

Position Paper

On Basel Committee's Proposal on "Operational risk – Revisions to the simpler approaches"

The *Arbeitskreis der Automobilbanken* (AKA) and the *Verband der Automobilindustrie* (VDA) represent the leading automotive captives of the automotive industry.

The Finance Captive Companies are an indispensable partner to the vehicle manufacturers in the marketing of passenger and commercial vehicles. As two thirds of all vehicles sold in Europe are financed with credit or leasing, the leasing business is an important segment of the captive companies with great importance for the real economy.

We would like to seize the opportunity to comment on the Basel Committee's proposed revisions to the standardised approach for measuring operational risk capital. We would particularly draw your attention to the fact that the new calculation of the business indicator will lead to a dramatic increase in capital requirements for leasing companies belonging to a supervised group.

A. General Comments

As far as we are aware, there have been no major difficulties in the leasing business in the past. Therefore, leasing companies that do not belong to a banking or financial holding group are only regulated on a reduced scale in many countries or to some extent not regulated at all. Operational risks in the leasing business are comparable or even lower than in the credit business.

The Basel Committee proposes the addition of leasing expenses and leasing income in the Business Indicator. However, as regards the credit business the Business Indicator is calculated as the difference between interest income and interest expenses. Given the proximity of the leasing business to the lending business, it is not appropriate and not commensurate with the risks involved that the leasing income and leasing expenses from Operating Leasing and Finance Leasing are to be added instead of being subtracted from one another in order to calculate the Business Indicator.

Hence, the proposed determination of the Business Indicator for the leasing business would lead to the following consequences:

- a tremendous increase of capital requirements for the leasing business of up to 10 times compared to the current requirements,
- an unprecedented discrimination of the leasing business in comparison to the credit business from a risk management perspective and
- an intensification of existing regulatory-related distortions of competition between leasing companies belonging to a supervised group and the non- or only partially supervised leasing companies

If not amended the new capital requirement will severely impair if not completely destroy the business models of leasing companies that belong to supervised groups because it will no longer be possible for them to cover their capital costs.

B. Consideration of the Leasing Business in the Business Indicator

As required by the Basel Committee, all income and expense items that are associated with the component "Services" are added to determine the Business Indicator. This applies, inter alia, to the "Other Operating Income and Other Operating Expenses". Since the Basel Committee assigns the expenses and revenues from the leasing business to the "Other Operating Income and Expenses", the leasing expenses and income from Financial and Operating Leasing fall under the scope of "Services" and to be added to determine the Business Indicator.

I. Strong economic link between leasing income and leasing expenses

In contrast to other operating income and expense components there is strong economic link between leasing income and leasing expenses which is even stronger than in the lending business. *Leasing income from leasing business cannot be thought without leasing expenses belonging to such business. Thus, it is economically and from a conceptual point of view not appropriate to require double backing with equity for one and the same business. This makes the difference to other kinds of income and expense components where such strong link does not exist.*

A netting of the leasing income and leasing expenses is necessary to allow for the strong economic link.

II. Equal characteristics of Leasing Business and Credit Business

In addition, the leasing business has a close proximity in nature to the lending business in view of the fact that it takes over the financing function for the lessee. Accordingly, the leasing business has to be backed with capital to cover credit risks under the Credit Standardised Approach and the Internal Rating Based Approach.

The Business Indicator for the credit business is calculated as the difference between interest income and interest expenses. Given the proximity of the leasing business to the lending business, it is not appropriate that the leasing income and leasing expenses from Operating Leasing and Finance Leasing are to be added instead of being subtracted from one another in order to calculate the Business Indicator.

Both in the case of a financial and an operating lease, the lessor adopts a similar financing function to that in the lending business. Although some differences exist between a leasing contract and a loan agreement, they do not justify such a different treatment. Despite certain deviations from the lending business, the operational risks in the leasing business are not higher than in the secured lending business. The legal risks from the collateralisation are likely to be significantly lower in the case of leasing than in the secured lending business since the lessor is formally the legal owner of the leased asset and the legal status of the rightful owner is in principle less subject to legal dispute. In the credit business, however, the legal and other operational risk of an unsuccessful collateralisation is significantly higher than in leasing due to the possibility of legally ineffective surety agreements and the dynamic development of case law governing the field of security interest.

