ASSILEA
Associazione Italiana Leasing

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Assilea's Position Paper on Basel Committee on Banking Supervision's Consultative Document: *"Standards. Revisions to the Standardised Approach for credit risk" (December 2014)*

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 Consultative Document: "Standards. Revisions to the Standardised Approach for credit risk" (December 2014), referring to the Leaseurope's and ABI's Position Papers for the more general questions.

Contents

1. Possible impacts of the revision to the S.A.

Leasing is an asset-finance product that requires an high degree of specialization. The ownership of the financed asset and the link with the manufacturing sector are the main strengths of the leasing product. It plays an important role in the European SMEs financing (ref. two recent ECB publications: *Financial Integration in Europe*, of April 2014 and *Monthly Bulletin* of July 2014). It is offered both by the major generalist banks and by specialised banks and financial intermediaries.

Currently, among specialised banks or financial intermediaries, many of the leasing major players adopt the standardised approach. Therefore, the proposed increases in risk weighting for the different exposure classes would strongly affect the sector and SMEs access to finance, with further negative effects on the European economy.

In the present Position Paper we propose some little changes to the proposed revision of the standardised approach that would limit the negative effects on the real economy, which would be caused by a decrease in the leasing sector offer.

2. Definition of bank exposures

As in some countries leasing financial companies are supervised by the competent European and National Authorities, it is important that the exposure towards these financial intermediaries are weighted as exposures towards banks.

This principle is already introduced in chapter 2.1, lett. i), second paragraph: "*The proposed approach treats exposures to securities firms and other financial institutions as exposures to banks as long as these firms are subject to prudential standards and the level of supervision equivalent to those applied to banks, and the risk drivers described below (or the information to calculate them) are publicly disclosed...*"

The Committee proposes a definition of bank exposure for regulatory capital purposes in Annex 1, paragraph 12: *"A bank exposure is defined as a claim (including loans to, and senior debt instruments of, the bank) on any financial institution that is licensed to take deposits from the public, and is subject to the prudential standards and level of supervision in accordance with the international practices relevant for such an institution..."*.

In our opinion, the definition of "bank exposure" should be enlarged to include all the supervised entities carrying on banking-like activities, even when they are not licensed to take deposits. As written in the EBA's Report on the perimeter of credit institutions (November 2014): *"In four Member States there are no entities carrying on banking-like activities without any solo prudential requirements (AT, FR, IT and SK)."* Exposures towards supervised leasing financial intermediaries should be treated as bank exposures and not as exposures to corporates. This concept becomes even more important in the light of the current consultative document, where quantitative drivers are introduced for the risk weighting of the different exposure classes. In particular, risk drivers proposed for exposures to banks (CET 1/Tier 1 ratio and NPA ratio) seem to be largely more appropriate for exposures towards supervised financial intermediaries than the risk drivers proposed for exposures to corporates (leverage and revenue).

We, therefore, ask you to modify the proposed definition of bank exposure for regulatory capital purposes in Annex 1, paragraph 12, as follows: *"A bank exposure is defined as a claim (including loans to, and senior debt instruments of, the bank) on any financial institution that is ~~licensed to take deposits from the public, and is~~ subject to the prudential standards and level of supervision in accordance with the international practices relevant for such an institution..."*.

3. Retail Leasing exposures

Most of the equipment and automotive leasing exposures have the characteristics to be included into the retail exposures. As already mentioned, leasing companies can be specialised in specific sectors and asset industries and, in those cases, the proposed new granularity requirement proposed (0.2%) might be not fulfilled.

Nevertheless, retail leasing exposures deserve a 75% risk weighting because they have to be included into the category of "loans secured by durable goods" [ref. Par. 2.4, ii) Treatment, point (i)]. In leasing contract the guarantee represented by the leased asset is even more strong as the lessor maintains the "ownership" of the asset for the whole duration of the contract.

