ASSOCIATION FRANÇAISE
DES SOCIÉTÉS FINANCIÈRES

Paris 27th march 2015

Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

Basel Committee
Revisions to the standardised approach for credit risk – consultative document

Dear Madam, Dear Sir,

Please find attached the French ASF position on the "Revisions to the standardised approach for credit risk" consultation.

Yours sincelery,

Yves-Marie LEGRAND

Deputy Manager

24 avenue de la Grande Armée - 75854 Paris Cedex 17 • Tél. : 33 (0)1 53 81 51 51 • Fax : 33 (0)1 53 81 51 50 • asfcontact@asf-france.com
Bruxelles : Rue du Luxembourg 19-21 B-1000 • Tél. : 32 2 506 88 20 - Fax : 32 2 506 88 25 • europe@asf-france.com

www.asf-france.com

ASF
ASSOCIATION FRANÇAISE
DES SOCIÉTÉS FINANCIÈRES

ASF RESPONSE TO BCBS CONSULTATION ON

REVISIONS TO THE STANDARDISED APPROACH FOR CREDIT RISK

As a unique representative body of all the French specialised credit institutions and financial institutions which represents 290 entities, ASF contributes to an appropriate recognition of the specialised financial activities like equipment and real estate leasing, factoring, consumer credit and auto loans and leases, mutual guarantee societies which – with an outstanding of more than €215 billion in 2014 – accounts for about 20% of total amount of credits to the real economy in France.

We would like to thank you for giving us the opportunity to respond to the “Revision of the standardized approach for credit risk” consultation. We would like to draw your attention to some facts and suggestions related to the specificities of our credit activities**.**

Preliminary comment

As a preliminary comment, ASF would propose that risk drivers for a revised standardized approach take into account the specificities of the credit activity of specialized credit institutions.

Leasing activities

The unique feature of a lease is the lessor’s ownership of the leased asset. These ownership rights provide lessors with a valuable and efficient form of in-built security which makes leasing extremely low-risk. Asset ownership represents a major advantage for lessors compared to other financial products such as traditional loans, which are typically not secured on physical assets but rather with financial collateral or personal guarantees.

Leasing activities of ASF members are secured by the property of the asset. This direct ownership of the financed asset by the credit institution provides its exposures to individual, retail and corporates exposures with specific and solid collateral. We consider that this asset property collateral specific to leasing should be considered as a positive risk driver.

Concerning leasing activities, Deloitte undertook research on behalf of Leaseurope, the European leasing and automotive rental association, including two reports “Implicit Risk Weights for SME Leasing in Europe” and “The Risk Profile of Leasing in Europe: the role of the leased asset” which demonstrates that default and loss rates for leases are significantly lower than for traditional lending.

Factoring activities

Factoring is a self-liquidating exposure where the default risk of the client is mitigated and subordinated to the risk of dilution and/or default of the assigned debtor. Moreover, in non- recourse factoring, the factor also provides credit coverage on the debtor exposure, so that, depending on the agreement, the default risk of the debtors may be actually and completely transferred from the client to the factor.

In factoring activity, Loss Given Default (LGD) ratio is usually lower than the 45% level assumed in the proposal to determine risk weights since the factor, during the relationship, can monitor the trend of the payments by the debtor and intercept earlier than other financiers any signal of decay in credit quality. The Expected Loss Ratio for factoring exposures is very low.

As EUF, of which ASF is a member, we consider that there is a strong case for the introduction of a specific approach for factoring exposures, and in particular: i) to allow the possibility to weight the factoring exposure to a client accordingly to the risk weight of the assigned debtors, ii) to provide a lower, specific risk weight for factoring exposures, by way of a cap or a cutoff on the applicable risk weight.

Guarantee financial institutions
Most residential loans are secured in France by guarantees ("cautions") and not by mortgage. This type of guarantee, that have proved to be at least as solid as mortgage (see Q9), and that is recognized in EU regulation, should be permanently named and considered equivalent to mortgage in BCBS papers.

General comment

The proposed modifications lead to an increase in almost all the risk weight coefficients, whereas BCBS claims that it is not its intention. We estimate that the table proposed for credit institutions leads to an increased risk weight of 20 to 30%; the table proposed for corporates leads to an increased risk weight of 20 to 60%, the table proposed for residential real estate leads to an increased risk weight of 25 to 30%.
As the risk weight levels of the revised standardized approach are expected to be used in the definition of the Capital floor, it is important that the final risk weight do not diverge in a too large extent from the IRB approaches levels.

