

**Assilea's Position Paper on the Basel Committee on Banking Supervision's
Second Consultative Document:
"Standards. Revisions to the Standardised Approach for credit risk"
(December 2015)**

Assilea, the Italian Leasing Association, represents the Italian leasing industry. Our members are leasing companies classed into generalist banks, specialist banks, non-banking financial intermediaries, brokers and dealers, long-term rental companies, outsourcers specialised in the leasing market. The Association's key task is to carry out institutional activities with a view to providing information and assistance to its Members and contributing towards the solution of leasing-related issues at different levels, in different domestic and international venues.

*Assilea is member of **Leaseurope** (the European Leasing Federation) and of **ABI** (the Italian Banking Association) and has actively participated to the drafting of the Position Papers released by the above mentioned Federation and Association.*

We thank you for the opportunity offered with this consultation. In this paper we outline the major concerns of our industry about the implementation of the Second Consultative Document: "Standards. Revisions to the Standardised Approach for credit risk" (December 2015), referring to the Leaseurope's and ABI's Position Papers for the more general questions.

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General overview

We very welcome the major improvements introduced in this Second consultative document regarding to:

- a more favourable risk weighting treatment for the unrated SMEs exposures which do not meet the criteria to be treated as regulatory retail exposures;
- the deep revision of the real estate exposures' risk weighting framework proposed in the first consultative document;
- the aligning with the IRB "defaulted" exposures definition.

We also noted that, in the proposed document, exposures towards financial institutions which are subject to prudential standards and to a level of supervision equivalent to those applied to banks, are treated as exposures towards banks.

Nevertheless, we would like to draw your attention to some aspects that, as we will explain in the present paper, might introduce some inconsistencies in the new Standardised Approach regarding to:

- some features of the real estate weighting proposed framework (e.g. Loan Splitting vs. Whole Exposure option);
- the new treatment proposed for defaulted exposures;
- the treatment of interbank exposures with a maturity longer than 3 months.

In Europe, Deloitte undertook an extensive research (which Leaseurope shared with you) which demonstrates that the leasing business model leads to significantly lower risk compared to traditional lending. The research was based on a portfolio of 3.3 million lease contracts in 15 European countries and major Italian leasing companies participated to this research with a 22.1% share in terms of total financed amount in the sample.

Default rates and loss given defaults (LGDs) for leasing Retail and Corporate exposures resulted to be 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 10x higher than the real risks for SME leases within the Retail class that one-year defaults on leasing.

On the basis of these evidences of the lower default and loss rate observed in the leasing market, we also propose you to consider to revise, in the asset finance sector, the granularity requirement proposed for retail exposures.

1. Real estate exposures

The new real estate exposures' risk weighting differs significantly from that proposed in the first consultative paper and in specific situations contains even lower risk weights than those of the previous consultation. Nevertheless, it still appears too conservative if compared with the current one and, for some aspects, too much conservative if compared with the IRB approach.

1.2 Loan splitting (LS) instead of the Whole Exposure (WE) option

In order to estimate the impact of the new rules proposed in the current consultation paper on the real estate leasing exposures RWAs, we took as reference the aggregate of the total Italian real estate leasing portfolio (one of the biggest European real estate markets) and, for this portfolio, we compared the aggregate RWAs calculated according to the Standardised Approach with the RWAs calculated according to the IRB approach. As the existing real estate leasing portfolio is mainly on not residential buildings, the rules applied in this calculation are those regarding not residential real estate (i.e. “commercial real estate”).

We analyzed the simplest case among those described in the consultation paper, the one described in paragraph 58, where the repayment is not materially dependent on the cash flows generated by property and where the requirements in paragraph 50 are met.

According to the rule proposed in paragraph 58 of the document, the minimum RW between 60% and the RW of the counterparty should be applied when LTV is $\leq 60\%$ and the RW of the counterparty should be applied when LTV $> 60\%$.

The definition of the LTV ratio is that of paragraph 52: the loan amount is reduced as the loan amortises, while the value of the property is maintained at the value measured at origination unless national supervisors elect to require banks to revise the property value downward.

