

**ASF RESPONSE TO BCBS CONSULTATION ON
REDUCING VARIATION IN CREDIT RISK-WEIGHTED-ASSETS /
CONSTRAINTS ON THE USE OF INTERNAL MODELS APPROACHES**

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 €220 billion in 2015 – 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 “Reducing variation in credit risk-weighted-assets – Constraints on the use of internal models approaches” Consultation Paper. We intend to draw your attention to some facts and suggestions related to the specificities of our specialised credit activities.

1. Preliminary comments

Europe is the first economic zone in the world, with the specificity that its economy is at 70% financed by its banking system. We then consider that Basel rules have a stronger impact on the European jurisdictions' economies, and that it should be taken into account in the Basel Committee proposed regulatory calibrations.

The current proposals would lead to a major increase in French banks risk weighted assets (RWA) in contradiction with the statement that Basel III measures would not globally increase capital requirements.

ASF considers the BCBS proposals globally detrimental to specialized credit activities such as leasing, factoring, consumer credit and real estate financing. They could lead to sharp increases in the RWAs for those activities. Some of these specialized credit activities are conducted through dedicated subsidiary credit institutions inside consolidated banking groups. There is a significant risk for these business lines to be arbitrated within deleveraging decisions due to the proposed measures. Specialised activities finance real economy activities in Europe (households and SMEs) and so, current proposals would be at the end detrimental to the financing of the European economy.

Models have proven to be reliable and are duly controlled and validated by European NCAs. We believe that parameters floors are inconsistent with the internal modeling approach. Moreover, conceptually, it seems not normal to mix standardized approach with internal models analyses. At least we believe that the BCBS objectives would not be achieved: the constraints on the use of internal models to some types of exposures, and the introduction of parameters floors would lead to less risk sensitivity, and would not increase comparability.

We estimate that BCBS proposals are to be reconsidered in the context of the current European Banking Authority work on internal models parameters - among which the definition of default that is a major source of variability - that we believe will improve comparability and reduce variability while maintaining risk sensitivity.

2. Scope of the use of internal models

We do not agree with the statement that some portfolios are not suitable for internal models. French banks can demonstrate on the opposite that the outcomes of the models on these portfolios are rather conservative, whereas standardized calculations of RWA for these concerned exposures would weaken the entire risk framework.

For example, the proposals concerning Large corporates would lead to a major raise in risk weighting for these exposures, and eventually major impacts on their financing. Indeed large corporates would fall under mandatory SA approach whereas in Europe only 25% of corporates are rated, and most rated corporates are in the BBB range. It means that in most cases risk weighting would be 100% in Europe, demonstrating a strong lack of risk sensitivity.

It may be replied that there are few large corporates, but the unauthorized internal modeling would also concern all their subsidiaries, most of which would become unduly 100% risk weighted. If prices were to increase as a consequence, it may be relied that large corporate have the ability to accede directly to financial markets. But they will still need specialised financing, such as factoring and leasing which will not be found on financial market.

3. Parameters floors

Secured LGD floors

- As mentioned in the preliminary comments, we believe globally that the introduction of floors within internal models seems counterintuitive and would reduce the risk sensitivity.
- We estimate the level of over-collateralisation required for an exposure to be considered secured too high. As a result, some corporate leasing exposures could be classified as unsecured and subject to an LGD floor of 25%, higher than the “other physical” LGD floor of 20%, despite the fact that leasing is an asset based form of lending.
- We also consider that the distinction within Qualifying Revolving Retail Exposures between “transactor” and “revolver” is not appropriate for European consumer credit industry. It would bring unnecessary complexity and probably less comparability.

20% “Other physical” floor

We consider the proposed 20% LGD floor “other physical” much too high and not granular enough. Equipment Leasing industry would be strongly hit since observed LGD for leasing are much lower.

In fact, as described in our response to the BCBS consultation paper on the “Revision of the standardised approach”, 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 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.

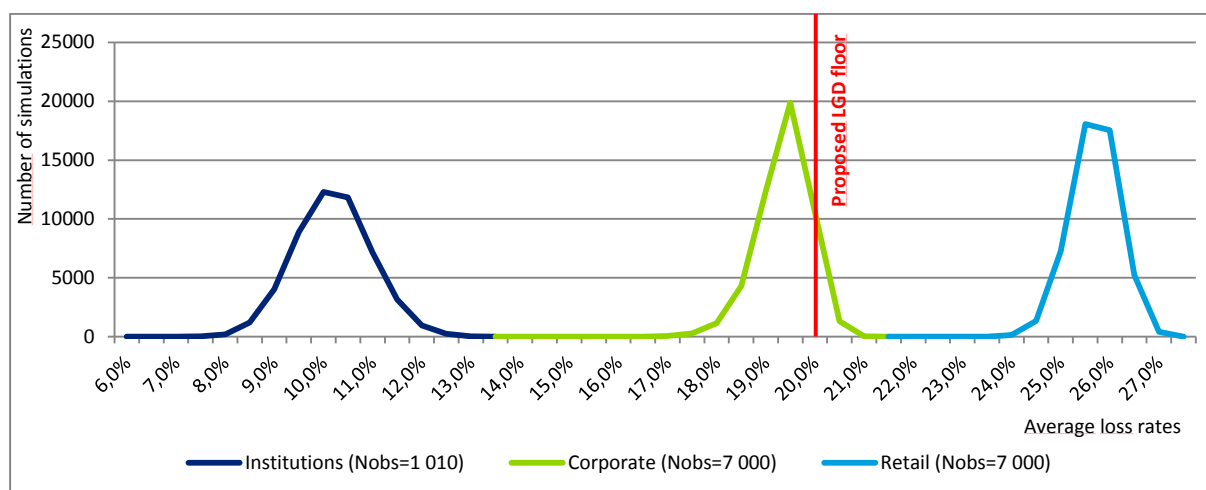
Default rates and LGD within the leasing activity are low because the lessor is funding a physical asset crucial to the client's core business activities. Businesses therefore prioritise lease payments because they need these assets to run their business. As the asset is a key working tool for the lessee,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

Additionally, the lessor owner of the asset 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.

