

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” second Consultation Paper.

We intend 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, as shown below, 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. In factoring activity, Loss Given Default (LGD) ratio is usually lower than the 45% since the factor is the owner of the assigned receivables and is paid by the assigned debtor.

We would recommend that factoring should be treated separately as a specific class of exposures.

At least, the role of purchased receivables as mitigants, already provided in the Foundation-IRBA with the 35% risk weight, should be extended to the SA. Credit Conversion Factor for exposures to factoring client should be kept to 0% and, in any case, should not exceed the one proposed for short-term self-liquidating trade letters of credit (20%).

Mortgage loans / Guarantee financial institutions

Most residential loans are secured in France by guarantees (“cautions”) and not by mortgage. This type of guarantee, that has proved to be at least as solid as mortgage and that is recognized in EU

regulation, should be permanently named and considered equivalent to mortgage in BCBS papers such as what is written in BCBS Consultative Document Capital treatment for “simple, transparent and comparable” securitisations¹.

We also believe that some of the operational requirements (§170 (a) in particular) are too detailed and should be left to the local regulator to appreciate. Taking the example of French public sector guarantees, which are prevalent in the social housing and associative sectors for instance, the requirement for the bank to *“have the right to receive any such payments from the guarantor without first having to take legal action”* would mean none of them can be recognized, which would be in blatant contradiction with the protection they have been shown to provide in case of financial difficulties.

Exposures to other financial institutions

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 the European Capital Requirement Regulation.

A treatment of these financial institutions as corporates would be punitive and not justified.

Short term exposures to banks and other financial institutions

ASF welcomes the fact that short term exposures receive a preferential treatment (Annex 1 - §18 referring to Table 6 §17). Indeed, 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.

Corporate and retail exposures

As a general comment, we consider that the due diligence requirements mentioned in Annex 1 - §14 and 15 should be more precisely described otherwise they might differ from one jurisdiction to another. It should also be made sure that the requirements are coherent and compatible with operational abilities, especially the necessity to review the risk profile every year.

Concerning Retail exposures, we take the view that the granularity criterion according to which no aggregate exposure to any single counterparty should exceed 0.2% of the overall regulatory retail portfolio is too restrictive and should be set at a higher level. This limit could make it harder for smaller credit institutions to compete with larger players. We recommend introducing a higher limit (of at least 0.5%) of the overall regulatory portfolio in order to be sufficiently granular while not disadvantaging smaller institutions.

Concerning credit institutions that are subsidiaries of a banking group, it should also be clarified whether the portfolio perimeter is to be considered on a solo basis or on a consolidated basis.

Loans secured by durable goods

As presented in introductory comments, we consider that risk weighting should also be determined according to the type of credit activity. Concerning retail and corporate exposures, we strongly believe that there is a case for identifying leasing as a subcategory with a predictable risk profile substantially lower than that of general business lending.

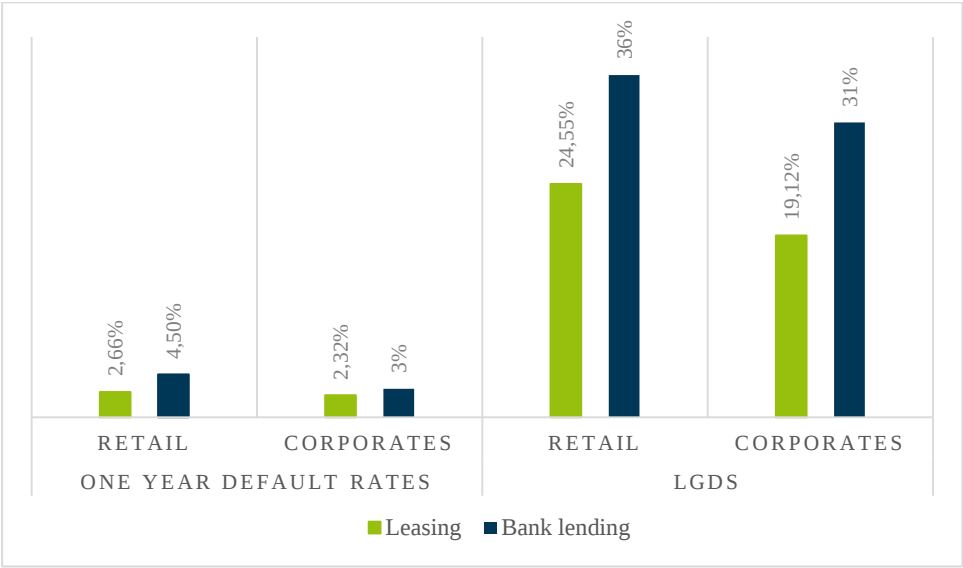
The unique feature of a lease is the lessor’s ownership of the leased asset. These ownership rights provide lessors with a valuable and efficient form of in-built security which makes leasing extremely

