

PRUDENTIAL REGULATION OF LEASING

Why is leasing important for the European economy?

In 2018 leasing firms helped European businesses invest in assets worth more than €384 billion, reaching **€802 billion of outstanding portfolio** at the end of the year. Leasing is a relevant form of finance for more European SMEs than any other individual form of lending aside from short-term credit lines (around **47% of all European SMEs**)¹ and is also popular amongst larger corporates. Leasing is also used to support the public sector (e.g. leasing of equipment/vehicles to schools, hospitals, etc.).

Leasing will be essential for **financing the sustainable transition**, promoting a circular economy and sustainable mobility. By allowing asset use without asset ownership, leasing could enable a fundamental shift in traditional consumption and production models towards “the circular economy”.

Leasing companies are on the forefront of providing efficient and innovative equipment management **mobility solutions** for businesses and private individuals. By ensuring assets are matched with customer needs whilst at the same time setting a gold standard for repair and maintenance services, leasing companies ensure the **reduction in environmental impact** of business activity is continuously improved upon. Furthermore, leasing companies are pioneering the deployment of assets utilised for renewable energy generation, providing services on a single asset to entire turnkey operations.

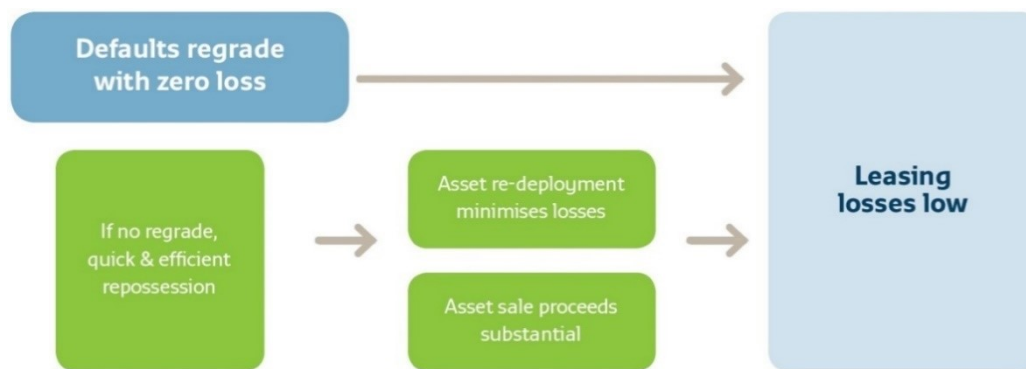
At the same time, our industry plays a pivotal role in registering the cleanest passenger cars and commercial vehicles with European fleets, thereby significantly improving the environmental impact of mobility. Moreover, leasing companies also ensure the best maintained vehicles enter the nearly new car market.

Why is leasing low risk?

As leased assets are normally **critical pieces of equipment needed to run a business**, in difficult situations lessees have a tendency to prioritise lease payments over other commitments. Therefore, leasing default rates tend to be lower than those for traditional loans. Even in cases where a default does occur, the importance of the leased asset for the business continues to play a role in incentivising lessees to return to a healthy payment schedule, in order to avoid losing the asset. In this sense, legal ownership carries weight and in practice it is often not necessary for lessors to exercise their ownership rights in the case of a default. If the default does not regrade to healthy, the lessor can significantly minimise losses through the sale or re-lease of the asset. As the **lessor is the legal owner of the asset** this process is also usually quick and efficient, e.g. there is no need to force the client into bankruptcy. In many cases, the sale of the asset will cover a significant part of the lessor’s outstanding exposure. In fact, it is even possible for a lessor to make a gain in situations when the market value of the asset to be sold exceeds the outstanding payments at default.

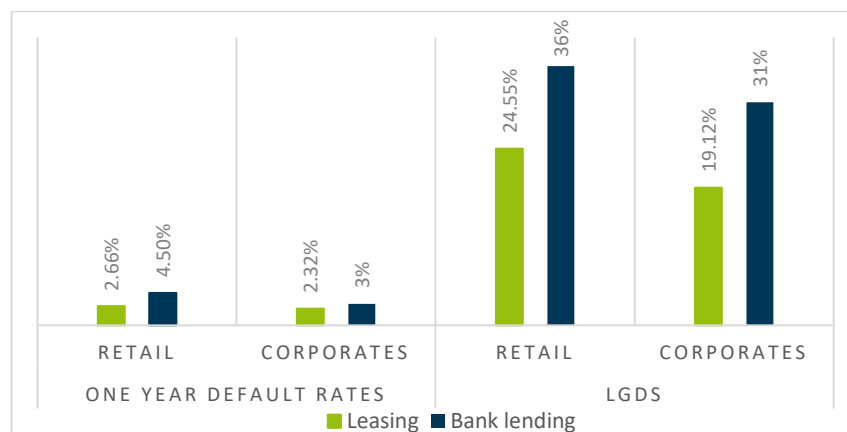
¹ See [European Commission SAFE Survey report for April – September 2019](#).

