Leaseurope

The Voice of Leasing and Automotive Rental in Europe

Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

Brussels, 24 June 2016

Re: Consultative document on reducing variation in credit risk-weighted assets - constraints on the use of internal model approaches

Dear Sir/Madam,

Leaseurope welcomes the opportunity to respond to this consultation. Leaseurope brings together 45 member associations representing the leasing, long term and/or short term automotive rental industries in the 33 European countries in which they are present. The scope of products covered by Leaseurope members' ranges from hire purchase and finance leases to operating leases of all asset categories (automotive, equipment and real estate). It also includes the short term rental of cars, vans and trucks. It is estimated that Leaseurope represents approximately 92% of the European leasing market. In 2014, total outstanding volume worth €729.5 billion and total new leasing volumes worth €274.2 billion were granted by the roughly 1400 firms represented through Leaseurope's members.

1) <u>General comments</u>

Our understanding is that the purpose of this consultation, as well as the consultation on revisions to the Standardised Approach to credit risk, are to provide clarity of use and decrease heterogeneity in practice amongst supervised institutions. However, we are deeply concerned that the changes proposed will not achieve this, but rather will raise the required levels of bank capital, which have already seen substantial increases through Basel 2.5 and Basel 3. We believe this is contrary to the Group of Governors and Heads of Supervision (GHOS) mandate and would hinder lending to support the economy.

Our experience in Europe is that credit risk models have proven to be reliable and supervisory authorities have invested years of hard work and careful consideration into controlling and validating them. Constraints on the use of internal models to some types of exposures, and the introduction of parameter floors, would lead to less risk sensitivity not increased comparability. Conceptually, referring to measures and practices under the Standardised Approach as a benchmark for internal modelling under the IRB Approaches does not contain a clear rationale.

We suggest that the BCBS proposals should be reconsidered in the context of decreasing heterogeneity unrelated to risk, rather than limiting the use of internal models and raising capital requirements. The current European Banking Authority work on internal model parameters - where the definition of default has been identified as a major source of variability – is a good example of attempting to improve comparability while maintaining risk sensitivity.

Lease finance is an important mechanism for funding the real economy, particularly for SMEs, with low default and loss rates. We therefore urge the Committee to ensure that any further changes to the calculation of regulatory capital do not result in lenders restricting the provision of finance, particularly through asset finance.

2) <u>Scope of the use of internal models</u>

We question the Committee's views that exposures to banks, other financial institutions and large corporates are best regulated under the Standardised Approach as there is significant market analysis on them for ratings purposes and low numbers of defaults present difficulties in modelling.

Firstly, low default exposures are, by definition, low risk exposures. Forcing these exposures under the Standardised Approach would result in overly conservative risk weights, penalising them unnecessarily. Any difficulties experienced in modelling should rather be addressed with clear guidelines and institutions working closely with their supervising authority.

Secondly, not all banks and financial institutions are rated and thus subject to market analysis. An important number of our membership (i.e. leasing firms) are financial institutions (FIs) that are not rated. Many of them in Europe are of smaller size and therefore ratings are not common. Furthermore (and more importantly), leasing companies have long lasting and stable financing relations with their investors/banks. Therefore investors/banks have very detailed and relevant information on these entities which rating agencies or other external parties would not possess.

Thirdly, large corporates could see a major impact on their financing if exposures to these entities are moved to the Standardised Approach. Any large corporates without an extremely high rating, which is rare for non-government entities, would experience higher risk weightings due to the decreased risk sensitivity applied to them. Increases in funding costs for firms that have a large footprint in multiple economies could have unintended negative side effects.

We would urge the Committee not to exclude certain exposures from using the IRB Approaches based on assumptions regarding their ratings status. If this is not a possibility, we would propose that exposures to subsidiaries and/or smaller unrated entities should be allowed to utilise internal models. In these cases it is clear that banks/investors do have significant additional relevant information for internal risk modelling. Without this distinction, specialised subsidiaries and smaller leasing companies would be discriminated against, which is not in line with the principle of regulatory proportionality.

3) <u>Parameter floors</u>

The Committee proposes applying floors to Probability of Default (PDs), Loss Given Default (LGDs) and the credit conversion factors (CCFs) used to determine Exposure at Default (EAD) for off-balance sheet items. We challenge the need for parameters floors in principle (please refer to our general comments), as these types of limits on internal modelling under the IRB approaches only serve to artificially raise capital requirements, rather than encouraging comparability. We therefore urge the Committee to reconsider the introduction of any floors.

