Leaseurope

The Voice of Leasing and Automotive Rental in Europe

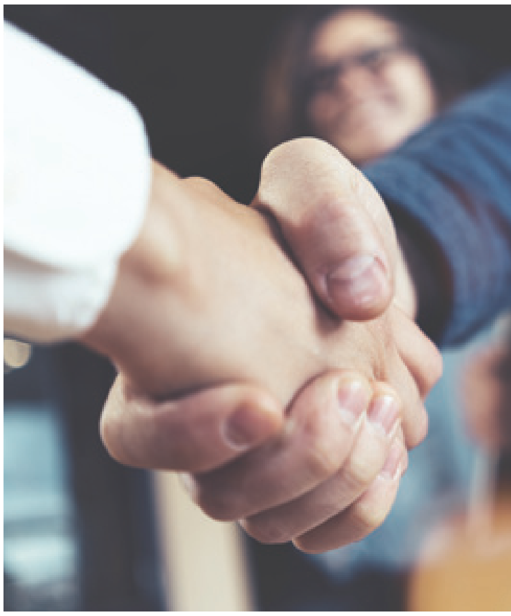
Environmentally Friendly

Sustainable Finance

Low Risk

PRUDENTIAL TREATMENT OF LEASING

A Proposal for Sustainable Growth in Europe



Investment

Growth

SMEs

Leasing: An investment in growth and sustainability

Leasing plays an important role in achieving sustainable growth in Europe by helping European businesses access productive assets

DIFFERENT SECTORS
R&D and innovation,
infrastructure,
industrial technology,
agriculture,
healthcare,
environmental technologies

MANY BUSINESSES
high growth/innovative firms,
SMEs,
exporters,
large corporates

PUBLIC SECTOR
schools,
hospitals,
city infrastructure

BY SUPPORTING BUSINESS INVESTMENT, LEASING BOOSTS GDP AND ECONOMIC GROWTH IN EUROPE

€384 billion New leasing volumes in 2017[1]

2.5% GDP Leasing's contribution to GDP

Leasing is a particularly vital source of finance for SMEs in Europe[2]

- 48% of EU SMEs state leasing is a relevant form of finance for them in 2017[3]
- 42.5% of SMEs use leasing according to Oxford Economics
- €104 billion of SME investment in fixed assets financed by leasing
- 9 million SME firms in Europe supported by leasing
- SMEs that use leasing invest more than twice as much as those that do not
- Exporting and 'growth' SMEs rely on leasing to finance over 20% of their investment

By allowing asset use without asset ownership, leasing could enable a fundamental shift in traditional consumption and production models towards "the circular economy"

- Replacing old, polluting equipment with cleaner, energy efficient assets
- As lessors are the owners, assets and materials can be re-leased, refurbished, reused or recycled
- Ensures access to capital for sustainable energy production like wind turbines, biofuel processing plants, photovoltaic panels, long lasting battery cells etc.
- Leasing helps drive uptake of clean vehicle technology, with pollution from the leased car fleet steadily dropping each year

Leasing is a key source of finance for European firms, helping to fund projects for our future!

1. Leaseurope Annual Survey, 2017
2. Oxford Economics report on The Use of Leasing Amongst European SMEs, 2015
3. European Commission, Survey on the access to finance of enterprises (SAFE), 2017

Leasing's low risk profile is not currently recognised in prudential legislation

CREDIT RISK IS LOW IN THE LEASING BUSINESS MODEL COMPARED TO OTHER FORMS OF LENDING[4]

Businesses need their leased assets to run (vehicles, IT equipment etc.) therefore defaults are low

> 1.9% one-year average default rate for leasing during economic crisis years (2007-2011)

> Compared to 3% median default rate for bank Corporate exposures in 2010 (2.5% for Retail)[5]

As leased assets are key working tools, defaults often return to a healthy status with no loss

> Around two thirds of all lease defaults return to healthy

As the owners, lessors recover much more from physical assets than other types of lenders by selling/re-leasing

> 66%-82% of exposure at default covered by asset sale on average, depending on asset type