Asset ownership represents a major advantage for lessors compared to other financial products. This is demonstrated by the results of a recent research conducted by Deloitte on behalf of the European Leasing Federation (Leaseurope). In the Deloitte's Report: *The Risk Profile of Leasing in Europe: The role of the leased asset,* it has been showed that default and loss rates for leases are significantly lower than for traditional lending. According to this study, 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.

The automotive leasing sector could also deserve a better treatment. Italian data about automotive leasing show lower percentage of defaulted contracts in the portfolio and higher recovery rates.

4. Leasing is an asset-based finance very different from Specialised Lending

Even if leasing financing is an asset-based finance, the leasing product doesn't have the characteristics to be included into the specialised lending exposures listed in Annex 1, par. 3, point 21:

- the leasing exposure is towards a company or an individual and is not towards an SPE created specifically to finance and/or operate physical assets;

- the borrowing entity has independent capacity to repay the obligation through its business or professional activity;
- the terms of obligation give the lender (lessor) the ownership of the asset but not the control over it and over the income that it generates; the leasing asset does not directly "generate" income, but it is used as a mean of production for the lessee;
- as a result of the preceding factors, the primary source of repayment of the leasing obligation is the income generated by the business/professional activity of the lessee who, in order to obtain the leasing financing, need to demonstrate to have an independent capacity of commercial enterprise.

These characteristics are present in all leasing contracts, even in real estate leasing ones where the "commercial real estate" is under construction. Real estate leasing is not an income-producing specialised lending as the prospects for repayment and recovery on the exposure does not depend primarily on the cash flow generated by the asset. Real estate leasing on buildings under construction can neither enter into the category 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.

5. Commercial Real Estate

5.1 Definition of Commercial Real Estate exposure

In Annex 1, par. 9.2, point 43, commercial real estate is defined as: an exposure secured by a mortgage on a "commercial property". Note 59 clarify that "office and multipurpose commercial premises and/or multi-tenanted commercial premises" can be included into this definition. Nevertheless, a more clear and broad definition should be introduced, as: "not residential real estate exposure". This definition would include all real estate different from the residential ones (industrial buildings, offices, shops, hotels etc.) and would be coherent with the final definition clarified in the EBA's Single Rulebook Q&A (Q&A 2014_1214)[1].

5.2 Treatment (a third option)

Real estate leasing differs from mortgages because the lessor maintains the "ownership" of the asset for the whole duration of the contract. The full ownership of the leased real estate allows the leasing company 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 new approaches for real estate exposure proposed in the Consultative Paper based on the LTV ratio do not fit to real estate leasing market (a 13.5 billion sector in terms of yearly new business), which represents an important source of finance for business real estate investment (especially for SMEs) in some important European countries (e.g. Italy, France, Austria, Spain).

[1] http://www.eba.europa.eu/single-rule-book-qa

In our opinion, the LTV ratio (and the DSC for residential real estate) should not be the only main risk driver for real estate exposures weighting. The ability of the lessor to correctly evaluate the real estate asset financed should be part of the weighting mechanism. In particular, in addition to require higher risk weights for higher LTV ratio, it should be introduced a mechanism that, notwithstanding the initial LTV ratio level, would reward the lessor when the asset does not depreciate during the contract life; allowing him to apply a 50% weighting when the LTV ratio becomes lower than 60% (or 50% if referred to the market value, as specified in note 60).

For commercial real estate, we propose to consider, in addition to option A and option B, the possibility to adopt a third option: option B2, that would work as follows. At the beginning of the contract, when real estate leasing LTV is ≥ 75%, the exposure is 120% weighted, when LTV ratio decreases down to the following range of values: 60% ≤ LTV ≤ 75%, the leasing real estate exposure will be weighted at 100%; than when LTV < 60% (or 50% if referred to the market value, as specified in note 60) option A with note 59 could be applied with a 50% risk weighting of the real estate exposure.