¹ BIS - Consultative Document Capital treatment for “simple, transparent and comparable” securitisations (novembre 2015) page 23 : “[40%] on a value-weighted average exposure basis for the portfolio (before the application of the credit risk mitigation) where the exposures are loans secured by residential mortgages or fully guaranteed residential loans”

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.

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 prioritise 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 regrade back 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, resulting in low loss rates. 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.

In Europe, Deloitte undertook extensive research (which has been shared with the Committee) on behalf of Leaseurope, the Association of leasing and automotive rental in Europe. The research demonstrates that the leasing business model leads to significantly lower risk compared to traditional lending. The graph below shows the results of the research, which was based on a portfolio of 3.3 million lease contracts in 15 European countries. The graph shows that default rates and loss given defaults (LGDs) 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. European capital requirements under the Standardised Approach are also shown to be 10 times higher than the real risks for SME leases within the Retail class.



This result is consistent with data for other equipment finance markets, for example in the US and Canada, confirming that businesses across any jurisdictions will prioritise paying for equipment finance because they need these assets to continue to run their businesses.

We believe that the risk sensitivity of the proposal can be further increased without introducing unnecessary complexity. As the current proposal does not reflect properly the real risks of leasing exposures and does not recognise physical collateral for credit risk mitigation, we propose various ways to increase the risk sensitivity of the framework:

- We regret that the TFSA did not propose any specific treatment for this type of lending, and we disagree with the notion that it would introduce undue complexity. For the purpose of this consultation, which is quite advanced in the process, we propose differentiated risk weights within an existing exposure class e.g. a specific “secured lending” or “leasing” risk weight within the Retail/Corporate classes. This could be achieved in one or two additional lines, as is done with SME exposures, with the inclusion of a workable definition.

- Ultimately, we strongly believe that there is a demonstrated case for differentiated risk weights calibrated as a distinct exposure class e.g. a new “secured lending” or “leasing” exposure class. This option will make the regulation more risk sensitive. Appropriate risk weight calibration is currently being investigated and we would be happy to provide our assistance in establishing an effective treatment.
- Alternatively, the appropriate recognition of physical collateral within the Credit Risk Mitigation (CRM) framework of the Standardised Approach could achieve a similar outcome.

Factoring corporate exposures

We would recommend creating a specific factoring exposure, as factoring activities present specificities leading to a lower risk profile compared to bank loans.

As far as the factoring exposures are concerned, the reimbursement of the funds lent to the client comes from the debtor portfolio (the clients of the client) purchased by the factoring company.

The cost of risk of the factoring entities (measured by the mean of the burn rate) has been proved to be far less than 50% of the cost of risk of equivalent portfolios run by banks.

It is our opinion that a 50% risk weight for those exposures should have to be retained for corporate factoring features, whatever the underlying type of corporate size where to the funds are lent.

This point has already been highlighted in the past, as the receivables LGD already amounts a 35% level in the § 295 of the International Convergence of Capital Measurement and Capital Standards of June 2006. Besides, we strongly advocate:

- the ability to apply the risk weight of the assigned debtor when operational requirements are met,
- and the ability to apply the facility level approach to purchased receivables, according to which every invoice would be considered as a single credit obligation.