As a result, the leasing income and leasing expenses from the leasing business should be netted like the interest income and interest expenses from the lending business. Otherwise, only owing to the methodology used to calculate the Business Indicator, the capital requirement of a leasing business having a comparable operational risk profile compared to that of a lending business would be significantly higher than that of the lending business. In the case of operating leases the impact would be dramatic due to the fact that the leasing income comprises due to its specific accounting treatment elements that are from an economic point of view not income.

II. Calculation of Business Indicator

In the case of the leasing business, the level of the Business Indicator depends on its accounting treatment and the allocation of economic (beneficial) ownership. Since the criteria for the allocation of economic ownership have not been globally harmonised, the allocation of economic ownership of the leased asset, and therefore the question whether the lessor should enter a leasing receivable or the leased object on his balance sheet, may differ from country to country and depends on the particular accounting framework that is in practice there.

1. Financial Leasing – Reference: Leasing receivables

If the lessee is considered by the relevant accounting framework to be the beneficial owner, it is deemed Financial Leasing. In this case, the treatment in the balance sheet and in the profit and loss account (financial statement) is carried out analogously to how it is carried out in the credit business. Here, the interest income from leasing makes up the leasing income and the interest expenses represent the leasing expenses. In contrast to a credit transaction, in which the interest income and interest expense are set off, the interest expense (as leasing expense) and the interest income (as leasing income) would have to be added in a leasing transaction. This is obviously not appropriate. Therefore, the leasing expense in the form of interest expense and the leasing income in the form of interest income should also be offset with one another in Financial Leasing just as is the case in the credit and loan business.

2. Operating Leasing – Reference: Lease Object

If the lessor is considered by the relevant accounting framework to be the beneficial owner, the lease object is entered into the accounts by the lessor. In this case, it is deemed Operating Leasing. Typical operating lease contracts are partial amortisation contracts where the lessee repays the difference between the purchase price of the leased asset and the estimated residual value that is calculated in the leasing instalment. Whereas the so-called Financial Leasing is booked like a credit transaction and therefore only the interest earnings are incorporated in the income statement as leasing income, the entire leasing instalment including the calculated redemption, which is from an economic point of view no income element, must be booked as leasing income in the case of Operating Leasing. Without a correction of the redemption contained in the lease income, the Business Indicator in the case of Operating Leasing is significantly higher than in the case of Financial Leasing with comparable risk because the redemption portions are to be backed by equity as well in addition to the interest calculated in the leasing instalment. In our view, this is not appropriate and entails a distortion of the Business Indicator. Since the leasing expenses also raise the Business Indicator in the case of Operating Leasing, from a formal perspective even the depreciation included in the leasing expenses might also be taken into account if these deductions are not separately shown in the P&L. In addition, the interest expenses included in the leasing expenses would then have to be taken into account as a risk-increasing factor. From an objective standpoint, this certainly seems unjustified.

3. Consequences

With comparable operational risks, leasing contracts would be discriminated against credit contracts through significantly higher capital requirements. This discrepancy is particularly striking in the case of Operating Leasing.

The leasing income and leasing expenses of operating lease contracts with an operational risk profile that is comparable to a financial leasing would be significantly higher due to the mentioned specific accounting treatment. These distortion effects will be aggravated by the fact that one business can be deemed as operating leasing in one country and as finance leasing in another country. The capital requirements would just deviate significantly due to accounting specifics.

As a result, only netting can ensure comparable capital requirements both for operating leasing and finance leasing and the lending business. It is the conceptual right answer to consider the economically strong link between leasing income and leasing expenses.

In addition, netting is required due to the fact that the sales proceeds have to be booked as leasing income and the de-recognition of the leased assets has to be booked as leasing expenses. From an economic point of view only the net result is leasing income or leasing expenses.