> 20% of the time, asset sales fully cover any potential losses

Due to these high recoveries, losses on defaulted contracts for leasing are low

> 22% average loss given default, only rising to 25% when adjusted for downturn conditions

> Compared to 30% average loss rate for bank Corporate exposure in 2010 (25% for Retail)

REAL UNEXPECTED LOSS FOR LEASING = 1.1%

Regulatory capital required for European leasing

8.3% Standardised Approach

5.8% IRB-Foundation Approach

5.3% IRB-Advanced Approach

Current Capital Requirements Regulation (CRR) does not reflect the real risks of the leasing business

Depending on the approach used, requirements are between 5 and 8 times higher than necessary

- In 10,000 simulations per year, leasing's realised losses (expected & unexpected) were never higher than the regulatory capital requirements, which are designed to cover only unexpected losses
- Standardised Approach does not allow the positive impact of leased assets to be taken into account
- IRB Approach treats leasing the same as bank loans secured by physical assets, despite their different risk profile

> **"Regulatory capital requirements significantly overstate the risk profile of leasing exposures. This applies in particular to the Standardised Approach because the leased asset is not recognised as an eligible collateral"**
>
> Univ.-Prof Dr Thomas Hartmann-Wendels, University of Cologne

OUR RESEARCH DATASET

More than 2.4 million individual leasing contracts during peak financial crisis years across 25 European countries

4. All results from "Capital Requirements for Leasing: A Proposal Adjusting for Low Risk", 2017, University of Cologne for Leaseurope.
5. EBA, 2011 EU-Wide Stress Test Aggregate Report, Aggregate Report, 2011, p. 13

How to improve prudential regulation to support sustainable financing

Existing regulations do not reflect the real risks of leasing exposures, and proposals in the new Basel III standard would disincentivise leasing even more

- Input parameter floors unjustifiably penalise low risk forms of lending
- Prescribed haircuts are excessively conservative, more leasing is considered ‘unsecured’
- Benchmarking IRB Approaches to the Standardised Approach artificially limits the benefit of internal modelling, particularly since lease collateral is not recognised in the Standardised Approach and thus capital requirements here are high
- Estimated 11% increase in capital requirements for European lessors under the IRB-A due to the output floor alone[6]
- Inability to use the IRB-A Approach for banks and large corporates significantly raises capital requirements for these exposures

NEW BASEL PROPOSALS AFFECTING LEASING

IRB-FOUNDATION	IRB-ADVANCED
OVERCOLLATERALISATION – only considered ‘secured’ if collateral value minus a 40% haircut is larger than the outstanding loan value at default **REVIEWED**	
REGULATORY LGD **REVIEWED** 45% unsecured bank Corporates / 40% unsecured non-bank Corporates / 25% secured on physical collateral	LGD FLOORS **NEW** 25% unsecured Corporate / 30% unsecured Retail 15% secured
OUTPUT FLOOR: capital requirements under the IRB Approaches cannot be lower than 72.5% of what they would have been under the Standardised Approach **NEW**	

Leasing (where the asset is owned by the finance company during the life of the agreement) should no longer be treated in the same manner as bank loans secured on physical assets, as the risks are completely different

a) Introducing a specific risk weight for leasing exposures under the Standardised Approach would bring it more in line with the real risks, while also ensuring any output floor does not result in excessive limits on the IRB Approaches

b) Haircut should be reduced for lease exposures, as if not adjusted leasing would require a regulatory LGD of 16%[6]

c) A leasing specific regulatory LGD under the IRB-F Approach, different to “other physical assets”, would ensure physical asset specialists like lessors are not penalised

d) Any input floors should be calibrated at levels which do not artificially raise LGDs for low risk business models

LEASEUROPE PROPOSALS FOR BETTER RECOGNITION OF LEASING’S LOW RISK

a) STANDARDISED APPROACH	
Amend Art. 122 & 123 CRR to include new leasing risk weights	Proposed risk weights for leasing exposures: 50% Retail leasing / 65% Corporate leasing
IRB-FOUNDATION	**IRB-ADVANCED**
b) Add specific haircut for leasing collateral of 20% OR equivalent overcollateralization of 125%	
c) Specific leasing collateral in Art. 230(2) Table 5 CRR: 20% leasing LGD	d) Specific LGD input floors for leasing portfolios (both Corporate & Retail): 10% secured leasing / 20% unsecured leasing