However, if floors are to be introduced they should take into account the risk profiles of various different business models and should not unduly penalise low risk forms of lending. Failure in this could lead to otherwise healthy, beneficial lending being disincentivised in terms of capital allocation and cost of funding.

LGD floors

a) 20% Other physical collateral floor

We suggest there is a strong case for differentiating auto and equipment leasing exposures (where the asset is owned by the finance company during the life of the agreement) with a specific parameter floor. Otherwise leasing will fall under the category of "other physical" collateral or even "unsecured", where the proposed LGD floors do not reflect the reality of leasing exposures.

The Committee states that there is some evidence that the realised value of other collateral types is significantly less than the carrying value during stressed periods, however **this is not the case for leasing, where the lessor owns the leased asset**. These ownership rights provide lessors with a valuable and efficient form of in-built security which makes leasing extremely low-risk. As the asset is a key working tool for the counterparty's business, many defaulted leases regrade back to a healthy situation with a zero loss. Leasing firms are generally asset specialists with sophisticated recovery and disposal systems due to the nature of their business model and ownership of the asset makes repossession relatively fast and straightforward (if it is necessary at all). Therefore a large proportion of the recovery often comes from the physical asset, either through sale or re-lease. If the value of the asset exceeds the amount outstanding at default, the lessor can actually make a gain in the case of a default.

In Europe, Deloitte undertook extensive research on our behalf (which we have sent to the Committee with this position) which demonstrates that leasing LGDs are significantly lower than the proposed floors for "other physical", as well as being lower compared to traditional lending. This research was based on a portfolio of 3.3 million lease contracts in 15 European countries covering the crisis years from 2007-2011.

Figure 1 shows that default rates and LGDs for leasing Retail and Corporate exposures are significantly lower compared to bank lending averages. These leasing LGD figures are for stressed conditions, average loss rate figures are even lower. This result is consistent with data for other equipment finance markets, for example in the US and Canada, confirming the low risk of the leasing business model in general.

Figure 1:

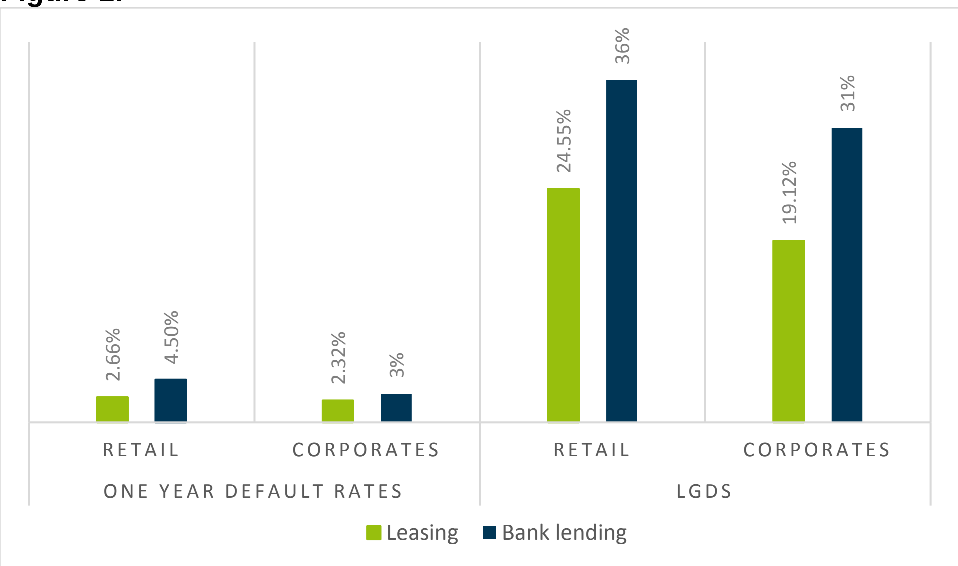
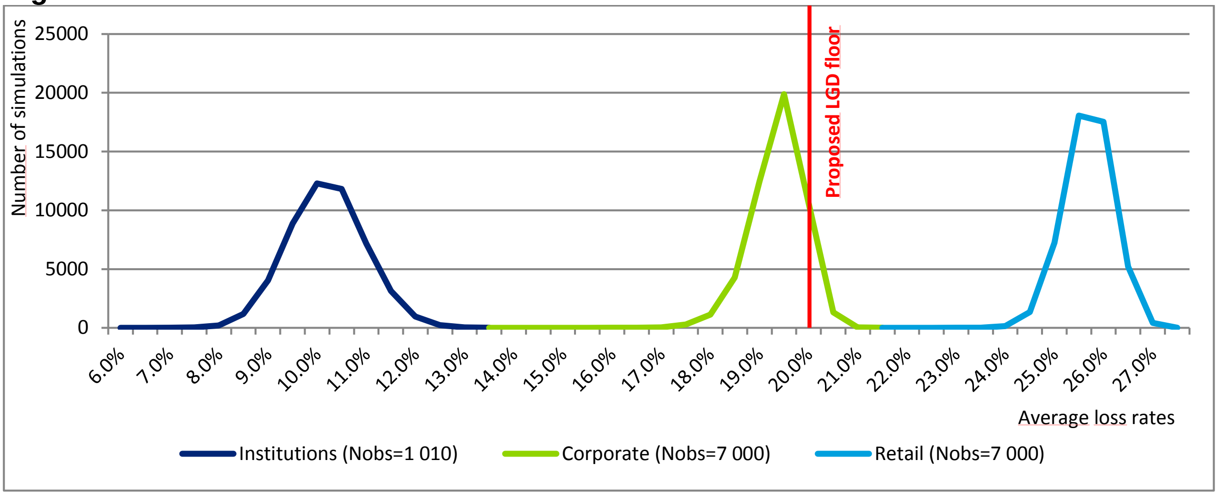