Lessors are able to maximise recoveries through sale of the leased asset because they are **asset experts**, building tailored approaches to managing and realising residual values. Recovery is performed according to the asset type, involving remarketing experts to assess the best course of action in the event of a default, including re-lease or resale possibilities. For instance, lessors often have access to local as well as global resale markets, and can sell the asset through auctions, vendor networks, wholesale, direct or use online marketplaces to make sure they maximise asset sales. Lessors also often work in close partnership with the asset manufacturers to reduce asset risk, for instance having buy-back agreements with them at a set price under certain conditions. For lessors, asset risk and management is part of their core business. Other lending products are typically not secured on the basis of physical collateral (e.g. other lenders have a preference for guarantees, etc.) as providers of these products do not have the same expertise as lessors when it comes to evaluating and managing physical assets.



What were the losses for leasing as a result of the financial crisis?

In Europe, Deloitte² undertook extensive research on our behalf which demonstrates that the **leasing business model leads to significantly lower risk compared to traditional lending**. The graph below shows that default rates and Loss Given Default (LGD)s 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.



² See [Deloitte, The Risk Profile of Leasing in Europe: The Role of the Leased Asset, 2013](#)

What is the required regulatory capital compared to actual unexpected losses for leasing?

Table 1 below presents the main results of the Cologne University³ research calculations for the current CRR. For all three regulatory credit risk approaches, **capital requirements are much higher than the unexpected losses** for leasing in a downturn simulation. As expected, the Standardised Approach (SA) yields the highest regulatory capital requirements followed by the Foundation Internal Ratings-Based (F-IRB) approach, with the Advanced Internal Ratings-Based (A-IRB) approach leading to the lowest regulatory capital requirements. However, even the A-IRB approach requirements are still almost **five times higher** than the unexpected losses in the simulation.

The realised losses were never higher than the regulatory capital requirements in any of the simulations performed (10,000 per year). Note that the realised losses include expected as well as unexpected losses, whereas capital requirements are designed to cover only unexpected losses. In this respect, the comparison of realised losses and capital requirements is **extremely conservative**. This result underpins the main conclusion that current regulatory capital requirements do not account for the low risk profile of leasing exposures in an appropriate way. Therefore, introducing even more conservative changes in the prudential framework will have a **significant negative impact for the leasing industry**.

Table 1: Comparison of regulatory capital requirements and unexpected losses split by years

	2007	2008	2009	2010	2011	Total
Standardised	8.17%	7.97%	8.33%	8.44%	8.50%	8.31%
IRB-Foundation	5.29%	5.41%	5.92%	5.94%	5.92%	5.76%
IRB-Advanced	4.03%	4.57%	5.56%	6.12%	6.50%	5.55%
Unexpected loss	1.03%	1.45%	1.29%	0.65%	0.52%	1.09%

What is the issue with the prudential treatment of leasing today?

In Europe more than 80% of the total leasing volumes are provided by leasing companies regulated under the CRR directly or indirectly through parent company's consolidated reporting. For this reason, it is critical to support lessors' financing of business investment by recognising the low risk profile of leasing within the CRR through the inclusion of a **new category for movable leasing**, as is already the case for real estate.

Under the **Standardised Approach**, the risk weight implicitly reflects both Probability of Default (PD) and LGD risk parameters. For smaller unrated Corporates, which is an important part of the leasing portfolio, the risk weight is 100%. For Retail exposures, the risk weight is 75%. This means that currently the Standardised Approach **treats leasing in the same manner as an unsecured loan**, ignoring the impact that lease collateral has on risk. Currently, only those lessors using the Standardised Approach are penalised by this treatment, however with the introduction of output floors in the Basel III agreement these issues will also significantly penalise lessors following the IRB Approaches as their capital requirements will be benchmarked to the Standardised Approach levels.

³ See [Cologne University, Capital Requirements for Leasing: A Proposal Adjusting for Low Risk, 2019](#)

In addition, the introduction of **LGD input parameter floors** for secured and unsecured lending unjustifiably penalise lending products with intrinsically low levels of losses, like leasing. Furthermore, the Basel proposal to increase **over-collateralisation** requirements to 166% of the exposure value in order to consider lending as 'secured' is far too conservative for lessors that, unlike bank lenders, have asset management as a core capability. As a result, even more leasing exposures would be considered 'unsecured', leading to effective input floors that are unnecessarily high. Clearly in the case of leasing, the input and output floors are not catching 'outlier' values and **limit the benefits of sound risk management**.

