Leaseurope

The Voice of Leasing and Automotive Rental in Europe

Leaseurope Response to Green Paper on Financing Long Term Investment

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Leaseurope[1] Response to Green Paper on Financing Long Term Investment

I. Introduction

This paper describes the important role leasing can play in achieving sustainable European growth by helping European businesses to access productive assets.

It begins by explaining how and why leasing is ideally placed to finance productive investment in a vast range of sectors and activities (including R&D and innovation, infrastructure, industrial technology, capital-intensive projects, healthcare, environmental technologies, etc.) as well the investment of enterprises, and throughout all stages of a firm's development (from young start-ups to companies that are far along their life cycle). It also sets out the reasons for why leasing is especially well suited to catering for the needs of smaller businesses.

The paper also includes a description of how leasing activities in Europe have been affected by the financial crisis. It concludes with a list of suggestions we wish to explore with the European Commission to ensure that leasing achieves its maximum potential to support European long-term investment.

i) What is leasing?

A lease is a contract whereby a leasing company (lessor) makes an asset it owns available to another party (lessee) for a period of time in exchange for payment. Across Europe, a range of different types of contractual agreements fall under the notion of "leasing". The common feature of all these arrangements is that the lessor retains ownership of the leased asset throughout the contract term. It is the inbuilt security provided by the retention of ownership rights that allows lessors to provide businesses with the use of assets in situations where traditional loans would not be available to these firms.

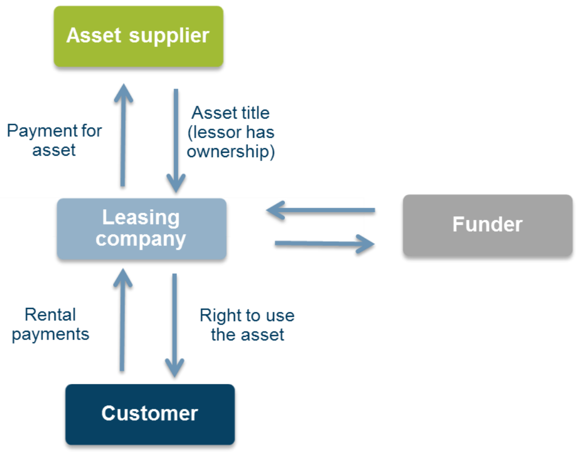

Figure 1. A typical lease transaction

[1] Leaseurope is the body representing the European leasing industry. It brings together 43 member associations in 32 European countries. 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 2012, total new leasing volumes worth €253 billion were granted by the firms represented through Leaseurope's members. More info at www.leaseurope.org.

ii) What can be leased?

Almost any type of physical asset can be leased, as can certain intangible assets. Examples of leased assets include, but are not limited to, plant and manufacturing equipment, IT equipment and software and software licences, printing machines, photocopiers and telecommunication equipment, construction and logistics equipment, passenger and commercial vehicles, as well as other means of transport, medical equipment, renewable energy producing equipment, infrastructure, utilities and property, to name but a few.

ii) Who are European lessors?

Lessors can be banks, bank-owned and non-bank leasing companies, including manufacturers of assets and other independent or commercial companies. Mirroring the broader financial system in Europe, the European leasing industry has traditionally been funded by the banking sector, either through banks' direct ownership of leasing companies or through bank funding of non-bank owned companies, which includes manufacturer-owned lessors.

II. Leasing's contribution to the European economy

i) Supporting investment in productive assets

Leasing's economic importance lies in the fact that it is a major source of investment support for European businesses[2]. It is used across the board by companies of all sizes and in all industries[3], as well as being extremely useful to support the public sector (e.g. leasing to schools, hospitals, etc.).

In 2012, European lessors granted new leases worth more than €253 billion and the portfolio of leased assets in their hands at the end of that year was worth over €732 billion[4]. Leaseurope data shows that in 2011 leasing enabled 21% of all equipment investment in Europe[5].