In the Annex, we enclose the risk weighs resulting from the adoption of each of the 3 options (A with the national discretion, B, and B2) applied to a 12 years commercial real estate leasing contract:

- if the real estate value depreciates during the contract life (H1) the sum of the total weighting under option B2 is only slightly lower than that calculated adopting option B;
- on the contrary, if the real estate asset maintains its value during the whole duration of the contract (H2), the sum of the total weighting under option B2 remains considerably higher than the current Basel 2 treatment (with the 50% rule under national discretion), but would be lower than that calculated under the proposed option B, with a reward to the leasing company that had correctly evaluated the real estate at the beginning of the contract.

In remaining at your disposal for further simulations, we ask you to introduce the above mentioned third option.

5.3 Finished property as operational requirement

The introduction of the "finished property" operational requirement to recognise the real estate risk mitigation can be justified by the uncertainty of the final destination of the real estate asset and by a more prudential approach towards any speculative real estate investment. Provided that, as already explained in paragraph 4, in a leasing contract, building financing begins only after the signature of the contract and the final user of the real estate asset is the lessee or someone granted by the lessee, the fulfilment of the "finished property" requirement should not be required for real estate leasing contract.

Annex: Real Estate Leasing simulation

Results

Value of the property:	1.000.000
LTV:	90%
Initial rent %:	10%
Lease term:	12 years
Amount of the loan:	900.000

Annual rentals

Exposure to corporate (tranche of the loan not covered by any type of guarantee is risk-weighted at 100%)

Use of standardised approach

Hypothesis

H1= Annual depreciation of the value of the property: 4,2%. This percentage is calculated as the average depreciation observed for former real estate leased assets remarketed over the years 2012-2014 (source: Assilea Remarketing Survey)

H2= Value of the property constant over lease term.

No hypotesis of property price appreciation were made. This is consistent with the consultative document, where it is said that (page 36, annotation 36) "to ensure that the value of the property is appraised in a prudently conservative manner, expectations of future price appreciation should not be considered".

T	Total amount of the loan (outstanding)	Basel 2 Risk-weight - H1	Basel 2 Risk-weight - H2	Basel Committee consultative document - "Revisions to the Standardised Approach" (Option A) - H1 e H2	Basel Committee consultative document - "Revisions to the Standardised Approach" (Option B) - H1	Basel Committee consultative document - "Revisions to the Standardised Approach" (Option B) - H2	Option "B_2" - H1	Option "B_2" - H2
1	848.822	598.822	598.822	619.640	1.018.587	1.018.587	1.018.587	1.018.587
2	791.228	551.762	541.228	577.596	949.474	949.474	949.474	949.474
3	731.734	502.359	481.734	534.166	878.080	731.734	878.080	731.734
4	670.277	450.567	420.277	489.302	804.332	670.277	804.332	670.277
5	606.792	396.341	356.792	442.958	606.792	606.792	606.792	606.792
6	541.214	339.630	291.214	395.086	541.214	541.214	541.214	541.214
7	473.472	280.382	236.736	345.634	473.472	355.104	473.472	236.736
8	403.495	218.542	201.747	294.551	403.495	302.621	403.495	201.747
9	331.210	165.605	165.605	241.783	248.407	248.407	165.605	165.605
10	256.540	128.270	128.270	187.274	192.405	192.405	128.270	128.270
11	179.407	89.704	89.704	130.967	134.555	134.555	89.704	89.704
12	100.000	50.000	50.000	73.000	75.000	75.000	50.000	50.000
Sum of risk-weighted exposure		3.771.983	3.562.128	4.331.959	6.325.813	5.826.169	6.109.024	5.390.138

	Option A		Option B		Option "B_2"	
	H1	H2	H1	H2	H1	H2
Difference with Basel 2	559.976	769.831	2.553.830	2.264.041	2.337.040	1.828.010
			H1-H2=	289.789	H1-H2=	509.030

Basel 2. Exposure is risk-weighted at 50% for the tranche of the loan that does not exceed 50% of the real estate market value, and at 100% (i.e. risk weight for exposures to corporate) for the tranche of the loan that exceeds the 50% threshold.

