



**The Basel Committee on Banking Supervision:
The New Basel Capital Accord
Consultative Document
January 2001**

**Comment on the recognition of the risk-mitigating effect of
physical mobile collateral**

Supporting Document to the letter of 11 May 2001 to the President of the
Bundesaufsichtsamt für das Kreditwesen
(Federal Banking Supervisory Office)

Berlin, 11 May 2001

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1 Introduction

The Basel Committee's latest proposals contain a number of substantial improvements and instances of progress compared with the first Consultative Document of June 1999. The inclusion of internal rating will give institutions the broader capacity to determine their individual capital requirements on the basis of their own estimates. To the proposed approaches of varying complexity for corporate exposures, a separate approach to the more risk-sensitive treatment of retail portfolios and a calculation method for taking account of granularity within a portfolio are now added.

Given the extremely complex nature of the proposals, the planned consultation period of four months seems too short. In order to assess the effects of the proposed regulations and so issue a detailed response, an Internal Rating Project was initiated by our member institutions. Within the scope of this project, we carried out extensive surveys about rating systems with retail banks, autobanks (car financing institutions) and specialised banks for commerce and industry. We then analysed the extent to which these rating systems satisfy the requirements of the second Basel Consultative Document, and identified further avenues for development.

In the course of the study, we were confronted with various unresolved questions that remain in need of clarification; only the broad outlines of these are sketched out in the Consultative Document. This is particularly true regarding the question of the exact level of future capital requirements. The results of the recently commenced second Quantitative Impact Study are only scheduled to be presented after the expiry of the assigned consultation period. Without precise knowledge of the final parameters, it is impossible to arrive at a satisfactory assessment of the quantitative impacts of the proposals on capital requirements for institutions and borrowers.

Among the primary borrowers from the member institutions (retail banks, autobanks and specialised banks for commerce and industry) of the Bankenfachverband (German Association of Specialised Banks) are private individuals and small and medium-sized enterprises. In order to secure the loans they take out, these borrowers are often only able to post mobile assets as collateral, especially vehicles. For autobanks, the transfer of title of ownership (*Sicherungsübereignung*) of vehicles within the retail banking business and the commercial loan business, accounting for around 90% of total collateral, represents by far the most significant securitisation instrument. It is of crucial importance for the business of our

member institutions, as other risk-mitigating techniques such as credit derivatives or netting agreements are for the most part not available to them. The non-recognition of this kind of transfer of title of ownership would be highly detrimental to these institutions, as the additional operational requirements cannot be compensated for, and the overall result would be capital requirements that were consistently higher than under the present regulatory system.

It accordingly makes sense for the scope of eligible collateral to be brought more closely into line with the forms of collateral normally used by banks. We therefore welcome the Basel Committee's stated intention to take collateral more extensively into account than hitherto in connection with prudential capital requirements. However, the scope of eligible collateral has in essence been limited to financial assets as well as residential and commercial real estate collateral. As a result, the Committee's proposals fall a long way short of reflecting the reality of collateral used in banking practice, especially in the business of lending to small and medium-sized enterprises. For this reason, the risk-mitigating impact of the transfer of title of ownership regarding vehicles should also be recognised.

2 The starting point according to the second Basel Consultative Document

For the class of corporate exposures, the Basel Committee proposes that the risk-mitigating effect of physical mobile collateral should not be recognised in either the Standardised Approach or the IRB Foundation Approach. Only in the IRB Advanced Approach does the possibility exist for banks to take physical mobile collateral into account within the framework of their own LGD estimates, provided that certain operational requirements - still in need of clarification - are fulfilled. For the class of retail exposures, physical mobile collateral are to be taken into account under similar conditions as those set out in the IRB Advanced Approach within the framework of banks' own LGD estimates. In this area, because of no operational requirements have so far been specified, considerable clarification is still needed.

3 The legal and economic arguments for the request

3.1 Request for physical mobile collateral to be recognised

The Bankenfachverband calls for physical mobile collateral to be included within the scope of eligible collateral in the **IRB Foundation Approach, the Standardised Approach for**

corporate exposures and in any potential **Standardised Approach for retail exposures**. The legal and economic arguments in favour of this request are set out below.