Leasing allows businesses and other types of lessees to manage their working capital more effectively by spreading payments to use the asset over the contract period. Leasing also enables clients to upgrade their assets easily to the latest technologies so that they may remain competitive. It is often more affordable and quicker to obtain than other forms of finance[6] and provides greater operational flexibility[7] in comparison to the outright purchase of an asset.

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[2] Sources: Leaseurope; Eurostat (2011) *Access to Finance Statistics*; Oxford Economics (2011) *The Use of Leasing Amongst European SMEs*; International Finance Corporation (2009) *Leasing in Development: Guidelines for Emerging Economies*; European Investment Fund (2012) *The importance of leasing for SME finance*; and UEAPME (2012) *UEAPME Newsflash*.

[3] Oxford Economics (2011) *The Use of Leasing Amongst European SMEs* and European Central Bank (April 2013) *Survey on the Access to Finance of Small and Medium-Sized Enterprises in the Euro Area*

[4] Leaseurope (2012) *Annual Statistical Enquiry*

[5] Leaseurope calculation based on new leasing volumes as a percentage of gross fixed capital formation (GFCF) in equipment. Leasing volumes are taken from Leaseurope's Annual Statistical Enquiry 2011, GFCF equipment figures are taken from the European Commission's DG ECFIN database AMECO extracted on 12/09/2012.

[6] European Bank for Reconstruction & Development – EBRD (2011) *Special Study: Bank's Leasing Operations (Regional)*

[7] i.e. the ability to match the contract to actual asset usage needs.

By helping its clients to invest more, leasing can foster greater economic growth. According to a study by Oxford Economics conducted in 2011, a relatively small increase in the uptake of leasing would create an important boost to European GDP growth[8].

Leasing is particularly appropriate for SMEs. Around 40% of all European SMEs make use of leasing, which is more than any other individual form of lending[9]. Additionally, according to the OECD, it is the financing source with the highest rate of successful applications amongst SMEs[10].

ii) Leasing is particularly well suited to supporting SMEs

The Commission's Green Paper acknowledges the important economic role of small businesses in Europe and notes that it is precisely their size is that can make them more vulnerable in accessing a variety of financing means compared to larger firms, particularly in times of crisis. One of the main reasons for this is their reported "inability to provide sufficient collateral or guarantees to the lender"[11].

Compared to leases, secured loans tend *not* to be secured on physical assets as the providers of these products do not have the same expertise and skills as lessors when it comes to evaluating and managing physical assets. Other lenders will therefore prefer non-physical collateral (such as guarantees, etc.) or real estate collateral (e.g. business owner mortgaging his/her private home) for risk mitigation purposes. A lender's requirements to post additional collateral can often place an additional burden on enterprises, particularly SMEs, potentially making them more vulnerable or less willing to invest.

Leasing allows SMEs to finance up to 100% of the purchase price of an asset *without requiring any additional collateral*. This is because the asset being leased *is* the collateral (the leasing company owns the asset and can put it to another use or sell it if the lessee defaults on payment). For start-up SMEs that do not have a strong credit history, for those who may not be in a position to post collateral, or for SMEs in sectors that are generally perceived as being riskier, leasing is therefore particularly advantageous in comparison to other types of finance[12]. Leasing can also cater well to the needs of very small firms (micro entities) which form the category of small business that suffers the most from a lack of access to finance. Lastly, while some forms of finance are better suited for companies that are at a certain point in their lifecycle, leasing is appropriate for use throughout the lifespan of any SMEs' business.

Section 3.2 of the Green Paper refers to claims that equity may be a better instrument than debt for long-term investment, particularly in cases of information asymmetries and moral hazard. However, it is important to recall that the ownership rights of lessors that are inherent in the leasing instrument provide lessors with a very effective tool for dealing with information asymmetries and

[8] Oxford Economics (2011) The Use of Leasing Amongst European SMEs shows that a modest uptake of leasing by SMEs alone would add an extra 0.9% to 1.5% to the level of GDP by the end of 2020.

