Leaseurope

The Voice of Leasing and Automotive Rental in Europe

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DG Markt

By email
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Dear Patrick

Please find Leaseurope's response to the Commission's consultation on the CRD Review attached.

Our response focuses on two issues directly impacting on the European leasing industry, namely the recognition of real estate collateral under the large exposure framework and the treatment of unguaranteed residual values for leasing which is subject to a certain number of technical amendments under the CRD Review.

Regarding physical collateral, we very much appreciate the discussions we had with you and your staff in April and have adapted our response accordingly. We have in particular listed a number of arguments in favour of maintaining the 50% haircut for real estate in the large exposure regime and would like to stress that this is of utmost importance for the European leasing industry.

Other issues that have been the focus of much debate in recent months, including several aspects of the large exposure regime such as interbank and intra-group exposures, although of importance to the leasing industry, have not been addressed here directly. We therefore refer the Commission to the EBIC reaction on these topics.

For any further information you may require on our response, please do not hesitate to contact me or Jacqueline Mills at j.mills@leaseurope.org or +32 2 778 05 66.

Yours sincerely,

Tanguy van de Werve
LEASEUROPE DIRECTOR GENERAL

Copy to:

Martin Špolc, Policy Officer
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About Leaseurope

Leaseurope is the voice of leasing and automotive rental in Europe. In 2007, the firms represented through our 46 Member Associations in 34 countries across Europe granted new leasing business worth in excess of 340 billion euros, making the European leasing market the largest in the world. Together, these companies finance just under 20% of all European investment and around 28% of all European investment in moveable goods.

Part I. Large Exposures: Credit Risk Mitigation – Physical Collateral

1. Leaseurope strongly supports the Commission's proposal to recognise real estate collateral for credit risk mitigation purposes in the new large exposure framework. The Commission's suggestion is in line with CEBS's conclusion on real estate collateral in its advice on large exposures and the industry believes that this solution is the most appropriate when it comes to reaching middle ground in terms of the costs/benefits relating to the various options considered by CEBS.

2. Furthermore, we welcome this proposal as it corresponds to the treatment adopted by some Member States under the current regime, with the advantage of no longer being a matter of national discretion. Consequently, we believe that the Commission has achieved at least two of its objectives in the drafting of this proposal, namely (i) amending the current regime only when necessary and (ii) removing as far as possible areas of current national discretion within the new regime.

3. Although we are disappointed that other physical collateral recognition is not on today's agenda, we accept this situation and will be happy to contribute to the debate at a more appropriate time. Physical collateral recognition is key for the European equipment leasing industry and is indeed at the very core of its business. We would therefore like to take this opportunity to state that we are fully aware that the objectives of a large exposure regime are different to that of the solvency regime in that it is a back-stop regime designed to limit the risks arising from traumatic losses due to unforeseen events which are not fully captured by minimum capital requirements. Consequently, we recognise that the liquidity of any collateral to be accepted in such a framework is paramount. Nevertheless, we do believe that certain types of leased equipment **are sufficiently liquid for these purposes** as they can be realised quickly and with relative certainty as to the recoverable amount.

4. This is because a significant portion of the types of assets typically leased (such as fleets of cars or trucks) are part of liquid secondary markets even in times of economic downturn, are easy to bring to the secondary market at a low cost, can be remarketed on different markets by many players and in different countries and are not subject to rapid technological development in comparison with the duration of the lease portfolio. Moreover, if the collateral has to be realised, due to the fact the lessor is the owner of the asset and does not have to exercise its security or mortgage right or go through lengthy bankruptcy procedures (as is the case with other secured loans), the lessor is in a position to repossess and realise the asset in a timely manner. Ownership is thus truly a distinguishing feature of lease financing compared to other forms of secured finance in this respect.

5. Generally speaking, our members take the view that the non recognition of physical collateral is not satisfactory as this results in the absence of differentiation between collateralised exposures and non collateralised exposure in terms of regulatory requirements even though an institution is in a better situation from a risk point of view if it has an asset as collateral rather than none at all. However, as there is no scope to continue the debate on other physical collateral for the time being, this part of our response focuses on **real estate collateral**. Moreover, as property leasing relates mainly to commercial real estate rather than residential real estate, we will limit the remainder of our comments in this part to the treatment of commercial property exposures. This section therefore covers the proposed haircut for real estate collateral, the recognition of commercial real estate under construction and sets out suggestions for improving the wording of the proposal.

