022	4Y	0.80	0.38	1.18
01/01/2023	5Y	0.90	0.49	1.39
01/01/2024	6Y	0.95	0.63	1.58
01/01/2025	7Y	1.00	0.76	1.76
01/01/2026	8Y	1.07	0.83	1.90
01/01/2027	9Y	1.17	0.90	2.08
01/01/2028	10Y	1.28	0.97	2.25



# Financing component – approach 1 (...continued)

## Discount rate matrix – German lease

Date	Tenor	Base Rate (DE Sovereign Curve)	Capped Base Rate	Financing Component (CDS)	Discount Rate (%)
		A	A* capped at zero	B	A* + B
01/01/2019	1Y	-0.65	0.00	0.15	0.15
01/01/2020	2Y	-0.62	0.00	0.20	0.20
01/01/2021	3Y	-0.58	0.00	0.27	0.27
01/01/2022	4Y	-0.46	0.00	0.38	0.38
01/01/2023	5Y	-0.32	0.00	0.49	0.49
01/01/2024	6Y	-0.23	0.00	0.63	0.63
01/01/2025	7Y	-0.12	0.00	0.76	0.76
01/01/2026	8Y	0.00	0.00	0.83	0.83
01/01/2027	9Y	0.11	0.11	0.90	1.01
01/01/2028	10Y	0.24	0.24	0.97	1.21

# Financing component – approach 2

## Indicative spread using borrower's credit rating

---

Determining the appropriate **borrower (entity) specific** charge:

1. Consider entity ultimately responsible for lease payments
2. Use borrower **specific credit rating**
  - Readily available
  - Key financial metrics to assign credit rating per entity
3. Apply an appropriate spread
  - Obtain bond yield curve aligned to:
    - Industry
    - Region
    - Credit rating
  - Remove the risk-free rate component
  - Residual is the indicative spread

# Financing component – approach 2 (...continued)

## Credit rating

Unlisted	
91) Company Tree Ratings ▾	
92) Alert	
Page 1/1 Credit Rating Profile	
1) Bloomberg Default Risk   DRSK »	
Moody's	
2) Outlook	STABLE
3) Issuer Rating	Baa3
4) Long Term Rating	Baa3
5) LT Corp Family Rating	WR
6) Senior Unsecured Debt	Baa3
7) Probability of Default	WR
8) Standard & Poor's	
9) Outlook	STABLE
10) LT Foreign Issuer Credit	BBB-
11) LT Local Issuer Credit	BBB-
Fitch	
12) Outlook	STABLE
13) LT Issuer Default Rating	BBB-
Australia 61 2 9777 8600 Brazil 5511 2395 9000 Europe 44 20 7330 7500 Germany 49 69 9204 1210 Hong Kong 852 2977 6000	
Japan 81 3 3201 8900 Singapore 65 6212 1000 U.S. 1 212 318 2000	
Copyright 2018 Bloomberg Finance L.P. SN 120038 H194-1499-1 21-Nov-18 17:50:32 GMT GMT+0:00	

# Financing component – approach 2 (...continued)

## Bond yield curves



# Financing component – approach 2 (...continued)

## Risk-free rate in bond yield





# Financing component – approach 2 (...continued)

## Discount rate matrix – UK lease

Date	Tenor	Base Rate (GBP Sovereign Curve)	EUR Composite Rate (BBB+, BBB, BBB-)	6M EUR Libor	Risk Premium (Indicative Spread)	Discount Rate (%)
		A	B	C	D = B – C	A + D
01/01/2020	1Y	0.76	0.05	-0.22	0.27	1.03
01/01/2021	2Y	0.74	0.23	-0.19	0.42	1.16
01/01/2022	3Y	0.74	0.46	-0.12	0.58	1.31
01/01/2023	4Y	0.80	0.71	-0.03	0.75	1.54
01/01/2024	5Y	0.90	0.96	0.05	0.91	1.81
01/01/2025	6Y	0.95	1.19	0.15	1.04	1.99
01/01/2026	7Y	1.00	1.41	0.24	1.17	2.16
01/01/2027	8Y	1.07	1.59	0.34	1.25	2.32
01/01/2028	9Y	1.17	1.75	0.44	1.31	2.48
01/01/2029	10Y	1.28	1.89	0.54	1.36	2.63

# Financing component – approach 2 (...continued)

## Discount rate matrix – German lease

Date	Tenor	Base Rate (DE Sovereign Curve)	Capped Base Rate	EUR Composite Rate (BBB+, BBB, BBB-)	6M EUR Libor	Risk Premium	Discount Rate (%)
		A	A* capped at zero	B	C	D = B – C	A* + D
01/01/2020	1Y	-0.65	0.00	0.05	-0.22	0.27	0.27
01/01/2021	2Y	-0.62	0.00	0.23	-0.19	0.42	0.42
01/01/2022	3Y	-0.58	0.00	0.46	-0.12	0.58	0.58
01/01/2023	4Y	-0.46	0.00	0.71	-0.03	0.75	0.75
01/01/2024	5Y	-0.32	0.00	0.96	0.05	0.91	0.91
01/01/2025	6Y	-0.23	0.00	1.19	0.15	1.04	1.04
01/01/2026	7Y	-0.12	0.00	1.41	0.24	1.17	1.17
01/01/2027	8Y	0.00	0.00	1.59	0.34	1.25	1.25
01/01/2028	9Y	0.11	0.11	1.75	0.44	1.31	1.42
01/01/2029	10Y	0.24	0.24	1.89	0.54	1.36	1.60

# Disclaimer

---

*Disclaimer: this presentation is provided for general guidance and informational purposes, to assist in understanding the issues related to discount rates under IFRS 16. This presentation should not be relied upon to determine the discount rates in any particular case.*

# Questions



# Thank you

FAAS Corporate Treasury, UKI



**EY** | Assurance | Tax | Transactions | Advisory

Ernst & Young LLP

© 2018 Ernst & Young LLP. Published in the UK.  
All Rights Reserved.

The UK firm Ernst & Young LLP is a limited liability partnership registered in England and Wales with registered number OC300001 and is a member firm of Ernst & Young Global Limited.

Ernst & Young LLP, 1 More London Place, London, SE1 2AF.

[ey.com](https://www.ey.com)