LGD is dependent on the type of financed asset. We consider that the floor cannot be identical for all kinds of assets. A one size fits all 20% LGD floor would lead to a strong decrease in risk sensitivity compared to the current internal models.

In Europe, Deloitte undertook extensive research on our behalf (which we have attached at the end of this position) which demonstrates that leasing LGDs are significantly lower than the proposed floors for "other physical", as well as being lower compared to traditional lending. This research was based on a portfolio of 3.3 million lease contracts in 15 European countries covering the crisis years from 2007-2011.

In the light of this research work, as shown on the graph below, the proposed LGD floor of 20% for other physical collateral is far too high for corporate leasing exposures. Our distribution of estimated average loss rates show that the majority of European Corporate leases would fall under the proposed floor, which would significantly deprive internal models from their risk sensitivity on corporate leasing exposures.



These issues could be solved by introducing a lower floor for leasing exposures.

15% "Commercial or residential real estate" floor

The same assessment can be made concerning real estate financing (of which real estate leasing). The proposed 15% LGD floor is much higher than observed real estate financing LGDs in France, not granular enough and even punitive for the activity.

Moreover the proposal of a single « one size fits all » floor seems not coherent with the scaling according to LTV included in the BCBS consultation paper on the revision of the standardized approach.

15% "Receivables" floor

The proposed 15% LGD floor for exposures secured by receivables is too conservative.

Considering the low risk profile of factoring, and the much lower observed LGDs in dedicated credit institutions that have developed internal models, the impact of the proposal on RWA would be significant. If a floor is to be set, we would suggest not to set it above 5%.

Mortgages LGD floor

We believe that the LGD floor “mortgage” exposures should not be higher than 10%, which is conservative enough.

NB: Specific comment on Mortgage loans / 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 robust 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” securitizations¹.

EAD / Credit Conversion factors

We estimate that the proposal concerning the EAD subject to a floor is not justified enough, especially the percentage of use (proposed 50%) of the off balance sheet exposure using the applicable CCF in the standardised approach.

4. Parameter estimation practices and fixed supervisory parameters

Probability of defaults

More precision concerning the requirements for the modeling of PD could be useful. The proposed requirements could lead to interpretations, in opposition with the objective of increasing comparability (for example: definitions of “over time”, “business cycles”).

F-IRB Fixed LGD parameters

We notice that the proposed 20% LGD for exposures secured by receivables under F-IRB is lower than the current one (35%).

But we believe that a 50% haircut is too conservative and far from the actual practice, that consist in a financing facility that usually ranges from 60 to 80% of the outstanding amount of the receivables. Moreover, it could bring to unwanted consequences, pushing the institutions to reduce the amount of finance provided to the client in order to benefit most from the reduced LGD parameter. That could result in a counterintuitive shift towards riskier overdraft-like products.

Therefore, we would suggest that the haircut for receivables should remain at the same 20% level.

A-IRB – Secured / unsecured exposures

In general it seems difficult to identify precisely a loss on a specific downturn period, when recovery processes may last several years, and then overlap determined periods of time identified as downturn or not downturn.

We consider the term «Downturn years» not precise enough, with a risk of diverging interpretations leading to an increase of variability. There is a risk to create disparities between jurisdictions. If the objective is to increase comparability, we think that the criteria to determine this macro-economic

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**”

“Downturn years” term should be more precisely defined. For instance the criteria to be used for the choice of at least one downturn year on ten years should be clarified. Once well defined, the introduction of a floor to the downturn margin could be replaced by clear criteria to determine an appropriate downturn period.

A-IRB Modeled exposures / collateral not modeled

The proposed treatment of the collateralized part under F-IRB and the not collateralized part under A-IRB seems too complicated.

CCF

As mentioned in our response to the BCBS Consultation Paper on the “Revisions of the Standardised Approach for Credit Risk”, 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:

- 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.

Constraints on EAD where internal modeling is permitted

We estimate that proposed constraints are not clear enough, especially regarding “the quarantine of EAD / CCF estimates from the potential effects of the region of instability”.

We consider that not to cap EAD reference data to the principal amount outstanding or facility limits complex and somehow impossible to implement. EAD should on the opposite be capped to the outstanding amount and to 100% of the non-used amount of the facility.

The use of a 12 months fixed horizon estimation approach for EAD estimates seems not coherent with the idea of a default during the coming year.

Maturity

We believe that the unchanged 2.5 years fixed parameter proposed under F-IRB approach is not appropriate for institutions specialized in factoring. To increase risk sensitivity, we would propose the introduction of three buckets of regulatory F-IRB fixed values for the maturity factor “M”:

- M = 90 days like allowed in Europe in the Capital Requirement Regulation (Art. 162.2.e) of the CRR 575/2013) for the Advanced approach, as far as the purchased receivables are concerned,
- M = 1 year for exposures with duration up to one year,
- M = 2.5 year for the rest.

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