[9] Oxford Economics (2011) *The Use of Leasing Amongst European SMEs*. The report shows that 40% of SMEs surveyed used leasing compared to 38% for loans longer than 3 years (i.e. of a term equivalent to that of a typical lease) or 37% for overdrafts.

[10] OECD (2012) *Measuring Entrepreneurial Finance: A European Survey of SMEs*. See success rates in obtaining leasing compared to success rates in obtaining loans (2010).

[11] Eurostat (2011) *Access to Finance Statistics*, The main reasons given by banks to refuse requested loans from SMEs were: 'Poor credit rating', 'Lack of own capital' or 'Insufficient collateral'.

[12] European Investment Fund (2012) *The importance of leasing for SME finance*

moral hazard. At the same time, leasing is potentially much cheaper than equity[13]. It can therefore be an important complement to equity and is more readily available.

Moreover, according to the European Bank for Reconstruction and Development, the majority of small businesses witness an increase in their business activities as a result of leasing[14]. Additionally, SMEs that use leasing invest on average 57% more than those who do not[15]. Leasing is therefore not only a reliable source of support for SMEs even in the most uncertain economic conditions, it also contributes to the success of their businesses and helps them increase their investment levels.

iii) Supporting European manufacturers

Manufacturing represents 21% of the EU's GDP and 20% of its employment[16]. It is therefore a vital contributor to the European economy. As a result, the European Commission has recognised the need to promote the competitiveness and sustainable growth of European industry[17]. Leasing is also very well placed to help the EU reach this goal.

The most popular means of accessing a lease is through an asset vendor or dealer at the point of sale[18]. This means that clients benefit from a "one-stop-shop" for obtaining the use of an asset, services related to its on-going operation as well as a financing solution. This convenience provides a clear advantage for lessees in comparison to other forms of financing, which often have to be arranged separately to the asset purchase.

iv) Enabling smart and sustainable growth

As Europe reduces its carbon footprint in line with the Commission's Low-Carbon Roadmap, the focus on producing and using energy efficient assets has increased. Consequently, businesses demand and need more energy efficient assets. Leasing can help firms gain access to such assets. For instance, by allowing and encouraging the uptake of clean vehicle technology, the leased car fleet in Europe has become steadily less polluting over the past few years[19]. Similarly, recent research has also recognised the importance of leasing to achieve the required rejuvenation of European truck fleets in order to adopt necessary fuel-saving (and safety) technologies[20].

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[13] According to the Oxford Economics (2011) *The Use of Leasing Amongst European SMEs,* the number one reason SMEs gave for using leasing was that the price of leasing was cheaper than that of other forms of finance.

[14] EBRD (2011)

[15] Oxford Economics (2011)

[16] DG Research & Innovation, *Innovation in Manufacturing*

[17] DG ENTR, *Industrial Competitiveness*, The European Commission has stated that industrial policy and competition policy are at the core of its new competitiveness policy framework and have a direct impact on the business environment in Europe.

[18] Oxford Economics (2011) 67% of lessees surveyed use the manufacturer channel, compared to 58% for the banking channel and 36% for the direct sales network of finance companies.

[19] Leaseurope (2012) Between 2009 and 2011, the average CO_2 emissions of newly purchased vehicles in a leased fleet of 6 pan-European companies active 8 European markets decreased from 149 g/km to 133 g/km.

[20] CE Delft (October 2012) *Market Barriers to Increased Efficiency in the European On-road Freight Sector* – report presented during a European Commission (DG CLIMA) workshop "Onroad Freight Efficiency Technology Market Barriers", Brussels, 15 October 2012.