Figure 2 shows that the proposed LGD floor of 20% for other physical collateral is far too high for Corporate leasing exposures. Our distribution of estimated average loss rates show that **the majority of European Corporate leases would fall under the proposed floor**. If the proposed floor of 20% were to be utilised, the risk of Corporate lease exposures would be significantly overestimated, under an internal modelling approach which is in theory meant to achieve improved risk sensitivity.

Figure 2:



A secondary issue involves the level of over-collateralisation required for an exposure to be considered secured. As a result, some leasing exposures could be classified as unsecured and subject to an even higher LGD floor of 25%, despite the fact that this is an asset based form of lending.

These issues could be solved by introducing a separate floor of 15% for leasing exposures, which have a completely different risk profile and business model compared to bank lending secured by physical collateral. As the Committee's stated objective in introducing the floors is to eliminate low value outliers, and not to prejudice entire low risk forms of lending, this recommendation would make the proposed regulation better fit for purpose.

b) 15% Commercial or residential real estate collateral floor

The same assessment can be made concerning LGD floors for commercial or residential real estate collateral (which would include real estate leasing). The proposed 15% LGD floor is much higher than observed LGDs for real estate leasing in France for example, which would artificially raise the capital requirements for these exposures. Moreover, the proposal of a single floor for exposures secured by real estate collateral is not consistent with the scaling according to LTV proposed by the Committee for the Standardised Approach.

4) <u>F-IRB LGDs values</u>

While we welcome the Committee's proposal to decrease the F-IRB LGD value for "other physical collateral" to 25%, we believe that a 20% value would better reflect the reality of Corporate lease exposures. Figure 1 shows an average downturn stressed LGD for Corporate leases of 19%.

5) Haircuts

We have significant concerns regarding the decision to increase the haircut applied to "other physical collateral" from 28.6% to 50%. As mentioned previously, leasing firms are asset specialists who utilise physical assets for a large portion of their recoveries, 80% on average (refer to research paper sent with position). We believe that a 50% haircut for leasing exposures would be far too conservative, particularly when applied to leases nearing the end of their maturity. We suggest that a haircut for leasing exposures be introduced at a 20% level.

We also welcome the removal of required minimum collateral for utilising secured LGDs under the F-IRB Approach. It is not clear why a similar approach would not be applied across the A-IRB too. We feel this is inconsistent and any minimum collateral requirements should be removed from the proposed LGD floors under the A-IRB, as is proposed for the F-IRB.

6) Credit risk mitigation framework

The Federation is concerned that the restrictions on the scope of application of the A-IRB approach would unduly penalise leasing activity in the area of credit risk mitigation, as the Standardised Approach does not recognise physical collateral for these purposes. Therefore it would be crucial, when applying the decision to remove the IRB option for certain exposures (such as large corporates), to introduce a specific form of risk mitigation in the Standardised Approach which would cover leasing exposures (e.g. other physical collateral).

I remain at your disposal, should you be interested in discussing any specific issue. Alternatively feel free to contact my colleagues Rafael Alarcón Abeti (r.alarconabeti@leaseurope.org – tel: +32 2 778 05 69) and Hayley McEwen (h.mcewen@leaseurope.org - tel: + 32 2 778 05 71).

Yours sincerely

Leon Dhaene
Director General