Leaseurope

The Voice of Leasing and Automotive Rental in Europe

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

Brussels, 27 March 2015

Re: Consultation Document on Revisions to the Standardised Approach for credit risk

Dear Sir/Madam,

Leaseurope welcomes the opportunity to respond to this consultation. Leaseurope brings together 46 member associations representing the leasing, long term and/or short term automotive rental industries in the 34 European countries in which they are present. The scope of products covered by Leaseurope members' ranges from hire purchase and finance leases to operating leases of all asset categories (automotive, equipment and real estate). It also includes the short term rental of cars, vans and trucks. It is estimated that Leaseurope represents approximately 92% of the European leasing market and in 2013 total new leasing volumes worth 251.9 billion Euros were granted by the firms represented through Leaseurope's members.

In general we wish to ensure that any possible further changes to the calculation of regulatory capital do not result in banks restricting the provision of finance to businesses in Europe, particularly through leases. Lease finance is an important financer of the real economy and particularly SMEs and it has low default and loss given default rates. Therefore it is important that any changes to assessment of credit risk - whether for the standardised or internal ratings-based approaches - should reflect this.

In particular we suggest in our response to Question 9 below there is a strong case for differentiating equipment lease finance with a specific risk weight. In Europe, our extensive research (that we have shared with the Committee) shows that leasing transactions have a Probability of Default that 40% lower than Retail SME lending in general. This result is consistent with data for other equipment finance markets, for example in the US and Canada, confirming that businesses will prioritise paying for equipment finance because they need these assets to continue to run their businesses. Furthermore as the asset is a key working tool for the lessee, many defaulted leases regrade back to a healthy situation with a zero loss, resulting in low Loss Given Default too.

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?

Section 2.1 of the consultation refers to options for applying risk weights to banks and other financial institutions that are "subject to prudential standards and the level of supervision equivalent to those applied to banks". We welcome this as it is important that non-bank financial intermediaries (such as many leasing companies in Europe) are not automatically classified as 'corporates' for credit risk assessment purposes, as that would unnecessarily restrict this important alternative channel of SME finance.

At paragraph 19 of Annex 1, the Committee restricts its definition of financial institutions to those with capital and liquidity requirements. Many non-bank financial institutions in Europe are subject to prudential supervision but not to capital and/or liquidity requirements. We would urge the Committee to select a single and consistent definition of 'financial institution' that reflects the fact that many such bodies in Europe will not take deposits from the public. A suitable definition could be "financial institutions authorised and supervised by the competent authorities and subject to relevant prudential and supervisory requirements".

We do not consider that CET1 ratio is necessarily a better indicator of risk than a bank's credit rating. Credit agencies assess banks' exposures using a mix of indicators that might be particularly useful when assessing the risk of non-bank financial institutions.

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?

We think it is important to assess whether the risk drivers will prove to be more reliable than credit ratings for most businesses. In Europe credit reports are generally reliable and are based on a wide range of different indicators including business position, profitability, sector, capital structure, funding sources and liquidity. Credit agencies in Europe provide reports on most businesses.

Credit agencies review corporates' business risk profile (including industry risk and competitive position which are meant to assess expected economic success) and financial risk profile (including funding and capital structure, review of cash flows and leverage, financial obligations) and additional factors including governance and management.

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.

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 concerned that banks will need to collect recent financial statements from small businesses, many of which in Europe are not required to file their accounts on public record. At present the banks are able to use automated links to credit agency reports. The proposal that banks 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 unnecessary complexity?

The risk sensitivity for corporate exposures would be increased by taking into account the low-risk nature of leasing transactions and having as a risk driver the extent to which the loan is secured by the lender's ownership of the asset. We expand on this in our answer to Question 9, below.

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

If the specialised lending category is to be introduced, we recommend it should be made clear that leases are not intended to be included. Under international lease accounting rules, a contract is defined as a lease where the lessee has control of the assets (and therefore by definition the income that it generates). To avoid unnecessary confusion or uncertainty it would be helpful if the Committee could cross-refer to the accounting treatment as confirming that leases should not be treated as specialised lending.

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?

There is a strong case for differentiating lease finance (where the asset is owned by the finance company during the life of the agreement) from other retail 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.

Deloitte undertook research on our behalf, 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 demonstrate that default and loss rates for leases are significantly lower than for traditional lending. According to the latter 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.

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. 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.

We are happy to discuss the full findings of this research with you which we believe make a compelling case for introducing specific risk weights for lease exposures.

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 banks to compete with larger players. It is also important that the criteria for exposures to be included in the regulatory retail portfolio clearly apply to all small and medium-sized businesses.

Q.10 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?
Q15. What other options might prudently increase the risk sensitivity of the commercial real estate treatment without unduly increasing complexity?

We recommend the Committee should amend option B to take account of the actual valuation of the commercial real estate during the duration of the contract. If the property is proven to retain its value during the contract life then the risk weighting should be adjusted accordingly.

Under option B, when LTV < 60% (or 50% if referred to the market value, as specified in note 60) the mechanism of option A with note 59 should be allowed with a 50% risk weighting of the real estate exposure. In this way, if the real estate value depreciates during the contract life the sum of the total weighting would be nearly the same. On the contrary, if the real estate asset maintains its value during the whole duration of the contract, the sum of the total weighting would remain higher than the current Basel 2 treatment (with the 50% threshold of the 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.

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. Nevertheless, provided that, in a leasing contract, real estate construction 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.

Finally, we ask you to insert a definition of commercial property. 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 clarifies 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, like the following one: "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 recently clarified in the EBA's Single Rulebook Q&A (Q&A 2014_1214[1]).

I remain at your disposal, should you be interested in discussing any specific issue. Alternatively feel free to contact my colleague Julian Rose (j.rose@leaseurope.org - tel: + 32 2 778 05 60).

Yours sincerely,

Tanguy van de Werve, Director General

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