Additionally, leasing addresses one of the general barriers that inhibits the development of sustainable energy production, i.e. a lack of access to capital[21]. In fact, leasing already facilitates the financing of equipment such as wind turbines, biofuel processing plants, photovoltaic panels, long lasting battery cells and so forth, allowing Europe to produce cleaner and more sustainable energy.

Leasing not only aids in replacing old, polluting equipment with cleaner and more energy efficient assets, it can also encourage the efficient use of scarce natural resources[22]. The fact that lessors are the owners of the assets they lease incentivises them to ensure that resources and materials that go into asset production are of high quality. Moreover, lessors are also incentivised to ensure that production materials and the individual parts making up an asset can be re-leased, refurbished, reused or recycled. Lessors have specialised asset knowledge and sophisticated asset management capabilities to deal with the often complex asset management issues that arise with asset ownership. Thus, leasing enables a more efficient allocation of resources occurs at macro level than when (non-specialist) businesses own assets outright.

By allowing asset use without asset ownership, the leasing instrument could enable a fundamental shift in our traditional consumption and production models. These new models of economic value creation have been referred to as "the circular economy" and are being examined seriously at European and international levels as a way forward in our environment of scarce resources[23].

III. Leasing is a low risk instrument

In Section IV of this paper, we have set out the positive impact of the lessor's asset ownership from the client's perspective. Looking at the other side of the transaction, from a lessor's perspective ownership rights imply that lessors benefit from the highest degree of security, making leasing a low risk instrument. Thanks to its asset ownership, a lessor it is able to efficiently repossess the leased asset in cases of default without having to go through lengthy bankruptcy procedures or having to realise a pledge or other security lien on the asset being financed.. Asset ownership also has other positive side effects from the lessor's point of view in that, in cases of payment delays, repossession is often not even necessary. Indeed, repossession tends to be more of last resort, as clients often prefer to remedy their payment situation in order to continue benefiting from the use of the leased asset. This is because leased assets are core assets crucial to running the business. The combination of these effects results in loss given defaults levels (LGDs) for leasing being to those of other (comparable) instruments.

21 International Finance Corporation (2009) *Leasing in Development: Guidelines for Emerging Economies*

22 Wuppertal Institute for Climate, Environment and Energy for the European Parliament (2012) *Leasing Society*

23 For instance, the European Parliament ENVI and ITRE Committees have been discussing the above mentioned Wuppetal Institute report on the leasing society and how such a model could help the European economy; a specific session of the 2013 World Economic Forum in Davos looked at how leasing could facilitate circular economy models which result in a more sustainable use of resources; the Ellen McArthur Foundation promotes the circular economy model and its website features several case studies of how businesses can successfully apply this model through leasing their products.

The risk profile of lease products is therefore low, and for lessors applying CRD requirements (directly or indirectly), this is reflected in low capital requirements. Consequently, this should incentivise regulated entities such as banks to invest in leasing as it allows them to continue to provide finance to the real economy but without consuming capital to the same extent as other products would.

IV. How the crisis and ensuing financial reform has affected leasing in Europe

An uncertain economic environment and low confidence implies that European businesses are reluctant to invest, and indeed, European gross fixed capital formation levels fell significantly in 2009 and have yet to recover[24]. European leasing volumes appear to have followed the trend of European investment levels (see figure 2 below), however, as the Commission Staff's working document points out on page 17, it is often difficult to separate out whether the performance of the past few years has mostly been demand or supply side driven.