According to the current rule, a 50% risk weighting is applied to the exposure not exceeding 50% of the market value of the real estate asset and the RW of the counterparty is applied to the residual part of the exposure. As respect to the current rules for non-residential real estate exposures risk weighting, the new rules would introduce:

- an higher risk weight (60% compared to the current 50%);
- an higher threshold for the application of this new risk weight (LTV $\leq 60\%$ instead of the current LTV $\leq 50\%$);
- paragraph 58 specifies that the risk weights in table 11 are to be applied – differently from now – to the entire exposure, without any possibility of splitting that position between the part of exposure not exceeding 60% of the real estate market value and the remaining part of the exposure.

The last point, among those mentioned above, would have the highest impact in terms of RWAs of commercial real estate leasing exposures.

In order to quantify the effects of this change in real estate exposure weighting, we made an estimation on the Italian eligible non-residential real estate leasing portfolio, starting from the calculation of the residual debt of the on-going performing contracts.

At the end of 2015, there were around 45,700 non-residential real estate leasing contracts in the portfolio sample, with a residual debt slightly below 30 billion euro. The original value of the real estate asset financed (original cost net of VAT) was around 50 billion euro.

On this original value, we estimated a 20% average devaluation (2.2% is the yearly depreciation of not real estate assets according to the Italian official statistics and 20% devaluation is coherent with the loss rate observed on the Italian statistics on the resale of real estate assets observed in the last ten years) to calculate the denominator of the LTV ratio for each contract (40.1 billion would be the devaluated total portfolio).

By applying the current risk weighting rules and assuming a corporate counterparty (100% risk weighting for the unguaranteed part of the exposure) the total RWAs would be around 20.6 billion (column “e” in Table 1 of the Annex). If we apply the consultation paper’s new proposed rule, the total RWAs would surprisingly increase up to 28.7 billion, with a 39% growth as respect to the one calculated according to the current rule. RWAs’ increase would be sensibly lower if we could apply the “splitting” rule with a 60% weighting of the part of exposure not exceeding 60% of the market value of the asset. In this way, the total RWAs would be around 21.2 billion euro, with an average 2.7% increase as respect to the RWAs calculated according to the current rule.

In order to ask you to maintain the “splitting” rule, we would like to demonstrate that this mechanism would grant conservative capital requirements. With this purpose, in our exercise we compared the results obtained applying the Standardized Approach with those obtained using the IRB approach, on the basis of the average values of PD, LGD and Maturity calculated on the sample portfolio.

The result is a total RWA of 19.1 billion euro if we use the corporate IRB formula (Table 2) and 16.6 billion euro if we use the SMEs IRB formula (Table 3). On the one hand, these values are to be considered quite conservative if compared with the RWAs calculated according to the new risk weighting mechanism in the Standardised Approach, by using the “splitting” rule. On the other hand, the elimination of the splitting rule would produce a disproportionate increase in capital requirements in the Standardised Approach if compared to the IRB one.

On the basis of these feedbacks, we ask you to introduce the Loan Splitting Rule (LS) instead of the Whole Exposure Rule (WE) in the allocation of Exposure At Default (EAD) to Loan To Value (LTV) buckets. As demonstrated above, this would lead to conservative RWAs that would be more consistent with those resulting by applying the IRB approach.

1.3 Treatment of the higher risk categories of real estate exposures

1.3.1 Higher risk categories with a risk weighting above 100%

In this second consultative paper, there are some real estate exposures that present risk weights above 100%. More specifically, when the prospects for repayment and recovery on the exposure materially depend on the cash flows generated by the property, risk weights figures could reach 120% (residential real estate) or 100% and 130% (commercial real estate) if LTV exceeds specific thresholds; in addition, a 150% risk weight is fixed for real estate exposures which do not meet the requirements of paragraph 50 and for ADC lending.

In all the mentioned cases, the real estate exposures are treated like defaulted exposures and/or more conservatively than unsecured and unrated non defaulted corporate exposures. This would not be consistent with the general risk framework of the Standardised approach, where if the guarantee is not recognised as eligible for credit risk mitigation purposes, the exposure is weighted according to the RW of the counterparty.

Therefore, consistently with the proposals in paragraph 55 and 59, we ask you to introduce a mechanism according to which real estate exposure's risk weights should be at the maximum the higher between 100% and the RW of the counterparty.