Exposure to SMEs

ASF members are very much involved in SME financing: SMEs represent the large majority of ASF members' clients in equipment leasing, real estate leasing and factoring.

ASF welcomes the proposed 85% risk weight proposed for unrated exposures to corporate SMEs. Yet, while considering the rationale leading to this preferential treatment, ASF recommends that the risk weight should be lowered to 75%.

Specialised lending

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.

Mortgage loans

As a general comment we notice as an inconsistency the fact that unsecured retail exposures benefit from a lower risk weight than secured real estate exposures with high LTV ratios: articles relative to real estate secured exposures (from §53 to 61) suggest higher risk weights than the 75% above mentioned notably with high LTV ratios.

LTV ratio

We believe that the LTV ratio is indeed predictive of loan default and/or loss incurred for exposures secured by real estate. Yet, we suggest that the definition of the LTV ratio, in § 52, should be adapted to the current European regulation: in the BCBS proposal, the value in the LTV ratio is not updated over the life of the loan, whereas European Regulation (EU) No 575/2013 (CRR) Article 208.3 requires the value of the collateral to be updated.

Finished properties

We suggest that the conditions mentioned in the definition of finished property in Annex 1 - § 50 should be modified:

- the “one to four units” condition is tied to the definition of “multifamily” in the USA and penalizes other parts of the world, including Europe, where apartments are the norm;
- the wording of the second condition on sovereign legal power and ability to ensure that the property under construction will be finished should be improved: in France there is a legal mechanism called “Garantie Financière d’Achèvement (GFA)”, which is compulsory for any residential building under construction, and ensures any buyer/borrower that the property will be completed in case the developer defaults. Despite the fact that the guarantee is provided by an insurance company or a financial institution and not directly by a sovereign entity or a PSE, this guarantee has been instituted by law.

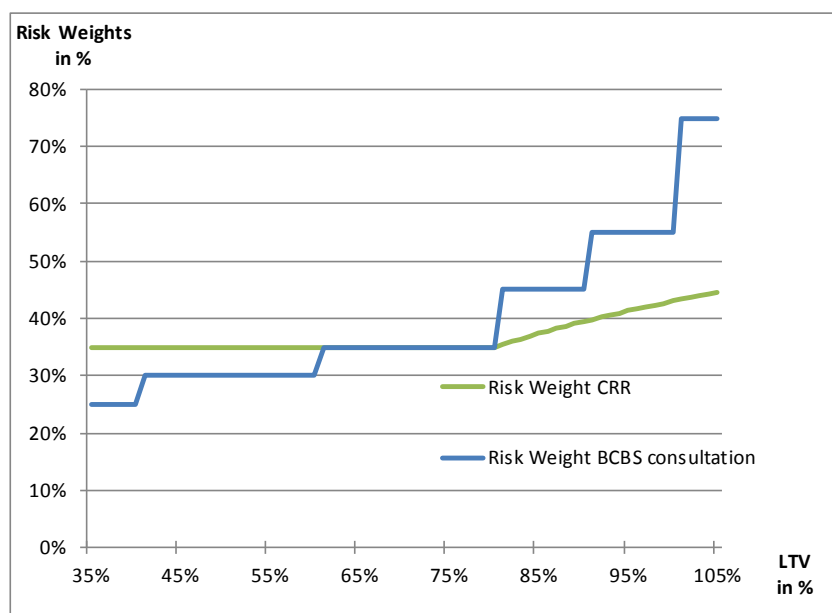
Loan tranching

Footnote 44 p. 35 states that “if a bank grants different loans secured by the same property and they are sequential in ranking order (ie there is no intermediate lien from another bank), the different loans should be considered as a single exposure for risk-weighting purposes, and the amount of the loans should be added to calculate the LTV ratio.