3.2 The legal position with regard to transfer of title of ownership

3.2.1 The legal construction

Transfer of title of ownership is a non-accessory means of security provision used in current lending practice that fills the gaps in secured lending uncovered by the rules on rights of lien in Germany. In connection with physical mobile assets, the transfer of title of ownership has become a substitute for liens on movable property, ensuring that the collateral accepted by the bank may carry on being used for economic gain by the borrower. Other countries have legal constructs comparable with the transfer of title of ownership in Germany: in France, for instance, there is the registered lien. In the absence of a relevant statute, the basis of a transfer of title of ownership arrangement is the collateral contract entered into between the guarantor and the bank. With this contract, the guarantor secures his or another subject's obligation to a bank by transferring ownership of a movable asset to the bank on a fiduciary basis; should the borrower fail to abide by his obligation, the bank is entitled to exploit its ownership of the collateral commercially. As a rule, the transfer of title of ownership occurs in accordance with §§ 929, 930 BGB (German Civil Law), i.e. through agreement on a mediated possession relationship (*Besitzvermittlungsverhältnis*) between the guarantor and the bank. As a result, despite transferring ownership, the guarantor remains in direct possession of the asset. He remains entitled to possession until such time as the bank claims the asset in order to settle the debt.

3.2.2 The legal enforceability

A transfer of title of ownership with respect to a movable asset that is performed in a legally valid manner puts the bank in a strong legal position. Among other things, this is shown by the fact that the bank can successfully fend off claims on the collateral made by third parties (e.g. by submitting the loan documents to the creditors, or launching a third-party appeal as per § 771 ZPO (German Rules of Civil Procedure) in the case of a threatened commercial exploitation of the collateral). Furthermore, should insolvency proceedings be launched with regard to the guarantor's assets, the bank has, according to § 51 InsO (German Rules of Insolvency), a so-called 'sequestration right' (*Absonderungsrecht*). This means that should the collateral be exploited commercially, the proceeds from this exploitation go to the bank (after the deduction of assessment and operating costs), even if the asset is exploited by the

insolvency administrator (§ 170 InsO). The basis for the transfer of title of ownership with regard to vehicles is provided either in the loan contract checked by the internal legal department, or in a separate, standardised, legally controlled collateral agreement; for this latter, standard contracts issued by various publishing houses within the banking sector are used.

The greatest threat to the legal enforceability of a collateral agreement comes if the bank loses ownership of the collateral due to the (unjustified) disposal of the collateral to a third party by the guarantor. However, with regard to this risk, in the case of transfer of title of ownership of vehicles it should be remembered that - according to §§ 929, 932 ff. BGB - the acquisition of a vehicle in good faith is only possible, if the associated vehicle documentation is transferred at the same time. It is anticipated that this position in property law will be implemented in the national legislation of all EU member states on the basis of Directive 1999/37/EC of 29 April 1999, which provides for the issue of an official document similar to the German '*Kraftfahrzeugbrief*' or vehicle registration document throughout Europe. For this reason, in most cases the vehicle documentation relating to transferred vehicles is kept either by our member banks themselves or at another bank's premises under the documentary collection system. On the other hand, for those customers to whom the vehicle documentation is entrusted for safekeeping on a fiduciary basis (as is sometimes the case for car dealer financing), this exposure is limited by means of regular collateral inspections conducted by the bank's own collateral inspectors. Accordingly, the legal position with regard to the agreement, acceptance and commercial exploitation of the collateral under a transfer of title of ownership may be regarded as clearly established on the basis of a definite legislative situation and many years of contract practice by the banks.