1.3.2 Real estate leasing on assets under construction

As mentioned in the previous position paper, **real estate leasing on buildings under construction cannot be considered under the scope of "Land Acquisition, Development and Construction (ADC)" lending** as the real estate is built after the signature of a leasing contract with a lessee who will use it in his business activity. Therefore, the future destination of the real estate asset is not uncertain neither it is uncertain the cash flow generated by the leasing contract, that has been already signed with the lessee.

2. Defaulted exposures treatment

We do not agree with the proposed new treatment of defaulted exposures, with risk weights that would not be any more linked to the level of specific provisions to defaulted exposures.

Firstly, as respect to the "status quo" situation, this new treatment would negatively affect in terms of additional capital requirements those banks with a more conservative approach to provisioning.

As an example, according to the current rules:

- Bank "A", with 100 of defaulted exposure and 20 of specific provision, calculates a RWA of 80 (100% of the net exposure),
- while Bank "B", with only 10 of specific provision for the same exposure amount, calculates a RWA of 135 (150% of the net exposure).

According to the new rules proposed in the current consultative paper:

- RWA calculated by Bank "B" would remained unchanged,
- while Bank "A" would see its RWA growing from 80 to 120 (150% of net exposure).

This effect would be a disincentive to more conservative provisioning policies.

Secondly, from a methodological point of view, also in the IRB approach, there is a relationship between the RW and the provisions. In fact, looking at the paragraph on "Risk-weighted assets for corporate, sovereign, and bank exposures" in the current IRB approach (paragraphs 328-330 of "Basel 2" document), we can see that: *"The capital requirement (K) for*

a defaulted exposure is equal to the greater of zero and the difference between its LGD and the bank's best estimate of expected loss..." where the best estimate of expected loss is an approximation of the impairment provisions (if not, any positive difference would be deducted to CET1); therefore in the IRB approach there is a strong incentive to include stressed macroeconomic conditions on impairment calculations in order to minimize the difference with the LGD (of defaulted exposures).

For this reason, and in order to incentive more conservative provisioning, **we ask you to maintain unchanged the current treatment of past due ("defaulted") exposures under the Standardised Approach.**

3. Banks and supervised intermediaries' exposures with a >3 months maturity

Under the conditions mentioned in par. 30, exposures towards supervised financial intermediaries can be treated as exposures towards banks. Nevertheless, even under this new scope of application, the proposed risk weights to exposures with a maturity longer than 3 months should be revised.

As the proposal currently stands, in fact, the same bank/supervised financial intermediary with the same rating or in the same risk class would be assigned a risk weight for these exposures that more than doubles the one for short-term interbank exposures. In our opinion there is no fundamental reason for such a gap and it should be narrowed by pulling down the risk weight proposed for longer-than-three-month interbank exposures.

The current proposed approach appears overly conservative, considering the low default experience of banks which are, after the crisis, much stronger in terms of capitalisation. As highlighted by the recent Basel III monitoring exercise report¹, larger International banks have already made major progress in recapitalization and the capital shortfall has been significantly reduced during the last years.

The purpose to gradually reduce the difference between interbank short term and more than 3 months maturity exposures' risk weights could be obtained even through an enhanced granularity in the number of the grades in Standardised Credit Risk Assessment Approach, that would be more coherent with the External Credit Risk Assessment Approach.

4. Retail and corporate exposures

We welcome the confirmation of the 75% risk weighting for retail exposures and the reduction of the risk weighting for SMEs exposures.

In the previous consultation paper, we asked for the recognition of the lower risk associated to leasing exposure due to the ownership of the leased asset. We welcome that in the present consultative paper you recognized that *"the only risk driver that had the potential of enhancing the risk sensitive of the exposure class was the extent to which an exposure is secured by durable*

¹ <http://www.eba.europa.eu/documents/10180/950548/CRD+IV++CRR++Basel+III+monitoring+exercise+report.pdf/f414a01e-4f17-4061-9b88-4e7fb89cc355>

goods". Nevertheless, at this stage and in the current proposed framework, you consider "that incorporating this risk driver would introduce undue complexity".