The requirement that the risk weight be assigned to the total exposure amount would have a significant increase in the capital charge for residential real estate. This is especially damaging for first time buyers which naturally fall into the high LTV tail for residential real estate. For example, in several EU jurisdictions first-time buyers can have an LTV well above 80%. In the revised BCBS proposal, the risk weight for such an exposure would be 75%, dramatically up from the 43% in the current Standardised Approach.

The lack of loan tranching would introduce significant cliff effects: a small incremental increase in LTV would result in a significant increase in the RW of the whole exposure.

Diagram below illustrates the cliff effects of Risk Weights depending on LTV (comparison between European Capital Requirement Regulation and current BCBS proposals), for residential real estate exposures, when the property is completed and repayment does not materially depend on cash flows:



Loan tranching is a sensible solution that avoids cliff effects and induces a better correlation between LTV and effective risk weights. It makes the framework more risk sensitive without unduly increasing the complexity of the methodology.

Consequently, we would propose the following alternative risk weightings, based on the same tranching as the one currently used in the European Capital Requirement Regulation i.e. each risk weight is the marginal risk weight of the tranche:

	LTV ≤ 40%	40% < LTV ≤ 60%	60% < LTV ≤ 80%	80% < LTV ≤ 90%	90% < LTV ≤ 100%	LTV > 100 %
Marginal RW by tranche	15%	30%	80%	90%	100%	100%
This translates into the following risk weights for loans at the following LTV levels:						
Loan LTV	40%	60%	80%	90%	100%	
Loan RW	15%	20%	35%	41%	47%	

Eligibility criteria for guarantees

We believe that some of the operational requirements (§ 170 (a) in particular) to make guarantees eligible are too detailed and should be left to the local regulator to appreciate.

With regard to sovereign guarantees (§181) we consider that a lower risk weight should be applicable even if the guarantee does not meet the operational requirement (§170 (a)) which requires that the guarantor must pay before the beneficiary first takes legal action. According to us, what matters is that the guaranty is unconditional. Whether it is paid upfront or later is less relevant. The requirement of not having to take legal action against the counterparty should be replaced by the requirement that the guarantee is unconditional.

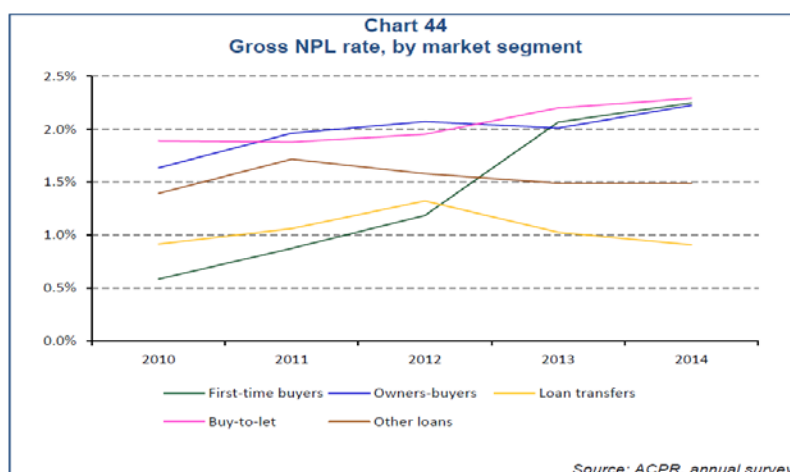
Grand-fathering clause

The increases in risk weights will negatively impact not only newly granted but also formerly approved exposures. Consequently, we strongly support the introduction of a grand-fathering clause.

Residential real estate exposures

We consider that § 54, 55 and 56 significantly negatively impact first time buyers, buy to let and properties under construction, whereas the Basel Committee mentions that “Increasing overall capital requirements under the SA for credit risk is not an objective of the Committee”.

- First time buyers financing, where LTV is often close to 100%, is heavily penalized: for a 100% LTV, risk weight is 75% in the proposal vs. currently 43% in the European Capital Requirement Regulation.
- “Buy-to-let” is also unfairly penalized (§ 56) while in France² comparable levels of losses are observed as compared with the real estate exposures that do not depend on cash flows.