Q1. What are respondents' views on the selection of the capital adequacy ratio? In particular, is the CET1 ratio superior to the Tier 1 ratio or the Leverage ratio? Do respondents agree that it is necessary to require calculations in accordance with Basel III in order to ensure a consistent implementation?

No comment

Q2. Do respondents believe the net NPA ratio is an effective measure for distinguishing a bank exposure's credit risk? What alternative asset quality measure, if any, should be considered by the Committee?

The net NPA ratio can be an effective measure of the quality of banks' balance sheet, but it also can be misleading in specific situations. For instance, French Guarantee Funds are not recognised under the regulatory capital calculation rules, while they are economically covering credit risk. Thus, the use of external ratings should be allowed by the regulator in specific situations, in order to reflect banks' balance sheet quality more accurately.

We underline the fact that comparability should be sought in NPA and CET1 definition in the proposal, since currently there is a lack of harmonization in the prudential and accounting definition across jurisdictions.

Q3. Do respondents have views on the proposed treatment for short-term interbank claims?

Credit institutions specialized in activities such as factoring, leasing or consumer credit may have few or no deposits. Short term interbank exposures must then be treated in a preferential way in order to ensure interbank liquidity. The proposed floor risk weight of 30% corresponds to an increase of 50% that is not justified.

Q4. Do respondents have suggestions on how to address these concerns on the treatment of exposures to banks? In particular, do respondents have views on how to treat exposures to banks not subject to Basel III in a consistent and risk-sensitive manner?

ASF agrees with the assessment that financial institutions will be treated as exposures to banks "*provided that these firms are subject to prudential standards and level of supervision equivalent to those applied to banks*", since many of its members are financial institutions regulated under the status of "Sociétés de Financement" (financing companies) and so duly regulated in France in a framework equivalent to CRR4 (Solvency and large exposures).
Yet, ASF is concerned by the precisions included in Paragraph 12 and 19 of the Annex, and propose that they should be suppressed: financial institutions deserving to be included in banks exposures do not necessarily collect deposits and may have been granted by National Competent Authorities (NCA) specific liquidity requirements.
Therefore, we ask for a clarification of this assessment to make sure that specialized financial institutions such as the French "Sociétés de Financement" (financing companies) are considered as bank exposures.
A treatment of these financial institutions as corporates would be punitive and not justified.

More generally, we consider that the use of external ratings should be allowed by the regulator in specific situations, in order to reflect banks' balance sheet quality more accurately.

Q5. Do respondents have views on the selection of risk drivers and their definition, in particular as regards leverage and the incorporation of off-balance sheet exposures within the ratio? Would other risk drivers better reflect the credit risk of corporate exposures?

As presented in introductory comments, we suggest to consider risk according to the type of credit activity. Asset based lending to corporates such as factoring and leasing should benefit a better risk treatment.

There is a strong case for differentiating lease exposures where the asset is owned by the credit institution during the life of the loan, from other corporate exposures. The main arguments presented in the demonstration included in Q9 could be taken into account to consider corporate exposures. The unique feature of a lease is the lessor's ownership of the leased asset. These ownership rights provide lessors with a valuable and efficient form of in-built security which makes leasing extremely low-risk. Asset ownership represents a major advantage for lessors compared to other financial products such as traditional loans, which are typically not secured on physical assets but rather with financial collateral or personal guarantees.

The current proposal is not adapted to factoring activities, in which the risk is transferred from the client to the factor. In factoring, LGD appears to be much lower than the 45% level assumed in the proposal to determine risk weight. The fact that the factor, monitors the trend of the payments by the debtor leads to very low Expected Loss Ratio for factoring exposures.