3.3 The economic assessment of vehicle collateral

3.3.1 The availability of market values and regular revaluation

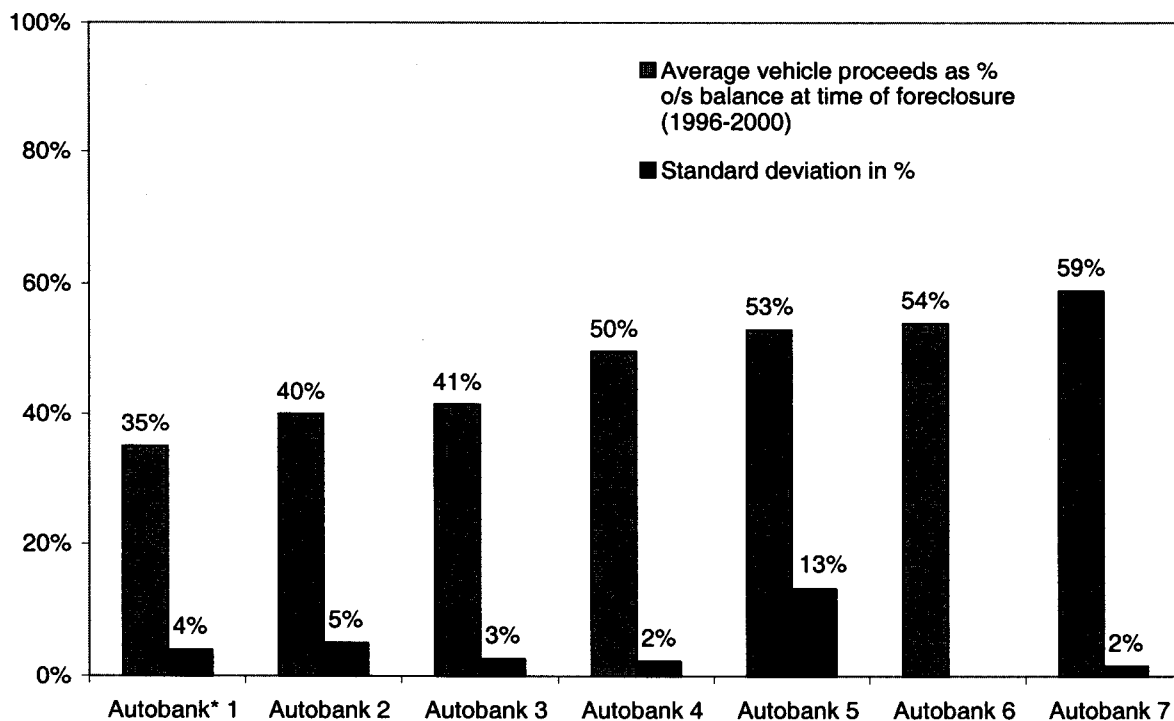
Current market values that are recognised by all significant market participants may be determined every month using comprehensive value listings, which exist for both new and second-hand cars and commercial vehicles (see, e.g. www.acmpage.com, www.eurotax.com (Schwacke-Liste), Dekra or www.dat.de). The company eurotax/Schwacke is represented throughout Europe (except for Finland and Sweden, where similar market-value providers operate), with a market share of approximately 80%; as such, it constitutes a transnational, reliable source of information for market values. Similar companies operate in this field in

Japan and in the USA, where there are at least three. To give some idea of the importance of value listings, some 6-7 million vehicles are valued and sold every year in Germany on this basis. The availability of these market values means that the banks have an objective instrument at hand with which collateral can be regularly revalued, as called for in the second Basel Consultative Document. This may be done one or more times a year.

3.3.2 Realisability of market values

Vehicle collateral may be valued as described above. The vehicles are commercially exploited via an extensive dealer network, and the proceeds are typically obtained within a month. This ensures that transferred vehicles are suitable and maintain their value.

The graph below shows vehicle proceeds as a percentage of the outstanding debt at the time of foreclosure for various autobanks during the period 1996-2000, with the associated standard deviations:



* Autobank = bank specialised in car financing

The decisive point is that, with the exploitation proceeds figures shown above for each bank, at least the market value (Schwacke's dealer purchase price) is realised. Schwacke's dealer purchase price therefore already represents a very conservative market value, as it already includes a deduction of 10-20% off the dealer's sale price (similar to the haircuts used for

financial collateral). The mean values shown likewise represent an approximation of the ratio of the adjusted market value of collateral to the exposure, which is used in the IRB Foundation Approach as a scaling factor to calculate the LGD^* . Without using a weighting scheme for the various participating autobanks, it is clear that half of the overall loan debt relating to vehicle financing is fully covered. In other words, the collateral:exposure ratio is around 50%. Finally, the operational proceeds per autobank show relatively little volatility during the surveyed period. This underlines the stability of vehicle market values. As the analysis shown here involved the participation of seven major autobanks and was conducted over a total of five years, we regard it as beyond dispute that vehicles provided as collateral should be recognised as value-sustaining, practical forms of security in an international context.