1. Level of the haircut applicable to real estate collateral

6. Leaseurope holds the unwavering view that in no case should the haircut applicable to the value of the real estate collateral be less than 50%[1].

7. We take this view for the following reasons:

   - As the Commission knows, the current large exposure framework already allows member states to recognise up to 50% of the value of the collateral in residential and commercial real estate exposures, with leases on these types of property being treated in the same way. Moreover, it should be noted that today's Article 113.3 q goes so far as to provide the possibility for member states to allow recognition of the **full value** of the property in a real estate lease exposure. Consequently, the Commission's suggested haircut of 50% is in line with current practice and in some cases (i.e. for property leasing transactions where the discretion is applied) it is even more conservative.

   - While we fully appreciate that the objectives of minimum capital requirements for credit risk and the large exposure framework are different, the idea of a 50% haircut for real estate exposures for large exposures is indeed similar to the principle of applying a 50% risk weight to 50% of the exposure for solvency purposes. This is in line with CEBS's recommendation and the Commission's objective to **deviate as little as possible from credit risk mitigation** treatment for minimum capital requirements.

   - Under a back-stop large exposure regime, where liquidity issues are crucial, the introduction of a haircut serves to ensure that all concerns relating to the timely realisation and certainty of the recoverable amount are more than sufficiently addressed. However, the haircut should not be so low as to fail to recognise the track record of European real estate markets. In this context, many stakeholders in this debate believe that 50% is too conservative. Nevertheless, we understand that there are reasons for not going beyond this limit and therefore are of the opinion that 50% is an **adequate compromise**.

   - The conditions for being able to recognise commercial real estate, included in Article 112.2 of the proposal referring to "compliance with the eligibility requirements and other minimum requirements set out under Articles 90 to 93", further guarantee a prudent approach to commercial real estate recognition. Indeed, these conditions ensure, amongst others, high quality monitoring of the asset, its value, volatility and condition and take into account the necessity for timely realisation of the collateral. Consequently, by respecting these conditions, institutions are already adequately addressing any liquidity concerns.

   - In the particular case of leasing, with lessors remaining the owners of the leased property throughout the contract term, the protection that institutions benefit from is even greater than in other cases. If realisation of the collateral is necessary, it will be timely as there is no need to execute a mortgage or other type of lien due to the ownership feature. Moreover, leasing firms' expertise in the remarketing of asset and the optimization of asset values ensure that every care is taken in relation to the asset and its disposal if necessary.

[1] In other words, the recognition of real estate collateral in the reduction of the large exposure <u>should be no less than 50%</u> of the value of the property.

8. As a result, we are of the opinion that the Commission's initial suggestion of 50% is more than sufficiently conservative and meets the objectives of prudential supervision in a single name concentration risk context. The European leasing industry would consequently fervently oppose any lowering of the haircut.

2. Commercial real estate under construction

9. Our members take the view that the proposal to exclude real estate under construction from this regime entirely goes too far. Indeed, while it may be more difficult to realise some types of real estate under construction, it should be noted that the very fact that the leasing company owns a piece of land alone ensures a certain value to the institution. Moreover, particularly in countries where demographic concentration has placed a premium on available real estate space, potential buyers are easy to find **regardless** of whether or not a building is being built on the land. Lastly, defaults during the construction phase are extremely rare.

10. Indeed, industry data and experience show that:

    - Defaults on real estate in the process of being built take place much less frequently than defaults on other real estate assets.

    - Average recovery rates on these types of assets are higher than 100%, implying that lessors actually are able to recover their entire dues, interest in arrears included. Moreover, recovery rates are not that different to those of some categories of fully built property.

    - The average period between repossession of the asset and the resale is short and does not differ to the average equivalent period for fully constructed property.

11. Our Italian member, the Italian Leasing association (ASSILEA) has provided the results of their surveys on recovery rates in the commercial real estate leasing sector. Their findings, which are summarised in the appendix to this response, support the statements made above. It is important to note that the Italian real estate market represents almost 50% of the entire European real estate leasing market on its own[2].