More generally, we consider that the use of only two risk drivers is too restricted and does not reflect the diversity of counterparties and activities. For some types of corporates, risk drivers as proposed are not calculable or inappropriate. Risk drivers should be determined according to the type of activity.
If leverage is to be a risk driver, then it would be better to assess relative leverage: too much leverage can introduce risk but the amount of leverage needs to be seen in relation to the industry, the asset intensity of the company, its operating model and other factors.
For instance, the leverage ratio cannot be applied to insurance companies, which as proposed leverage ratio will always be superior to 5 and then lead to a 90% to 130% risk weight, when some of the concerned companies in France are currently rated between A+ and A-. A specific treatment for insurance companies seems necessary, with risk drivers inspired from the Solvency II European

regulatory framework. We consider that a specific treatment is necessary regarding exposures to insurance companies, especially owing to their role in financial risk mitigation, and to their contribution to the most efficient risk allocation across various players and sectors. European regulators have put tremendous efforts in the new Solvency 2 framework, to ensure that capital requirements be closely aligned with risks taken. We think that levels of SCR (Solvency Capital Ratio) would be far more meaningful as risk drivers for these counterparties even though they may exhibit a volatile pattern.
For non-European entities, several jurisdictions have been deemed equivalent to Solvency 2 by regulators, and the risk metrics used in these countries would also be more relevant than blind measures based on leverage and turnover. Country specific calibrations (and even at business line level: Life / Non-Life) would enable to capture these fundamental specificities more accurately.
For instance, loss ratios and combined ratios could usefully complement risk assessment as far a Non-Life companies exposures are concerned.
We suggest thus the Basel Committee to use risk indicators relevant to the insurance industry.

Another example is Stock financing of new cars, an activity in which clients are car dealers. The maturity of contracts is generally very short, as the loan much be repaid as soon as the car is sold to final customer, which means that the major part of the contracts are repaid within 3 months. It is a low risk activity with LGD generally lower than 10% as the loan is secured by property of the asset, which can be easily and shortly repossessed, and which value is secured by buy-back agreements with automotive makers and the existence of a liquid market. As car dealers are generally small corporates with a high leverage ratio, risk drivers proposed for corporate exposures are not representative of the actual risk of this activity.

The current proposal penalizes corporates that may have low level of equity but which exposures are adequately collateralized. In general, we believe that it is not appropriate to limit the risk analysis to only two drivers. Collateral, pledged assets and guarantees are important risk management tools for a bank and should be taken into account for risk weighting.

We also underline that the proposed risk drivers could differ from one jurisdiction to another due to the diverging accounting rules. For a given product accounting measurement will be different due to the applicable framework (US GAAP, IFRS, French GAAP…), which is in contradiction with the comparability purpose of the proposed standard approach. This could have high impacts on the leverage ratio, and introduce a distortion of competition.

Q6. Do respondents have views on the appropriateness of the proposed treatment, especially with regard to SMEs? And about the more lenient treatment for start-up companies?

We are very concerned with the proposed weighting risks for SMEs.
ASF members are very much involved in SME financing. For instance in 2013 SMEs represented 74% of ASF members' clients in equipment leasing and more than 50% in factoring and real estate leasing.

The proposed matrix leads to an increase in RWA, since corporates with revenues < 5 M€ and between 5 M€ and 50 M€ would be at least weighted 90%, whereas high quality SMEs are currently treated with risk weight between 20% and 50% in France, through Bank of France rating in standard approach, or in IRB models.

We are concerned that credit institutions will need to collect recent financial statements from small businesses, many of which are not currently required to file their whole accounts on public record. At present credit institutions are able to use automated links to external credit rating reports (of which Bank of France reports in France). The proposal that credit institutions must apply a risk weight of 300% to exposures to an obligor that has not provided its revenue and leverage data to the lending bank is punitive and could be highly damaging to many small businesses.

Q7. Do respondents think that the risk sensitivity of the proposal can be further increased without introducing excessive complexity?

As exposed in preliminary general comments and in Q5, risk sensitivity for corporate exposures would be increased by taking into account the low-risk nature of asset based credit activity such as leasing and factoring transactions due to the credit institution’s property of the asset all along the life of the loan.

It should then be considered to introduce a positive risk driver linked to the fact that the exposure is secured by the ownership of an asset, all along the life of the loan, and is not directly dependent on the revenues generated by this asset (which is a main difference between asset based lending and “specialized lending” as defined in this consultation, cf. Q8).

Q8. Do respondents agree that introducing the specialised lending category enhances the risk sensitivity of the standardised approach and its alignment with IRB?