Basel Committee consultative document - Option A. Exposure is risk-weighted at 50% for the tranche of the loan that does not exceed 60% of the loan to value ratio, and at 100% (i.e. risk weight for exposures to corporate) for the tranche of the loan that exceeds the 60% threshold.

Basel Committee consultative document - Option B. Exposure is risk-weighted at 120% for the tranche of the loan that exceeds 75% of the loan to value ratio, at 100% for the tranche of the loan comprised between 60% and 75% of the LTV ratio, and at 75% for the tranche of the loan below 60% of the LTV ratio.

Option B_2. Exposure is risk-weighted at 120% for the tranche of the loan that exceeds 75% of the loan to value ratio, at 100% for the tranche of the loan comprised between 50% and 75% of the LTV ratio, and at 50% for the tranche of the loan below 50% of the LTV ratio (Basel 2 criteria).

Annex: Real Estate Leasing simulation

Hypothesis 1
Annual depreciation of the value of the property: 4,2%.

Value of the property:	1.000.000
LTV:	90%
Initial rent %:	10%
Lease term:	12 years
Amount of the loan:	900.000

Annual rentals
Exposure to corporate (tranche of the loan not covered by any type of guarantee is risk-weighted at 100%)
Use of standardised approach

	A	B	C	D	E	F	G	H	I	M	N	O	P	Q	R
T	Outstanding	Value of the property (4,2% annual depreciation)	50% value of the property (c)	Risk-weighted exposure - Basel 2 document and CRD IV-CRR (d) = (c*50%) +100% (a-c)	60% LTV (e)	60%*LTV*L	Basel Committee consultative document - "Revisions to the Standardised Approach" (Option A) = (c*50%) +100% (a-e)	Nuovo documento Basilea (opzione A2) = (b*50%) +100% (a-e)	Difference (g-d)	Basel Committee consultative document - "Revisions to the Standardised Approach" (Option B) - LTV	Basel Committee consultative document - "Revisions to the Standardised Approach" (Option B) - Risk-weighted exposure	Basel Committee consultative document - "Revisions to the Standardised Approach" (Option B) - Risk-weighted exposure (LTV threshold 50%)	Difference (n-d)	Option B_2	Difference (q-d)
1	848.822	1.000.000	500.000	598.822	458.364	540.000	619.640	578.822	20.818	85%	1.018.587	1.018.587	419.764	1.018.587	419.764
2	791.228	957.862	478.931	551.762	427.263	540.000	577.596	521.228	25.834	83%	949.474	949.474	397.711	949.474	397.711
3	731.734	917.500	458.750	502.359	395.136	540.000	534.166	461.734	31.807	80%	878.080	878.080	375.722	878.080	375.722
4	670.277	878.839	439.419	450.567	361.949	540.000	489.302	400.277	38.735	76%	804.332	804.332	353.765	804.332	353.765
5	606.792	841.807	420.903	396.341	327.668	540.000	442.958	336.792	46.618	72%	606.792	606.792	210.452	606.792	210.452
6	541.214	806.335	403.167	339.630	292.255	540.000	395.086	271.214	55.456	67%	541.214	541.214	201.584	541.214	201.584
7	473.472	772.358	386.179	280.382	255.675	540.000	345.634	236.736	65.252	61%	473.472	473.472	193.089	473.472	193.089
8	403.495	739.812	369.906	218.542	217.887	540.000	294.551	201.747	76.009	55%	302.621	403.495	84.079	403.495	184.953
9	331.210	708.638	354.319	165.605	178.853	540.000	241.783	165.605	76.178	47%	248.407	248.407	82.802	165.605	-
10	256.540	678.778	339.389	128.270	138.532	540.000	187.274	128.270	59.004	38%	192.405	192.405	64.135	128.270	-
11	179.407	650.176	325.088	89.704	96.880	540.000	130.967	89.704	41.264	28%	134.555	134.555	44.852	89.704	-
12	100.000	622.779	311.389	50.000	54.000	540.000	73.000	50.000	23.000	16%	75.000	75.000	25.000	50.000	-
Sum of risk-weighted exposure								Sum of differences	559.976				2.452.956		2.337.040
												Sum of risk-weighted exposure (LTV threshold 50%)	2.553.830		