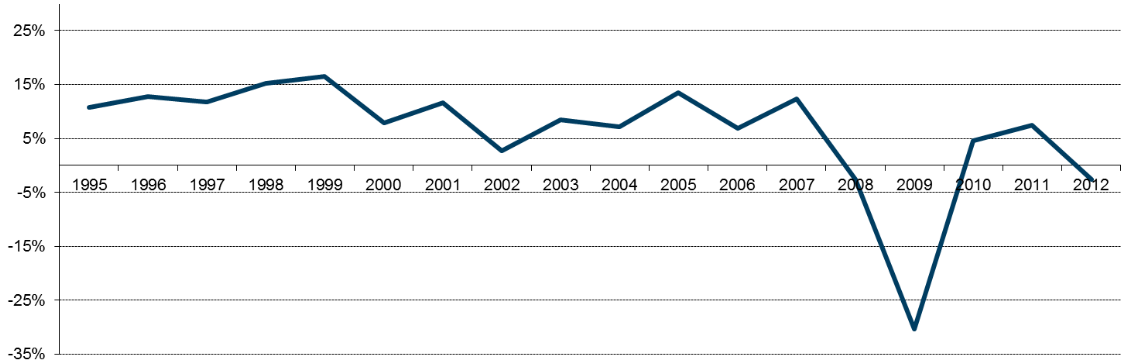

Figure 2. Evolution of new leasing volumes in Europe (YoY % change, 1995-2011) (Source: Leaseurope)

One way of looking at this issue is to compare new leasing volumes to business equipment investment, a measure we refer to as "leasing penetration" (see Figure 3 below). After remaining stable in 2007 and 2008, we observe a decrease in leasing penetration in 2009 and little change thereafter (we expect a slight decrease for 2012).

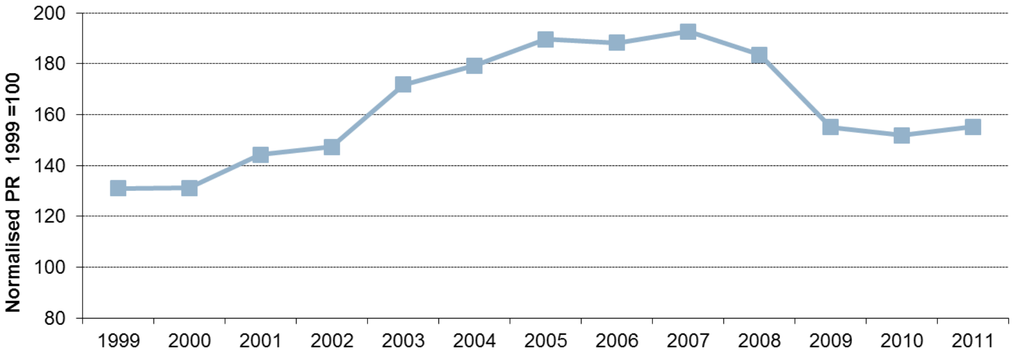

Figure 3. Evolution of European equipment leasing penetration rates (19 countries, 1999-2011) (Sources: Eurostat, AMECO, Leaseurope)

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[24] According to AMECO, in 2009, gross fixed capital formation for equipment in the Euro Area (17 countries) fell by 19%, remained flat between 2010 and 2011 and fell by a further 4% in 2012

All else being equal, if total European business equipment investment decreases due to a lack of confidence and demand, we would not expect to see a decrease in leasing penetration rates, particularly if there is an incentive for banks to invest in leasing given its low capital absorbency.

So why have we seen a decrease in European leasing penetration? Our analysis of the situation is that, in spite of its low risk nature, leasing activities have nevertheless been negatively impacted by banking group's reactions to the ongoing implementation of Basel 3 in Europe:

Basel 3 incentivises deleveraging, but is deleveraging always positive?

There is, however 'good' deleveraging (that leads to increased capital levels, better pricing for risk, a reduction in riskier assets, etc.), but also 'bad' deleveraging. Bad deleveraging can impact the availability of long-term financing for the real economy[25]. Once a financial institution has done all it can to improve its financial situation on the liability side, it has to look to the asset side and seek to reduce (risk-weighted) assets.

Although the low risk character of lease exposures is reflected in lower risk weighted assets for banks, it seems that some European banking groups have chosen to privilege other businesses instead, resulting in the divestment of various leasing activities over the past few years. In cases where banks have chosen to retain leasing activities, some bank-owned leasing companies have not always been allocated sufficient funding by banking parents to be able to finance new business opportunities. As a result, there is undoubtedly a level of demand from the real economy that is not being addressed.

