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European Federation of Leasing Company Associations
Fédération Européenne des Associations des Etablissements de Crédit-bail
Europäische Vereinigung der Verbände von Leasing-Gesellschaften

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ADDRESSEES:

- **Mr Patrick Pearson**	*Head of Unit*, Directorate of Banking & Financial Conglomerates, DG Internal Market & Services, EU Commission
- **Mr Giuseppe Siani**	*National Detached Expert*, Directorate of Banking & Financial Conglomerates, DG Internal Market & Services, EU Commission
- **Mr Andreia Enria**	*Secretary General*, Committee of European Banking Supervisors - CEBS

TREATMENT OF UNGUARANTEED RESIDUAL VALUES UNDER THE CRD

Dear Sirs,

Leaseurope has learnt from its members that the treatment of unguaranteed residual values (RVs) in the calculation of capital requirements under the Capital Requirements Directive (CRD) has given rise to varying interpretations among national supervisors often resulting in inappropriate transpositions of the Directive into local laws.

In order to resolve the issue, Leaseurope has contacted CEBS notifying them of the situation, providing Leaseurope's position and seeking clarification. While not yet having formally responded, CEBS' position appears to be that the issue is not a matter of supervisory convergence but rather a question of the CRD text itself being unclear. Therefore, they feel that they are not in a position to take action at this stage. In their view, this issue has to be dealt with by the CRD Transposition Group (CRD TG).

Consequently, Leaseurope has posted a question relating to the clarification of unguaranteed residual value treatment on the website of the CRD TG and is addressing this letter to the Commission/CRD TG.

Leaseurope requests that the CRD TG provide clarification so that consistent unguaranteed RV treatment for all European leasing firms is established. In our view, there can be no justification for differing treatments to coexist in this domain. Such a situation would plainly not result in a level playing field for EU leasing firms.

The following paragraphs provide details on the treatment proposed in the CRD, explain where conflicting interpretations have arisen and set out Leaseurope's position on the issue.

1. The CRD states in its Annex VII, Part 1, Paragraph 27 that

   "The risk weighted exposure amounts (for other non credit-obligation assets) shall be calculated according to the formula:

   > *Risk-weighted exposure amount = 100% * exposure value except for when the exposure is a residual value*[1] *in which case it should be provisioned for each year and will be calculated as follows: 1/t * 100% * exposure value; where t is the number of years of the lease contract term."*

2. If a lessee defaults, the RV risk is taken into account in the level of the LGD associated with the exposure. Thus, the capital under consideration in the above provision covers the RV risk when there is no default. This risk, which is a market risk, is the institution's exposure to potential loss due to the fair value of the leased equipment declining below its residual estimate at lease inception.

   As this risk is realised only (if it occurs at all) at the end of the contract term, it is appropriate that the risk weighted exposure of the residual value should be highest for the last year of the lease contract.

   This implies that there should be a build up of capital set aside to cover residual value risk cumulating when the lease contract comes to term.

   Therefore, **at the last year of the contract,** the risk weighted exposure amount is:

   t*1/t*100%*exposure = **100%***exposure, with t being the number of years of the lease contract.

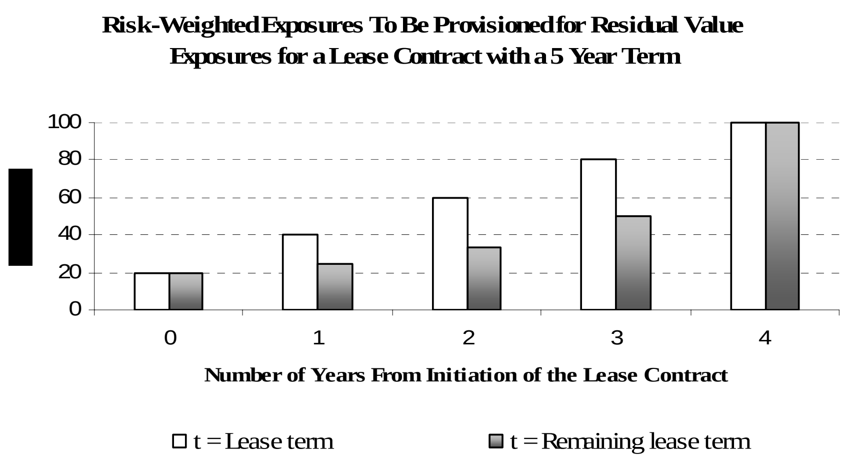
   This argumentation formed the justification to Leaseurope's suggested amendment to the Commission's original proposal for unguaranteed RV treatment under the CRD, the amendment in question being approved by the European Parliament and Council and now being part of the final CRD text as quoted above.