III. Methodology to determine the Business Indicator

Whereas the theoretical design behind the statistical analyses and its formulas are being presented in full detail, the Basel Committee has not released its empirical findings. However, we believe that to be necessary in order to understand the conclusions drawn by the Basel Committee. In view of the fact that the empirical findings are opaque to us, our position paper only focuses on the design of the Business Indicator. In our view, its design is not supported by an informed economic explanatory model. This would, however, be of urgent necessity since statistical analysis is only capable of explaining statistically significant relationships and not causal relationships. As a result, it may be the case that conceptual errors in the design of the Business Indicator components are not recognised when the number of companies impacted by the error is very small, or when the error has no significant effect on the statistical analysis with respect to certain expense and income situations at the companies in the sample due to the relatively low volume in relation to the company's overall business. But insofar as such components of the Business Indicator that are conceptually flawed in their derivation have a high significance for companies outside the sample due to a comparatively high volume level in relation to overall business, such inaccuracies can have extreme effects on the level of equity capital requirements. As explained above, this appears to be the case for supervised groups that have to adhere to the capital requirements for banks and that are engaged with main parts of their business in the leasing business segment.

Additionally, we assume that the leasing business in the examination sample was of mere subordinate significance and that the design of the Business Indicator was therefore not reflected in the empirical results. However, this error has a very large impact on the capital requirement where leasing transactions represent a significant business volume of the institution or financial holding group. In such a case, the

business model of leasing companies that belong to a group supervised by a banking regulatory authority is cast into doubt as a result of the exorbitant rise in capital requirements. This cannot be the intended purpose of the new regulations when it is evidently the case that the increased capital requirements are not justified by a higher operational risk in comparison to the credit business.

IV. Proposed modifications

In its typical form, leasing – both Financial Leasing and Operating Leasing – is characterised in contrast to the rental business by its financing function for the lessee. Owing to this proximity to the credit business, the leasing business should be treated in a comparable manner in order to ensure the existence of a "level playing field". This could be achieved by

- removing leasing from the component "Services",
- supplementing the component "Interest" with the description "economically similar income" and
- adding the leasing income and leasing expenses to this component.

This would also make it clear that what is involved is a business-oriented categorisation of the leasing segment and not an accounting-based allocation.

In Financial Leasing, the interest income contained in the leasing income and the interest expense included in the leasing expense should be offset in a similar way to the credit business segment.

But even in the case of Operating Leasing, a treatment comparable to that given to the credit business is also required when there is a strong economic link between the leasing income and leasing expenses and if the lessor assumes a financing function for the lessee. This is the case when the lessee redeems irrespective of the accounting treatment the difference between the purchase price and the estimated residual value through his payment of the lease instalments.

In all other cases, the treatment should be according to the guidelines for the rental business.

Since the redemption portion as to Operating leasing with which the difference between the purchase price of the leased asset and the agreed residual value is repaid is included in the leasing instalment to be booked as leasing income, this ought to be excluded in the calculation of the Business Indicator to avoid an unwarranted discrimination against Operating Leasing from the risk perspective. Furthermore, the interest expense booked in the leasing expense should also be deducted from the leasing earnings.

Owing to the allocation of beneficial ownership of the leased asset to the lessor, the book value of the leased asset should be diminished to reflect scheduled depreciation. For purposes of simplification, it may be desirable to deduct the scheduled depreciation available in the income statement from the leasing income instead of the redemption. Considered over a three-year period, the scheduled depreciation and regular redemption should not differ substantially from each other. The deduction of depreciation could achieve a correction of the leasing income comparable to the redemption so that the level of the Business Indicator would not significantly differ from that of a credit transaction with comparable operational risk.

C. Determination of the net interest income and the leasing earnings and leasing expenses in the event of a significant and effective risk transfer of securitisation positions

The question arises as to how the calculation of interest income and interest expenses and the leasing income and leasing expenses should be calculated if a significant and effective risk transfer of the securitisation positions has been effected according to the regulatory requirements, but due to different accounting objectives no balance-sheet derecognition of the securitised receivables takes place. We argue in this case, owing to the effective risk transfer, that the interest result and the leasing income and leasing expenses from these receivables can be kept out of the calculation of the Business Indicator and we ask for clarification of this point. This would also be appropriate in the context that the Servicing Fee from the administration of the receivables shall increase the Business Indicator. Otherwise, there would be an unjustified double counting.