12. Bearing in mind the above arguments and the fact that we are aware that the Commission wishes to adopt a conservative approach to exposures linked to the real estate market, we would recommend a compromise treatment for real estate under construction and suggest that the exposure be reduced by up to 35% of the value of the asset. Our drafting suggestion to this effect can be found below under point 3.

[2] Total new real estate leasing volumes of 46.4 billion euros were granted in Europe in 2007. New real estate leasing volumes in Italy were worth 22.7 billion euros during the same year.

3. Comments on the proposed wording and drafting suggestions

13. The following points address three areas where we believe the proposal could benefit from some degree of improvement to ensure clarity. When appropriate, we have made suggestions so as to assist the Commission in their drafting work.

1) Proposed treatment must be available for both Standardised and IRB Institutions

14. Although the proposal is drafted on the basis of the existing large exposure regime which refers to exposures receiving a risk weight of 50% under Articles 78 to 83 of the CRD, we understand from our discussions with the Commission that the proposed treatment would be available to all institutions, regardless of the approach they choose to apply for minimum capital requirements for credit risk. This assurance is based on the opinion of the Commission's legal experts who have examined the text and have concluded that the use of the words "**would** receive a 50% risk weight under Articles 78 to 83 …" is sufficient for the treatment to be applicable to IRB institutions.

15. We firmly maintain that there should be no discrimination between institutions applying the various approaches in this area and therefore welcome this conclusion.

16. In order to ensure legal certainty and to steer clear of any possible misinterpretation when it comes to national transposition of the new regime, we would nevertheless recommend that a **recital** be included in the new text so as to avoid any misunderstandings going forward.

17. Our suggested wording for such a recital is as follows:

Recital (new)

For the purpose of the large exposure regime, the recognition of real estate collateral is equally available to all institutions, regardless of the approach they have chosen to calculate minimum capital requirements for credit risk.

2) A degree of discretion still remains

18. As mentioned above, one of the principal reasons for us welcoming the Commission's proposal relates to the removal of the national discretion in the area of real estate recognition, rendering the provisions an option for the institution. However, we still have some concerns in this respect, namely that the Commission is **inadvertently hard-coding a national discretion** in the new regime. Indeed, while we fully agree that real estate collateral should only be recognised if the conditions referred to indirectly in the proposal are fulfilled, the current choice of wording implies that the treatment will de facto only be available as a matter of national discretion.

19. The current situation is as follows:

- Article 115.2 of the Commission's proposal states that commercial real estate may be recognised "only if the following exposures would receive a risk weight under Articles 78 to 83: …".

- The provisions referred to under these articles relate to Annex VI, Part 1 §44 and § 51-60 for determining the risk weights for commercial real estate. Under this section, a 50% risk weight is applicable **only as a matter of discretion** when authorities are satisfied that a certain set of conditions are met.

20. Institutions must of course prove to the satisfaction of supervisors that these conditions **are fulfilled**. However, our view is that if the conditions are indeed fulfilled, there should no longer be any level of discretion.

21. Consequently, we recommend that the wording used in Article 115.2 take this into account rather than refer to a discretionary provision; otherwise we believe that the Commission would effectively be embedding a discretion into the new large exposure regime when its objective is quite the opposite.

3) Recognition of commercial real estate under construction

Given our arguments in paragraphs 10 to 12 above, we would suggest the following compromise for the recognition of real estate under construction in the large exposure regime:

Article 115.2

2. For the purpose of this section, a credit institution may reduce the exposure value by up to [50%] of the value of the commercial property concerned, only if the following exposures would receive a 50% risk weight under Articles 78 to 83: (…)	For the purpose of this section, a credit institution may reduce the exposure value by up to [50%] of the value of the commercial property concerned, only if the following exposures would receive a 50% risk weight under Articles 78 to 83: (…)
(ii) exposures related to property leasing transactions concerning offices or other commercial premises.	(ii) exposures related to property leasing transactions concerning offices or other commercial premises.
For the purpose of the above, commercial property shall be fully constructed.	~~For the purpose of the above, commercial property shall be fully constructed.~~ **If the commercial property is under construction, a credit institution may reduce the exposure value by up to 35% of the value of the commercial property concerned, provided the same conditions as above for fully constructed property are fulfilled.**

Part II. Technical Amendments: Unguaranteed Residual Value Treatment

22. Leaseurope very much supports the Commission's proposals to harmonise the definition of a lease exposure under the Standardised and IRB approaches together with ensuring that the same treatment for unguaranteed residual values is available under all approaches. These proposals are a welcome improvement to an oversight of the initial CRD.