[1] Under certain conditions, **guaranteed** residual values form part of the lease exposure and are risk weighted as such as stated in Annex VII, Part 3 § 4. Therefore, Annex VII, Part 1, § 27 relates to unguaranteed residual values or guaranteed residual values not fulfilling the appropriate criteria.

3. Points 1 and 2 imply that the RV exposure amount should be split over the lease term. However, it is the practical details of how this split should be performed that is subject to varying interpretations. Some national supervisors assume that **t** is the **remaining** term of the lease (which decreases as time progresses) while others consider it to be the term of the lease **at initiation** of the contract (a constant)[2].

   When **t** is the *remaining* lease term, the result is that the capital to be set aside year after year increases as a convex function of the lease term whereas when **t** is the lease term *at initiation*, there is a constant provisioning of additional capital equal to 1/t*100*exposure value each year.

   This is illustrated in the graph below, which considers the example of a lease contract with a 5 year term. The bars in white indicate the risk-weighted exposure to be provisioned (in %) for the residual value exposure if **t** is defined as the lease term at initiation of the contract (in this case **t** = 5) while the bars in grey show the risk-weighted exposure to be provisioned (in %) when **t** is defined as the remaining lease term (here **t** decreases from 5 to 1 over the contract life).



4. It is Leaseurope’s opinion that t should be interpreted as the remaining lease term. Indeed, this view of the provision in Annex VII, Part 1 §25 is more in line with the real risk faced by the lessor than if t were to be considered as the lease term. This is due to the fact that the capital to be set aside to cover the residual value exposure increases proportionally more in respect to the time elapsed since the origination of the contract when t is the remaining term.

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[2] Yet others equate the text to meaning “100%*the discounted residual value”. We fail to see how this can be inferred from the original CRD wording. In our opinion such an interpretation reflects a definite lack of understanding of the risks involved in a leasing contract with an open (unguaranteed) residual value.

Leaseurope trusts that this paper will aid the CRD TG in clarifying the existing treatment of unguaranteed residuals under the CRD. Nevertheless, the Federation would like to point out that, when the current philosophy for determining regulatory capital comes under review, a more appropriate method of treating residual value taking into account the true risk institutions face in this area should be found. For instance, institutions could be allowed to use an internal model for residual value risk or diversification effects could be considered in a new residual value exposure framework.

It should be noted that residual value risk management is a key element of the leasing industry's know-how and that Leaseurope would be more than willing to contribute to discussions in this domain going forward.

We remain at your disposal to discuss the above issues. Please do not hesitate to contact Jacqueline Mills, Leaseurope Advisor, directly on +32 2 778 05 66 or at j.mills@leaseurope.org if you require any further information.

Yours sincerely,

Mr Tanguy van de Werve
LEASEUROPE DIRECTOR GENERAL

ABOUT LEASEUROPE

Leaseurope, the European Federation of Leasing Company Associations, was founded in 1972. The Federation is the umbrella body of both the leasing and rental industries in Europe, and is composed of 48 Member Associations in 34 countries. The countries represented by the Federation are: Austria, Belgium, Bosnia-Herzegovina, Bulgaria, Cyrpus Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Morocco, the Netherlands, Norway, Poland, Portugal, Romania, Russia, Serbia & Montenegro, Slovakia, Slovenia, Spain, Sweden, Switzerland, Ukraine and the United Kingdom.

Leaseurope's 2005 Annual Statistics of the European Leasing Market reveal that the new leasing business of its leasing Member Associations having taken part in the survey amounts to 263 billion euros. The Federation estimates that this represents around 97% of its market. The total Leaseurope market for 2005 is thus forecasted to be around 270 billion euros, making its market the largest leasing market in the world. The 1,300 or so leasing companies represented via Leaseurope's members account for more than 90% of all European leasing.