ASF want to make a strong case that we do not consider specialized credit activities such as leasing, factoring and consumer credit, that may in current life be named « specialized lending » to be included in the “specialized lending” exposures as defined in the consultation.
Leasing and factoring, for instance, are asset based lending, but instead of carrying extra risks, they are more secured than any other loan due to the credit institution direct property of the asset. Most assets financed in leasing do not generate direct revenues, and if they do, the payments of installments or rentals do not directly depend on the revenues generated by these assets.

Q9. Can respondents suggest, and provide evidence on, how to increase the risk sensitivity of the regulatory retail exposures treatment, either by differentiating certain product subcategories for which a specific risk weight may be appropriate; or by suggesting simple risk drivers that could be used to assess the risk of all retail exposures?

As presented in introductory comments, we consider that there is a case to consider risk weighting according to the type of credit activity. Asset based lending, such as leasing or factoring, to retail counterparties should benefit a better risk treatment.

As far as leasing is concerned, according to a Deloitte research study undertook on behalf of Leaseurope, the European leasing and automotive rental association, which was based on a portfolio of 3.3 million lease contracts in 15 European countries, one-year defaults on leasing Retail SME exposures were 2.7% compared to 4.5% for all Retail SME lending in 2010. Similarly, Loss Given Defaults for leasing were 19.6% compared to 33% for all Retail SME lending.

Default rates within the leasing activity are low because the lessor is funding a physical asset crucial to the client’s core business activities. Businesses therefore prioritize lease payments because they need these assets to run their business. As the asset is a key working tool for the lessee, many defaulted leases return to a healthy situation with a zero loss.

Additionally, ownership of the asset makes repossession relatively fast and straightforward for the lessor (if it is necessary at all). The lessor can then sell or re-lease the asset in order to decrease any losses on the default. If the value of the asset exceeds the amount outstanding at default, the lessor can actually make a gain in the case of a default.

The mentioned study makes a compelling case for specific risk drivers for lease exposures. We then think the extent to which a lending facility is secured by durable goods (ref. Par. 2.4, ii) can be a strong factor for a differentiated treatment from other retail exposures, and we consider that Retail leasing exposures deserve a lower risk weighting.
For example, auto finance (loans and leases) could be treated as a specific subcategory in the retail portfolio regarding its low risk profile. Information on the performance of auto finance activities is publicly available and can be collected from rating agencies' pre-sales reports on asset-backed securities auto loans[1].

Referring to our preliminary comment, we underline that Retail mortgage loans should be included in the residential mortgage loans exposure category whatever the type of guarantees they are backed with: guaranteed loans or mortgage loans. In France more than 50% of residential real estate loans are guaranteed by specialized guarantee funds that are regulated in a framework comparable to CRR4 (or by insurance companies regulated by the Solvency II regulation). In France in general, during recessions in 1992/1993 and since 2007, during real estate market contractions in years 1991/1996 and 2008/2009, the final cost of risk never went over 0,135%. This rate was in 2013 of 0,06%. Guaranteed residential estate loans present a specifically low risk profile. For those residential loans guaranteed by guarantee funds, those levels are still lower by 50% as proved in annual research studies of the french regulation Authority (Autorité de Contrôle Prudentiel et de Resolution – ACPR) on real estate financing, and the Joint Forum publication in february 2013: «Mortgage insurance: Market Structure, underwriting cycle and policy implications", Annex 2 p 22 à 25.

More generally, we would like to make the following points:
- We believe that the limit on the aggregate exposure to a single counterparty should be set at a higher level than 0.2%. This limit could make it harder for smaller financial institutions to compete with larger players.
- Small corporates currently included in the retail portfolio may be excessively impacted by a transfer into the corporate portfolio. The proposed definition of retail and the requirements to be considered as retail must be accurately defined and stable.
- The proposed matrix should include a segmentation allowing a lower risk weight for high quality exposures which LTV is under 60% and DSC under 35%.

Q10. Do respondents agree that LTV and/or DSC ratios (as defined in Annex 1 paragraphs 40 and 41) have sufficient predictive power of loan default and/or loss incurred for exposures secured on residential real estate?

DSC can be considered as a right risk driver for residential real estate exposures.
Yet, we underline the fact that it seems difficult to harmonize its calculation across all jurisdictions. It should then be defined in a very simple and stable way.

Q11. Do respondents have views about the measurement of the LTV and DSC ratios? (In particular, as regards keeping the value of the property constant as measured at origination in the calculation of the LTV ratio; and not updating the DSC ratio over time.)