23. Moreover, the Commission's proposal to clarify the interpretation of the latter treatment (the so-called 1/t rule) not only represents major progress in comparison to the current situation of having several diverging national interpretations, but also clearly illustrates the effectiveness of the CRD Transposition Group. Indeed this issue was discussed by the group who agreed upon a simple, clear and appropriate interpretation of the rule.

24. Consequently, we are largely satisfied with the proposals and the following drafting suggestions, based on queries raised by our members in reaction to the consultation, are simply intended to ensure that no ambiguity in the residual value treatment for leases under the CRD remains.

1) The "1/t rule" applies to specific kinds of residual values

25. As the Commission knows from previous discussions with the European leasing industry, the so-called 1/t rule applies to residual values that are not included within the lease exposure. In other words, it applies to those residual values that are unguaranteed or that do not fulfil the necessary conditions for being included in the lease exposure, i.e. does not qualify as a guaranteed residual value[3]. However, our members feel that there may be room for misinterpretation in this area and that a slight clarification of the wording would be beneficial.

26. We therefore suggest that the changes in the amendment below be made, in the Standardised as well as in the IRB Approaches to continue to ensure consistency.

2) The use of the word "properties" may lead to confusion

27. Although the Commission has used the words "property" and "properties" in the past and elsewhere in the CRD, namely in Annex VIII Part 2 § 10, setting out the minimum requirements for the recognition of "other physical collateral" (i.e. other than real estate) as well as in Annex VIII Part 2 § 11, setting out the minimum requirements for leasing, our members have pointed out that the continued use of this word in the context of the proposed change to the 1/t rule would lead to a misinterpretation of the provision.

[3] Indeed, Annex VII, Part 3, point 1.4 states that "Any guaranteed residual value fulfilling the set of conditions in Annex VIII, Part 1, points 26 to 28 regarding the eligibility of protection providers as well as the minimum requirements for recognising other types of guarantees provided in Annex VIII, Part 2, points 14 to 19 should also be included in the minimum lease payments".

28. Indeed, our members inform us that they understand the word property to only refer to **real** property, i.e. the equivalent of the US term “real estate” and cannot be construed to include moveable assets.

29. We understand that it is not the Commission’s intention to restrict in any way the 1/t rule to the unguaranteed residual values of real estate leases but that the treatment applies to leases of all kinds of assets, including non real estate assets. Consequently, we recommend that the word properties be removed from the proposal (again, in all approaches) and replaced by the generic term “assets”, no longer leaving any room for ambiguity.

30. If this minor change is not brought about, the very likely result would be that some Member States will be unable to transpose the provision in any other way than applying it to real estate leasing only. This will only bring about further unintended negative consequences for the European leasing industry and would be best avoided.

31. Our suggested drafting proposals relating to points 1) and 2) are as follows:

Standardised Approach:

E. Technical Amendments to Directive 2006/48/EC
(2) (e)

(e) The following point 16.1.90 shall be inserted:	(e) The following point 16.1.90 shall be inserted:
"16.1.90. The exposure value for leases shall be the discounted minimum lease payments. Minimum lease payments are the payments over the lease term that the lessee is or can be required to make and any bargain option (i.e. option the exercise of which is reasonably certain). Any guaranteed residual value fulfilling the set of conditions in Annex VIII, Part 1, points 26 to 28 regarding the eligibility of protection providers as well as the minimum requirements for recognising other types of guarantees provided in Annex VIII, Part 2, points 14 to 19 should also be included in the minimum lease payments. Those exposures shall be assigned to the relevant exposure class in accordance with Article 79. When the exposure is a residual value of leased properties, the risk weighted exposure amounts shall be calculated as follows: 1/t x 100% x exposure value, where t is the greater of 1 and the nearest number of whole years of the lease remaining."	"16.1.90. The exposure value for leases shall be the discounted minimum lease payments. Minimum lease payments are the payments over the lease term that the lessee is or can be required to make and any bargain option (i.e. option the exercise of which is reasonably certain). Any guaranteed residual value fulfilling the set of conditions in Annex VIII, Part 1, points 26 to 28 regarding the eligibility of protection providers as well as the minimum requirements for recognising other types of guarantees provided in Annex VIII, Part 2, points 14 to 19 should also be included in the minimum lease payments. Those exposures shall be assigned to the relevant exposure class in accordance with Article 79. When the exposure is a residual value of **a** leased ~~properties~~ **asset not included in the lease exposure**, the risk weighted exposure amount~~s~~ shall be calculated as follows: 1/t x 100% x exposure value, where t is the greater of 1 and the nearest number of whole years of the lease remaining."

IRB Approaches:

E. Technical Amendments to Directive 2006/48/EC
(4) (b)

(b) Point 1.4.27 is replaced by the following:	(b) Point 1.4.27 is replaced by the following:
"1.4.27. The risk weighted exposure amounts shall be calculated according to the formula:	"1.4.27. The risk weighted exposure amounts shall be calculated according to the formula:
Risk-weighted exposure amount=100% x exposure value, except for when the exposure is a residual value of leased properties in which case it should be provisioned for each year and will be calculated as follows:	Risk-weighted exposure amount=100% x exposure value, except for when the exposure is a residual value of **a** leased ~~properties~~ **asset not included in the lease exposure** in which case it should be provisioned for each year and will be calculated as follows:
1/t x 100% x exposure value,	1/t x 100% x exposure value,
Where t is the greater of 1 and the nearest number of whole years of the lease remaining."	Where t is the greater of 1 and the nearest number of whole years of the lease remaining."

32. We would also recommend that the Commission consider adapting the wording used in Article 86.8, which sets out the treatment for the residual value of leased properties, along similar lines, referring to leased assets rather than leased properties.

APPENDIX TO LEASEUROPE'S RESPONSE TO PROPOSALS FOR THE CRD REVEIW

MAIN FINDINGS OF ASSILEA'S[1] SURVEY
ON RECOVERY RATES OF DEFAULTED REAL ESTATE LEASE CONTRACTS

Table 1 – Italian leasing firms taking part in the survey

Year[2]	Number of leasing companies	Real estate leasing market share
2006	21	88,40%
2005	19	89,40%
2004	15	77,40%

Table 2 - General results (for constructed property and property under construction together)

Year	Number of assets relating to defaulted contracts	Number of assets not resold	Asset recovery probability (%)	Total resale value (€)	Average resale value (€)
2006	114	0	100	101.159.418	887.363
2005	138	0	100	80.713.837	584.883
2004	68	0	100	34.032.71	500.481

Table 3 – 2006 Results per building category (for constructed property and property under construction together)

Type of building	Number of assets relating to defaulted contracts	Average recovery rate on the residual debt[3] (%)	Min	Max	Average period between date of repossession of the asset and date of resale
Industrial	51	160,80	67,2	709,5	3,06
Retail outlets	28	114,72	45,6	165,8	8,69
Offices	10	170,18	75,4	455,8	8,28
Other	25	124,85	23,6	297,9	10,78
TOTAL 2006	**114**	**142,00**	**23,6**	**709,5**	**5,94**

Table 4 – Details of the recovery rates for <u>leasing on commercial property under construction</u>

Type of building	Number of leasing companies	Number of relating to defaulted contracts	Average recovery rate on the residual debt (%)	Min	Max
2006	3	14	107,8	81,7	165,8
2005	3	8	119,4	82,1	180,8
2004	-	-	-	-	-

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[1] Assilea is the Italian Leasing Association. Italian real estate leasing represents around 50% of the entire European leasing market. www.assilea.it

[2] Each survey takes into consideration defaulted contracts that have been written-off in a specific year.

[3] At the moment of default. Default is the date at which the leasing company interrupts billing of their lease payment receivables