D. Services

We understand the weaknesses of the Gross Income Indicator in principle. However, we see an addition of the Fee Income and the Fee Expenses and the addition of the Other Operating Income and the Other Operating Expenses as inappropriate. The main criticism of the construction of the Gross Income Indicator up to now has been that, with constant or increasing operational risks, the Gross Income Indicator has decreased on average during the last financial crisis and the capital requirements have therefore decreased as well. There is also the possibility that the Gross Income Indicator could assume the value zero or a negative value. In such cases, no backing of operational risks with equity would take place. In order to deal with such cases in a manner appropriate to the risks involved, an addition of the income and expense components is not required. It would be more appropriate to use the higher value from the Fee Income and Fee Expenses and the higher value of the Other Income and Other Expenses as the basis. This could achieve an appropriate capital adequacy backing since the Business Indicator would not fall even in times of crisis and would not attain a value of zero or below.

E. Exception required for credit brokerage

In the automobile industry, there is a dealer franchise network where the car dealer acts as an agent between customer and the credit institution or leasing company to offer loans and lease contracts. In return, the car dealer obtains and the credit institution or the leasing company has to pay a dealer commission fees if the bank or leasing company decides to grant the loan or to conclude the lease contract. The business relationship between the car dealer and the bank and leasing company is long-term oriented and generally exists for many years.

The processing of the loan application, the credit decision and subsequent administration of the contracts is typically carried out by the credit institution or leasing company. An additional operational risk arising from the credit brokerage therefore does not exist. The operational risks of the credit agreement so far are not different from those associated with a loan application initiated via bank staff.

The operational risks associated with lending are already covered by the net interest income from these transactions. The consideration of the amount of the dealer commission would have to be added to the interest result and thus further increase the capital requirement. This is not appropriate in our view. A double consideration of the same transaction with a capital requirement for operational risk should be avoided. It should be clarified that the commission for the brokerage of loans and leases contracts does not need to be included in the calculation of the business indicator.

E. Gains and losses from non-recurrent assets and disposal group classified as Held for Sale not qualifying as discontinued operations

We ask you to explain what exactly you mean by this and which specific items are to be classified under such a case.

Q1: It could be desirable that, when collecting data relating to losses in future, operational losses be recorded separately for the lending business and the leasing business so as to be better able to compare the loss characteristics in the lending and leasing business with one another. See our comments above to the weaknesses.

Q2: Basically, yes. However, the possibility cannot be excluded that the differences in the retail and corporate business segments are masked by the size indicator and therefore distorted. Smaller institutions often have their focus in the retail business. The coefficient for small institutions is very low. To that extent, there will probably be a high correlation between the operational risks in the retail business and the size of

the institution. If the size indicator is introduced as an additional variable, this can, especially when only a few larger institutions have their focus in the retail business, lead to the result that no statistically significant differences can be detected anymore in relation to all the institutions in the sample. To test whether levels of operational losses differ in the leasing and lending business, the analysis should be conducted without the incorporation of a size variable. If then indeed no differences in the coefficients of the corporate and retail business are identified, a business field division into retail and corporate customers would not make sense. Otherwise it would have been shown that the operational risk in the retail business is lower than that in the corporate business segment. Without a proper differentiation and breakdown of the credit and leasing business into a corporate and retail segment, the actual operational risk for medium-sized and larger companies with a focus on retail business would in some circumstances be disproportionately prominent. In such a case, at least in the credit and leasing business, the separation between retail and corporate business should therefore be maintained.

Q 3. Improvements are necessary in the design of the Business Indicator and the treatments of its component. From an economical and conceptual point of view one and the same business can only have one operational risk. This applies especially for the leasing business where a strong economic link exists between leasing income and leasing expenses. Thus, double capital requirements for one business should be avoided.

Q4: It would be useful in the course of the next QIS to collect loss data from the operational losses in the leasing business so as to be able to compare them with those of the credit business, in particular with regard to the figures for the Value at Operational Risk).

Q5: We have the impression that the range between €3 billion and €30 billion is too undifferentiated. Given that the operational risks increase with the size of the Business Indicator, a smoothing function should be used instead of buckets. The result of such a smoothing function should be multiplied with the amount of the Business Indicator.

Q6: See our answer to question 2.

Q7: No, as far as visible at this early point in time.

Q8: Highest Priority should have the correction of the business indicator for the leasing business.

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