In conclusion the current CRR already penalises leasing companies following the Standardised Approach and the finalisation of Basel III will penalise IRB lessors even further.

Why didn't the BCBS solve this issue in their proposal?

When Leaseurope raised these issues with the Basel Committee, they responded that our case was based only on European data and that our request was a **European rather than an international issue**. Therefore, they suggested that we deal with this in the European implementation.

In Europe, this is a relevant issue as the majority of the leasing portfolio is subject to capital requirements, which is not the case for all the other jurisdictions applying Basel rules.

How to solve the issue in the CRR in Europe

To better recognise leasing's low risk profile, we propose a **differentiated prudential treatment for leasing in Europe** as its business model and risks are completely different to other types of lending.

To summarise, we would propose the following:

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

- Introducing a **specific risk weight** of 50% for retail movable leasing and 65% for corporate movable leasing 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.
- Haircut should be reduced** for lease exposures, as if not adjusted leasing would require a regulatory LGD of 16%.
- 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

How did we come up with our proposals?

In deriving **leasing risk weights for the Standardised Approach** we had two requirements 1) that it cover unexpected losses for leasing and 2) that it is not lower than those under the A-IRB approach. For the first part, Cologne University did 66 different scenarios of various risk weights each using 10,000 bootstrap simulations randomly selecting portfolios of 40,000 contracts. For each of these simulations, the capital requirements with the proposed risk weights was compared to the unexpected loss for that portfolio. They found that a risk weight of 35% covers unexpected and expected losses in 99.9% of cases. However, this would result in capital requirements for the Standardised Approach being much lower than those for the IRB-A. Therefore, we benchmark the proposed Standardised risk weights for leasing to those calculated using the A-IRB Approach for our portfolio. A leasing factor that equalises capital requirements under the Standardised Approach and the A-IRB approach is calculated for each year, exposure class and asset type and a conservative buffer of 5% is added on top. We then use averages across these to come up with our proposal.

Under the **F-IRB-Foundation approach**, the final LGD used is a weighted average of the regulatory LGDs for secured and unsecured exposures, where security is determined with a haircut/overcollateralisation criterion. The Cologne University takes calculated downturn LGD estimates for our leasing sample, adds a 5% margin of conservatism and rounds up to the nearest whole number. This is then considered the proposed regulatory LGD if there are no haircuts (i.e. overcollateralisation of 100%). They then do the reverse and calculate the appropriate weighted average LGD under the Basel proposal of 166% overcollateralisation. This leasing appropriate LGD varies from 29% with no haircut to 21% with 166% overcollateralisation requirement. Therefore, if the current Basel overcollateralisation requirement is maintained, we would propose a leasing specific regulatory LGD of 20% and if the Basel regulatory LGD of 25% for secured is maintained, we would propose an overcollateralisation requirement for leasing of 125%.

Regarding **input floors**, it is difficult to accurately assess the impact on lease portfolios since there are many unknowns which have a major impact, including the new definition of default which is expected to lower LGDs, and the split between secured and unsecured portfolio, which is dependent on the criteria chosen. The university estimates the impact on machinery and equipment leased assets as a case study and finds that the average LGD could easily fall below the proposed LGD floor, artificially raising the capital requirements for an entire asset class. Therefore, we propose lowering the secured and unsecured input floors by 5% each in an attempt to avoid this scenario.

On what sample dataset are our proposals based?

Our dataset includes individual contract and default data from 12 major European leasing companies, covering their activities in 15 European markets. All participating firms are either banks or bank-owned companies and are subject to EU capital requirement regulation either directly or indirectly through their parent group. Both financial and operating leases are included, as well as leases to different types of counterparty. Our dataset represents more than **2.4 million lease contracts** with a total outstanding portfolio worth €45.7 billion.



The Voice of Leasing and Automotive Rental in Europe

Our sample covers a five-year time horizon, which is the required observation period for modelling internal PD and LGD as it should cover a full business cycle. The years we include (2007-2011) coincide with the economic and financial crisis in Europe and therefore show the situation for lessors during a **very difficult downturn period**. The years after 2011 saw difficulties in some specific markets and sectors, but not to the extent of the time period covered in our sample.

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About Leaseurope

As a Federation, Leaseurope brings together 45 associations throughout Europe representing either the leasing, long-term and/or short-term automotive rental industries. The scope of products covered by Leaseurope's members ranges from hire purchase and finance leases to operating leases of all asset types (automotive, equipment and real estate) and also includes the rental of cars, vans and trucks. It is estimated that Leaseurope represents approximately 91% of the European leasing market.

www.leaseurope.org