We also continue to consider too restrictive the 0.2% granularity requirement confirmed also in the second consultative paper for the retail exposures. Therefore, **we ask you the possibility to take into account the lower risk associated to loans secured by durable goods allowing for these exposures a different calibration of granularity requirements on the basis of the case by case dimension of this retail business.**

ANNEX

Real estate Leasing portfolio without resolution (in bonis) at 31.12.2015
20% average devaluation of the real estate buildings

Table 1

NEW RULES EFFECTS IN TERMS OF RWA'S INCREASE	a	b	c	d	e	f	g	h	i	j
	Number of contracts	Residual debt	Initial cost of the asset (original value)	Real asset's fair/market value	CURRENT RULE FOR ELIGIBLE EXPOSURES (50% weighting for the part of the exposure not exceeding 50% of the real estate market value)	PROPOSED RULE (60% - NO SPLITTING) 60% risk weighting only when LTV ≤60%	PROPOSED RULE (60% - SPLITTING) (60% weighting for the part of exposure not exceeding 50% of the real estate market value)	DIFFERENCE BETWEEN SPLITTING AND NOT SPLITTING	Difference with the current weighting if splitting	Difference without splitting
Hotels and leisure centres	2.728	1.514.129.097	2.513.477.981	2.010.782.385	1.041.654.167	1.454.497.493	1.069.025.169	385.472.323	2,6%	39,6%
Other buildings	10.316	8.601.510.897	14.021.006.946	11.216.805.557	5.969.210.866	8.287.417.481	6.122.514.529	2.164.902.952	2,6%	38,8%
Commercial premises	8.419	5.595.239.103	9.239.604.698	7.391.683.758	3.854.839.334	5.358.815.453	3.959.509.370	1.399.306.083	2,7%	39,0%
Industrial building	18.873	11.869.702.774	20.490.208.443	16.392.166.754	8.120.220.823	11.281.178.046	8.357.173.340	2.924.004.705	2,9%	38,9%
Public buildings	45	55.738.600	92.570.553	74.056.442	38.308.993	53.591.960	39.412.551	14.179.409	2,9%	39,9%
Offices	5.386	2.331.063.372	3.831.631.576	3.065.305.261	1.615.619.159	2.245.288.688	1.657.600.878	587.687.810	2,6%	39,0%
TOTAL	45.767	29.967.383.843	50.188.500.197	40.150.800.158	20.639.853.342	28.680.789.121	21.205.235.838	7.475.553.283	2,7%	39,0%

COMPARISON WITH THE RWA IN THE IRB

1) Basilea 2's formula for Corporate exposures

Maturity

M (9.8 cap at 5) 5,0

Table 2

Real estate PD (% of contracts on the existing regular real estate leasing contract portfolio that enter in a default status) (average of the Jan 2012-2015 period)	Average Real estate leasing LGD (all the recovery procedures closed in 2014)	Correlation - R	(a) $(1 - R)^{0,5} \times G (PD) + (R / (1 - R))^{0,5} \times G (0,999)$	K(1) LGD * N([a]) - PD * PGD	b	Maturity adjustment	K(2) K(1) * maturity adjustment	EAD	RWA K*12,5 * EAD
2,60%	18,6%	0,15	-0,80	0,03	0,10	1,48	5,1%	29.967.383.843	19.171.525.579

2) Basilea 2's formula for SMEs' exposures

Sales volume

\$ 25

Maturity

M (9.8 cap at 5) 5,0

Table 3

Real estate PD (% of contracts on the existing regular real estate leasing contract portfolio that enter in a default status) (average of the Jan 2012-2015 period)	Average Real estate leasing LGD (all the recovery procedures closed in 2014)	Correlation - R	(a) $(1 - R)^{0,5} \times G (PD) + (R / (1 - R))^{0,5} \times G (0,999)$	K(1) LGD * N([a]) - PD * PGD	b	Maturity adjustment	K(2) K(1) * maturity adjustment	EAD	RWA K*12,5 * EAD
2,60%	18,6%	0,13	-0,89	0,03	0,10	1,48	4,4%	29.967.383.843	16.646.734.914

Real estate Leasing portfolio without resolution (in bonis) at 31.12.2015

	RESIDUAL DURATION	
	DAYS	YEARS
Hotels and leisure centres	3.414	9,4
Other buildings	3.328	9,1
Commercial premises	3.536	9,7
Industrial building	2.981	8,2
Public buildings	3.373	9,2
Offices	3.425	9,4
Average not residential buildings	3.243	8,9