6. *“Capital Requirements for Leasing: A Proposal Adjusting for Low Risk”, 2017, University of Cologne for Leaseurope.*

How Europe benefits from these proposals

Excessive capital requirements not only restrict a lessor's ability to lease, they also make it harder for leasing firms to attract funding, with both impacting their ability to continue supporting European business

Well calibrated capital requirements will boost the capacity for leasing to fund productive assets

> Oxford Economics estimated a modest increase in leasing could raise GDP by 0.7%[7]

European businesses, particularly SMEs, would benefit from greater access to leasing, with employment increasing as a result

> 22% of SMEs reported an increased need for leasing, higher than any other form of finance[8]

By supporting the use of energy efficient technologies, low emission urban mobility and recycling/reuse of goods, leasing promotes a greener Europe

> For example, CO_2 emissions of the leased car fleet are more than 8% lower than all cars in the Netherlands[9]

>BEUC report finds that leasing is a cost-efficient way to finance zero emission vehicles[10]

Incentivising less risky lending would lead to better quality portfolios, contributing to the stability of the European financial system

Credit risk weights under prudential standards (i.e. Basel III and CRR) should reflect the real underlying risks. Failure in this could lead to otherwise healthy, beneficial lending being restricted and disincentivised in terms of capital allocation and cost of funding.

WHAT CAN THE EUROPEAN UNION DO?

The EU now has an opportunity to take the lead by supporting a form of finance that has been proven over the years to be both low risk and sustainable, which is critical for future growth and the move towards a more environmentally friendly Europe. European implementation of the new Basel standards should support a sustainable financial system, without hampering growth

Basel3
A research project by Leaseurope

Reports on leasing risk profile available

- Capital Requirements for Leasing: A Proposal Adjusting for Low Risk, Cologne University (2017)
- European Leasing: An Industry 'Prospectus', Deloitte (2014)
- The Risk Profile of Leasing in Europe: The Role of the Leased Asset, Deloitte (2013)
- Implicit Risk Weights for SME Leasing in Europe, Deloitte (2013)

7. Oxford Economics report on The Use of Leasing Amongst European SMEs, 2015
8. European Commission, Survey on the access to finance of enterprises (SAFE), 2017
9. VNA figures for leasing and ICCT data on all passenger cars, from 2014-2016
10. Element Energy report for BEUC & ECF on the Availability & Affordability of ZEVs, 2018

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GLOSSARY OF KEY TERMS:

Probability of default (PD) – the likeliness that a customer will default on their loan within the next year, based on historical data from similar types of clients

Loss given default (LGD) – if a customer defaults, what percentage of the money they owe is likely to not be recovered, either based on historical data or set by regulators

Haircut/overcollateralization – the proportion which is taken away from the market value of collateral on a loan, to account for the fact the realised sale price may be lower

Retail exposures – defined in the CRR as lending to a natural person or SME where the total value of loans per client is not more than €1 million

Corporate exposures – defined in the CRR as lending to SMEs and corporates where the total value of loans per client is more than €1 million

Expected loss – the loss a bank could expect based on historical experience under normal market conditions, usually a bank would hold sufficient provisions for this

Unexpected loss – any losses over and above the expected losses which were not predicted and therefore not provisioned, which is why banks are obliged to hold additional capital

YOUR CONTACTS

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ABOUT US

Leaseurope brings together 45 member associations representing the leasing, long term and/or short term automotive rental industries in the 32 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, machinery, ICT and real estate). It also includes the short-term rental of cars, vans and trucks. The types of institutions represented by the Federation include specialised banks, bank-owned subsidiaries, the financing arms of manufacturers as well as other, independently-owned institutions. It is estimated that Leaseurope represents approximately 94% of the European leasing market.

www.leaseurope.org