Annex: Real Estate Leasing simulation

Hypothesis 2
Value of the property constant over lease term

Value of the property:	1.000.000
LTV:	90%
Initial rent %:	10%
Lease term:	12 years
Amount of the loan:	900.000

Annual rentals
Exposure to corporate (tranche of the loan not covered by any type of guarantee is risk-weighted at 100%)
Use of standardised approach

	A	B	C	D	E	F	G	H	I	M	N	O	P	Q	R
T	Outstanding	Value of the property (4,2% annual depreciation)	50% value of the property (c)	Risk-weighted exposure - Basel 2 document and CRD IV-CRR (d) = (c*50%) +100% (a-c)	60% LTV (e)	60%*LTV*L	Basel Committee consultative document - "Revisions to the Standardised Approach" (Option A) = (c*50%) +100% (a-e)	Nuovo documento Basilea (opzione A2) = (b*50%) +100% (a-e)	Difference (g-d)	Basel Committee consultative document "Revisions to the Standardised Approach" (Option B) - LTV	Basel Committee consultative document - "Revisions to the Standardised Approach" (Option B) - Risk-weighted exposure	Basel Committee consultative document - "Revisions to the Standardised Approach" (Option B) - Risk-weighted exposure (LTV threshold 50%)	Difference (n-d)	Option B_2	Difference (q-d)
1	848.822	1.000.000	500.000	598.822	458.364	540.000	619.640	578.822	20.818	85%	1.018.587	1.018.587	419.764	1.018.587	419.764
2	791.228	1.000.000	500.000	541.228	427.263	540.000	577.596	521.228	36.368	79%	949.474	949.474	408.246	949.474	408.246
3	731.734	1.000.000	500.000	481.734	395.136	540.000	534.166	461.734	52.432	73%	731.734	731.734	250.000	731.734	250.000
4	670.277	1.000.000	500.000	420.277	361.949	540.000	489.302	400.277	69.025	67%	670.277	670.277	250.000	670.277	250.000
5	606.792	1.000.000	500.000	356.792	327.668	540.000	442.958	336.792	86.166	61%	606.792	606.792	250.000	606.792	250.000
6	541.214	1.000.000	500.000	291.214	292.255	540.000	395.086	271.214	103.872	54%	405.910	541.214	114.697	541.214	250.000
7	473.472	1.000.000	500.000	236.736	255.675	540.000	345.634	236.736	108.898	47%	355.104	355.104	118.368	236.736	-
8	403.495	1.000.000	500.000	201.747	217.887	540.000	294.551	201.747	92.804	40%	302.621	302.621	100.874	201.747	-
9	331.210	1.000.000	500.000	165.605	178.853	540.000	241.783	165.605	76.178	33%	248.407	248.407	82.802	165.605	-
10	256.540	1.000.000	500.000	128.270	138.532	540.000	187.274	128.270	59.004	26%	192.405	192.405	64.135	128.270	-
11	179.407	1.000.000	500.000	89.704	96.880	540.000	130.967	89.704	41.264	18%	134.555	134.555	44.852	89.704	-
12	100.000	1.000.000	500.000	50.000	54.000	540.000	73.000	50.000	23.000	10%	75.000	75.000	25.000	50.000	-
Sum of risk-weighted exposure								Sum of differences	769.831				2.128.738		1.828.010
												Sum of risk-weighted exposure (LTV threshold 50%)	2.264.041		