In France, for loans guaranteed by guarantee funds, buy to let risk profile is only 1,5 higher than the residential loan average, whereas BCBS proposed risk weights (§ 56) are 2,5 higher.

² See Autorité de Contrôle Prudentiel et de Résolution (French NCA) analysis entitled “Housing finance in France in 2014” published in July 2015

Besides, the 150% risk weight and the 120% risk weight corresponding to LTV above 80% (§56), should the repayment capacity depend on the cash flows generated by the property securing the loan, are higher than the 100% risk weight for defaulted real estate exposures (§78) and other assets (§80). This is inconsistent with the Basel Committee statement relative to containing capital consumption quoted above.

- “Properties under construction” suffer treatment conditions that would deserve to be more finely defined, as proposed above (see “Finished properties”).

Commercial real estate exposures

We consider that Commercial real estate exposures (including real estate leasing activities that represent in France an outstanding €35 Bn) are unfairly penalized (§58 and 60), with a higher risk weight of 60% - compared to the current 50% - when LTV is < 60%.

When LTV is > 60%, the corresponding risk weight in Annex 1 - Table 12 is at least 100% which corresponds to the risk weight for defaulted real estate exposures (§78) and other assets (§80). Therefore, the second consultative document creates a situation where a secured exposure receives a higher risk weight than an unsecured exposure.

This seems inconsistent with the Basel Committee statement relative to containing capital consumption quoted above.

Leasing specificities – leasing is secured by the property of the assets and presents a lower risk profile as developed above - are not enough taken into account in the proposal. As far as leasing is concerned, we consider that the risk weighting formula based on a comparison between a fixed coefficient and the counterparty's risk weighting, as introduced in Annex 1 – table 11, especially lacks risk sensitivity. Therefore, we would recommend extending the LTV bucketing principle proposed in Annex 1 - Table 9 to real estate leasing in order to improve the risk profile accuracy.

Besides, currently a 50% risk weighting is applied to commercial real estate exposure not exceeding 50% of the market value of the asset, and the risk weighting of the counterparty applied to the residual part of the exposure. According to §58, the risk weights described in Annex 1 - Table 11 are to be applied to the entire exposure, without any possibility of splitting between the part of exposure not exceeding 60% LTV and the remaining part of the exposure. This new rule would have significant impacts in terms of RWAs of commercial real estate (including leasing) exposures.

We would recommend keeping the current rule that allows splitting risk weighting between the part of exposure not exceeding LTV buckets and the remaining part of the exposure.

Land acquisition, development and construction (ADC) exposures

The ADC exposures risk weight treatment relies on the fact that the “source of repayment at origination of the exposure is either the future uncertain sale of the property or cash flows whose source of repayment is substantially uncertain”.

In France, residential and non-residential development financing schemes rely on key protective elements, both legal and financial:

- the immediate transfer of the legal ownership from the developer to the purchaser(s) through signed notarial acts, even though the building is not completed, and the presence of a bank completion guarantee. Such practice protects all parties (developers, bankers and final buyers). It is, in particular, common in France (strongly sponsored by the national competent authority – ACPR – and legally compulsory for the completion guarantee) through the legal mechanism of VEFA (“Vente en Etat Futur d’Achèvement”, defined since 1967 by French law) and GFA (“Garantie Financière d’Achèvement”);
- the presence of signed notarial sales as condition precedent. Signed notarial sales are a key element to secure the transaction, to validate the “adequacy” of the asset within its market and to demonstrate the likelihood of the future sales coming from the residual stock and their future related cash flows;

- non-residential financing are often secured by signed notarial sales to investors under the VEFA mechanism. They can also be secured by pre-leases (BEFA: “Baux en état futur d’achèvement”) to secure as well the future cash-flows deriving from the asset(s) at completion.

These legal and financial protections have demonstrated their efficiency during the past years, with very low historical default rates observed in such activity.