DSC after tax should be defined in a way that allows its calculation in all jurisdictions.

We consider that rents generated by the residential real estate financed specifically in the objective of generating rental revenues should be taken into account in the solvability analysis.

[1] See for example recent pre-sale reports for RCI Banque by DBRS and Standard & Poors.

We propose that the risk weight table, mainly taking LTV into account, should be better segmented through DSC. As it is proposed, it leads to risk weights much too superior to the 35% currently used.

We also consider that it is not logical that a guaranteed exposure could be affected a 100% risk weight when a not guaranteed exposure in “other retail” exposure category could be affected a 75% risk weight.

Q12. Do respondents have views on whether the use of a fixed threshold for the DSC ratio is an appropriate way for differentiating risks and ensuring comparability across jurisdictions? If not, what reasonably simple alternatives or modifications would respondents propose while maintaining consistent outcomes?

DSC is a right criterion, yet it should be better segmented in the table to allow a more balanced impact when combined with LTV.
We propose the following segmentation:
<=20%, >20% et <=30%, >30% et <=35%, >35% et <=40%, >40%.

Q13. Do respondents propose any alternative/additional risk drivers for the Committee’s consideration in order to improve the risk sensitivity in this approach without unduly increasing complexity?

We propose to consider besides LTV and DSC other risk drivers that have a major impact on the risk analysis:

- the life length of the loan : < = 10 y, >10 y et <=20 y, > 20 y et <30 y, <= 30 y et > 50 y, >50 y,
- the type of index : fix rate, revisable rate with a cap < 300 bp or > 300 bp, revisable rate without cap
- other securing accessories of the contract, such as insurances.

Q14. Which of the two options above is viewed as the most suitable for determining the risk-weight treatment for exposures secured on commercial real estate?

No additional comment.

Q15. What other options might prudently increase the risk sensitivity of the commercial real estate treatment without unduly increasing complexity?

According to our preliminary comment, we consider that commercial real estate leasing should benefit a specific treatment.
Real estate leasing differs from mortgages loans because the lessor maintains a direct “ownership” of the asset for the whole life of the contract. The full ownership of the leased real estate allows the credit institution to finance the entire value/cost of the asset and grants a quicker recovery/repossession of the asset in case of default of the contract.

Therefore, the approach proposed based on the LTV ratio does not fit in itself with real estate leasing activity. The application of the proposed risk weight would penalize this real estate leasing market which represents an important source of finance for business real estate investment, especially for SMEs, in some important European countries such as France, Italy, Austria and Spain.

Q16. Do respondents agree that a risk weight add-on should be applied to only retail exposures and exposures secured by residential real estate? What are other options for addressing this risk in a simple manner?

No additional comment.

Q17. Do respondents consider the categories for which a CCF is applied under the standardised approach to be adequately defined?

No additional comment.

Q18. Do respondents agree that instruments allocated to each of the CCF categories share a similar probability of being drawn and that the probabilities implied by the CCFs are accurate? Please provide empirical support for your response.

The alignment of the standardized approach to the IRB Foundation approach would have punitive effects on some guarantee financial institutions in France. For some of them, it could increase their risk weight from 20% to 75% of CCF, which could strongly threaten their business models.

Q19. What are respondents' views on the alternative treatments currently envisaged for past-due loans?

Regarding especially factoring activities, according to EUF, ASF considers the proposal too restrictive. We consider the current 150% flat risk weight for past due loans appropriate, also considering that the European Banking Authority is about to issue technical standards that could eventually increase the amount of past due loans.

Q20. Do respondents agree with the proposed treatment for MDBs?

No additional comment.

Q21. What exposures would be classified under "Other assets"? Is a 100% risk weight appropriate? (Please provide evidence where possible).

No additional comment.

Q22. What are respondents' views on the above alternative ways to define eligible financial collateral?

See preliminary comments.

Q23. What are respondents' views on the recalibrated supervisory haircuts shown in Table 4? What are respondents' views on how to eliminate references to ratings from the supervisory haircuts table? What could be the implications of eliminating references to external ratings?

We consider that for financial institutions and corporates exposures, and especially insurance companies, external guarantees should be considered as positive risk drivers.

Q24. What are respondents' views on the proposed corporate guarantor eligibility criteria?

No additional comment.