4 Proposals with regard to the recognition of physical mobile collateral

Proposal 1: Recognition of physical mobile collateral in the IRB Foundation Approach for corporate exposure

- Physical mobile collateral, especially vehicle collateral, should be explicitly included within the range of eligible collateral (paragraphs 110-114 in the document *The Standardised Approach to Credit Risk*, proposed extension of paragraph 99 in the document *The Internal Ratings-Based Approach*).
- Vehicle values from value listings should be adjusted by a conservative haircut, in order to take account of the exploitation period (approximately 10-30 days) and the valuation frequency (every month) fairly.
- This adjusted value of collateral should be taken into consideration in relation to the outstanding debt (as per paragraphs 194-202 in the second Consultative Document, “The New Basel Capital Accord”) via the adjustment of the LGD for unsecured loans ($LGD=50\%$) to an LGD^* for physically secured loans. In the case of a loan where, for example, the ratio of the adjusted market value of the vehicle collateral to the exposure was 50%, this would produce the following adjusted LGD^* :

$$LGD^* = LGD \times [1 - (1 - w) \times (C_A / E)] = 50 \times [1 - (1 - 0,15) \times (50/100)] = 28.75\%$$

This LGD^* would reduce the final risk weight, given the same default probability, in the example above, from RW to $0.575 \times RW$, i.e. a reduction of 42.5%. This would represent an economically sensible treatment of the vehicle collateral.

Proposal 2: Recognition of physical mobile collateral in the Standardised Approach for corporate exposures

It is proposed to apply a flat-rate risk weight of 50% here.

Proposal 3: Recognition of physical mobile collateral in a potential Standardised Approach for retail exposures

It is proposed that banks that do not (or may not) opt for the IRB Approach for retail exposures may substitute the risk weight of 100% by 60% if a vehicle is agreed upon as collateral by means of a collateral agreement.

5 Conclusion

In this request, an analysis is first offered of the starting position in the second Basel Consultative Document, which allows for the possibility of the recognition of physical mobile collateral in the IRB Advanced Approach and the IRB Retail Approach.

Against this background, a request is made for the risk-mitigating effect of transfer of title of ownership (or comparable international legal constructs) involving physical mobile collateral, especially vehicles, to be also accorded recognition in the IRB Foundation Approach, in the Standardised Approach for corporate exposures and in a potential Standardised Approach for retail exposures. The non-recognition of vehicles as collateral would put specialised banks, and especially autobanks, at an economic disadvantage compared with universal banks that they would be unable to compensate for. In extreme cases, this could lead to negative incentives for regulatory capital arbitrage by means of the leasing business. Although equivalent loan businesses are regulated equally in the Basel proposal, the scenario we are considering would give rise to a systematic bias to the disadvantage of the specialised banks, as the latter would be unable to compensate for the additional capital requirements for operational risks via the credit mitigation techniques (especially transfer of title of ownership) used by them.

The legal and economic arguments for this request are given. Both the legal construction of the transfer of title of ownership (and its international equivalents) involving vehicles and its legal enforceability are regarded as beyond question. The EU harmonisation process, leading to the introduction all over Europe of a document similar to Germany's '*Kraftfahrzeugbrief*' (vehicle registration document) will reinforce this state of affairs still further. In economic terms, reference is made to the existence at international level (Europe, USA, Japan) of recognised, reliable market values and the related possibility of conducting regular revaluations of vehicles. The subsequent analysis of vehicle exploitation proceeds for seven leading autobanks (including the banks of Italian, French and Japanese vehicle manufacturers) for the period 1996-2000 shows that the published market values are realisable on a sustained basis. It is also shown that the volatility of vehicle values during this period, compared with the security markets, is relatively low.

In order to make this request more explicit, the fourth section contains three proposals for the recognition of physical mobile collateral, to serve as the basis for discussion at the Basel Committee on Banking Supervision.