The counterintuitive and unexpected result of Basel 3 implementation in Europe appears to be that the absolute focus on de-leveraging has led to banks forgoing activities that are beneficial for the real economy.

Long-term funding is not necessarily easily accessible to lessors themselves

The vast majority of leasing companies in Europe, including non-bank and manufacturer-owned leasing firms, are mainly bank funded[26]. Moreover, leasing companies typically do not take deposits[27]. The liquidity requirements of Basel 3 (even if pending or in the process of implementation) mean that banking groups are privileging those activities that bring sources of liquidity and deposits rather than consume liquidity or are otherwise disincentivised by regulatory requirements. For instance, banks in some Member States may be forced to hold higher capital when lending to leasing companies. The cost of long term funding has risen across the board and, because lessors typically operate on a matched-term funding basis, they are forced to pay the premiums for the longer term funding they need to purchase assets.

Generally speaking, banks will choose to retain and invest in businesses that help them maximise their profitability and minimise regulatory requirements. Of course, each banking group's situation

[25] The World Bank, Policy Research Working Paper 6338, "*European Bank Deleveraging and Global Credit Conditions: Implications of a multi-year process on long-term finance and beyond*", E. Feyen and I. Gonzalez del Mazo

[26] Contrary to other jurisdiction such as the US where non-bank sources of funding are much more predominant

[27] Unless they are licensed to do so

will be different and specific analysis will have to be performed and choices made according to individual strategies, objectives and appetites. Nevertheless, our conclusion is that the current financial services regulatory environment is not putting in place the right incentives to allow leasing to fulfil its very important role of financing productive investment to the fullest extent. Ultimately this could be jeopardising European economic growth.

V. What can be done to ensure leasing achieves its full potential to help European long term investment?

i) Promoting awareness of the benefits of leasing

Despite its many economic benefits, leasing is still often not understood or is not fully recognised as being a crucial form of business support. The EU has a lot to gain in promoting the awareness of the leasing instrument and its advantages for clients and investors amongst the general public, policymakers and the funding/investor community. Leaseurope has produced an explanatory leaflet on leasing and its benefits that can be used for such a purpose.

ii) Improving access to funding for lessors too

European lessors also suffer from difficult, costly access to funding. For instance, helping the industry access institutional investors with long term funds that can be channelled through the leasing product to SME businesses would be extremely valuable. Initiatives to streamline and facilitate the setting up of securitisation transactions in the leasing business would also useful. Lastly, lessors should be allowed to benefit from financial instruments granted by the EU as well as at national level by Member States in the context of economic support programmes.

ii) Ensuring the regulatory environment does not disincentivise leasing

The low-risk nature of leasing must continue to be fully recognised for those entities that are subject to capital requirements. Moreover, liquidity, funding and leverage requirements should be designed bearing in mind that leasing is a non-deposit, long term activity.

New initiatives, such as proposals by the International Accounting Standards Board to change the way businesses are required to account for leases[28], should not be allowed to distort the development of the leasing market, nor should they risk impacting businesses' use of leasing. The extremely complex and burdensome nature of the proposed changes to lease accounting will bring about unnecessary costs for businesses who use leasing, without bringing better information to the users of accounts. Smaller businesses, although not immediately affected by the proposals (which would apply to listed firms in a first stage), would suffer immensely from having to deal with accounting complexity whereas today one of the main advantages of leasing is its simplicity and flexibility. Should the EU decide to adopt changes to current IFRS lease accounting into EU legislation, it is simply a matter of time before these concepts will be applied to the accounting requirements for smaller entities. We therefore encourage the Commission to carefully examine the long term impacts on businesses' access to productive assets that the adoption of this new standard could entail.

[28] IASB Leases Exposure Draft, 16 May 2013