Therefore, we propose the following formulation for § 61:

“61. Land acquisition, development and construction (ADC) lending will be risk-weighted at 150%. ADC includes loans to companies or SPVs financing any of the land acquisition, development and construction of any residential or commercial properties where the source of repayment at origination of the exposure is either the future uncertain sale of the property or cash flows whose source of repayment is substantially uncertain. ADC exposures will also include loans to companies or individuals to finance the acquisition of finished property where the repayment of the loan depends on the future uncertain sale of the property.

The repayment of the loan is deemed to be sufficiently secured by both the immediate certain sale of a significant proportion of the property to be developed or by the signature of pre-leases as condition precedent for the following cases:

<i>Residential / Signed notarial sales</i>	<i>Non-residential / Signed notarial Sales</i>	<i>Non-residential / Preleases</i>	<i>Non-residential / other cases</i>
<i>30% of the expected total sales revenues</i>	<i>100% of the expected total sales revenues</i>	<i>70% of the expected leases revenues</i>	<i>LTV <= 80% and a substantial amount of sales or preleases have been signed</i>

In such cases, the loan will be subject to a Risk weight of 100%.”

Real Estate asset in France is a key economic sector, strongly sponsored by the government. Development loans in France represent a stock of around €20 bn in 2015. A penalizing treatment for real estate loans, despite strong legal and financial protections, could jeopardize the financing schemes and have major impacts on a whole strategic economic sector.

Mortgage loans/guaranteed loans

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 the European Capital Requirement Regulation (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. The gross non performing rate for guaranteed loans is only 0.79%, which is much lower than the average NPL rate on residential loans (1,73% according to French NCA: ACPR).

Defaulted loans

Concerning factoring activities, ASF considers the proposal too restrictive.

We estimate the current 150% factor appropriate for past due loans, also considering that the European Banking Authority is about to issue technical standards that could eventually increase the amount of past due loans and that should also be taken into account by BCBS in this revision process.

We also consider the current rule that provides a relief in the RW applicable (100% instead of 150%) to past due loans where provisions exceed 20% of the exposure value, that has been dropped in BCBS proposal, should be confirmed.

Finally, as factoring activity is also linked to trade events that do not relate to a decrease in the creditworthiness of the debtor, we suggest that purchased receivables should be considered as being past due once the expected payment date has passed, *unless* there is evidence that the delay of the payment is due to commercial reasons other than financial difficulties of the buyer (i.e. disputes, payment flexibility, reconciliation processes, verification procedures etc...).

Credit Conversion Factors– Factoring point of view

Concerning factoring activities, ASF consider that the proposal to increase the CCF from 0% to 10%-20% for retail exposures and 50%-75% for corporate exposures is not justified. Credit Conversion Factor for exposures to factoring client should be kept to 0%.

At least, we believe that the CCF must not exceed the one proposed for short-term self-liquidating trade letters of credit (20%) as factoring is a short term and self-liquidating activity and can be assimilated, to a certain extent, to trade finance, as acknowledge by the Basel Committee itself³, and for the following reasons :

- the invoices to the final debtor are similar to the logic handled by trade letters of credits;
- they represent the formalisation of an economic transaction;
- no drawing on any credit line can be done, without having purchased beforehand adequate assets, meaning that any drawing is constrained like in the trade letters of credit.

Recognition of the credit insurers – Factoring point of view

Concerning factoring activities ASF recommends to provide a lower risk weight for exposures to debtors arising from purchased receivables that are assisted by a credit insurance contract and included in the 'plafond' (i.e. the maximum liability level) agreed by the insurer. A 35% LGD regulatory measure would be much more consistent with the empirical evidences on historical LGD for insured receivables (and even conservative, depending on the applied discount rate).

We advocate therefore either to recognise insurance contract up to the maximum liability, or to draw a specific treatment for the credit insurance taking into account the portfolio coverage characteristic of a credit insurance contract.

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³ Cf. Appendix 2 CGFS Papers No 50: Trade finance: developments and issues.