ASSILEA

Prot. 1877

Basel Committee on Banking
Supervision
Bank for International Settlements
Centralbahnplatz, 2
CH-4002 Basel
Switzerland

Rome, July 31st, 2003

Re: The New Basel Capital Accord (Third Consultative Paper issued in April 2003)

Dear Sirs/Madams,

Assilea, the Italian Leasing Association, represents almost the entire Italian leasing market: the second in Europe by business volume,[1] after Germany, and the largest in the European real estate leasing sector. Assilea is also member of Leaseurope, the European Leasing Federation.

Please, find hereby enclosed our comments about your Third Consultative Paper issued in April 2003.

Yours faithfully,

Mr. Antonio DATTOLO
President of the Assilea
Associazione Italiana Leasing - Italy

[1] according to the official statistics of the sector, published in Leaseurope's website www.leaseurope.org

BASEL II – CP3
COMMENTS FROM ASSILEA
31 July 2003

Issues relating to finance leases

Specific requirements expressly concerning leasing transactions have been introduced for the first time in Section H, "Minimum requirements for IRB approach", sub-section 10.

Paragraph 486
The relevant provision is that finance leases[2] "*will be accorded the same treatment as exposures collateralised by the same type of collateral… (CRE/RRE or other collateral).*" This requirement appears to be exceedingly penalising for leasing transactions, on the one hand, and unsure as to actual applicability on the other hand. For:

1. It appears penalising in that the legal ownership title to the leased asset allows the lessor to rely on far better recovery time and rates (i.e. lower LGDs) than in the case of similar asset finance transactions merely secured by mortgage or pledge, in connection wherewith the Bank of Italy has long collected ample statistical evidence showing that real estate leases have a far lower risk content than CRE lending transactions; and
2. It appears unsure as to actual applicability in that the "risk mitigation" effect implied in leasing transactions is fully available not only in the case of "immovable" (real) property, but in the case of other medium-to-high fungibility leased assets as well (e.g. motor vehicles, aircraft or printing presses), whereas paragraphs 484 and 485 require that national supervisors may allow for recognition of "other physical collateral", provided that certain standards which most leases are likely to comply with are met.

As for the first issue, having regard to the considerable size of the real-estate leasing market in Europe (around 20% of market share according to the official statistics)[3] and to the firmly-established low risk content of this specific asset finance instrument, though in the awareness that the level of risk associated with leases may vary from a country to another even to a large extent, and because of the different contractual, commercial and operational terms applied in practice in any one country relative to another, it is hereby suggested that each national Supervisory Authority should be allowed:

- under the Standardised IRB Approach, as similarly provided for in footnote 21 to paragraph 47 (CRE), to assign a separate, specific risk weight to real estate leases – equal to the risk weight accorded, for example, to RE (35%) or, at least, to the one currently in force (50%) for total exposure;

[2] The actual wording in the Basel document is, in fact: "*Leases other than those that expose the bank to residual value risk*", a phrase that appears to refer to the definition of a Finance Lease given by IAS 17.
[3] Published in Leaseurope's website: www.leaseurope.org.

- under the Foundation IRB approach, as similarly provided for in footnote 64 to paragraph 258, to assign a separate, specific LGDs to real estate leases, at a lower rate than the average LGD applied to CRE (35%), and not to require over-collateralisation or, in the alternative, only to require over-collateralisation at a lower level than that required with respect to CRE (140%, see para. 264); and
- under the Advanced IRB Approach, as similarly provided for in paragraph 298 with respect to RRE, to apply a specific, more favourable formula to the calculation of risk weights in the case of real estate leases.

As for the second issue, it is by no means clear at this time whether or how leases should be recognised depending on the type of leased assets for the purposes of risk mitigation. Should they not be so recognised, finance leases (possibly with the exception of real estate leases) would incorrectly be treated as plain unsecured loans at all times, even in case the relevant leased asset has a high or good fungibility. Therefore, it appears necessary to clarify the extent of, and any requirements applicable to, the recognition of the leasing of assets other than real estate. Thus:

- in respect of the Standardised IRB Approach,
  - national supervisors should be allowed to introduce more favourable risk weights for leases of highly fungible assets with a secondary market meeting the requirements under paragraph 484 (e.g. motor cars, ships, aircraft, *etc.*); and
  - the possibility should be restated for leasing companies to rely on the effects provided for in paragraph 50 with respect to loans past due more than 90 days[4] wherever any such loan is covered in full by other forms of "eligible collateral";
- in respect of the Foundation IRB Approach, the 40% LGD applicable to loans secured by other forms of "eligible collateral" (see paragraph 258) should be recognised, much as such 40% rate appears exceedingly penalising for many types of leased assets in any event, and so appears to be the required level of over-collateralisation (140%, see paragraph 264); and
- in respect of the Advanced IRB Approach, a specific, more favourable formula should be applied to the calculation of risk weights for leases relating to highly fungible assets.

<u>Paragraphs 191, 194 and 195</u>

It is unclear whether the provisions set out in relation to "physical assets" intended for specific uses (e.g. ships, aircraft and others), as well as to IPRE and HVCRE, should only be applied – as one may construe in some respects – within the context of project financing transactions. In any event, the possible application of the treatment required with respect to these asset classes to leasing would be entirely inappropriate, artificially complex and unreliable, in addition to being highly penalising for the leasing business at large. More specifically, it should be pointed out that, in the case of HVCRE assets – which may be taken also to include leasing exposures to real estate under construction (for which a more careful treatment than that of real estate already constructed would otherwise appear to be

4 In this connection, it is unclear whether, in light of the option granted to the Bank of Italy to use a 180-day definition of "default", as opposed to 90 days, in the case of retail and PSE credit obligations (see footnote 80 to para. 414), reliance can be made by Italian lessors on obligors past due more than 180 days in this case as well.

unjustified) – the resulting adverse impact may be even worse, since (see para. 220) they are excluded from the estimates under the Advanced IRP approach or (if so allowed by the national supervisor, see para. 252) only admissible with an extremely penalising "correlation".

Paragraphs 277, and 436 through 439
The requirement is that, in calculating EAD (Exposure at default), "*for on-balance sheet items, banks must estimate EAD at no less than the current drawn amount*". In fact, since PD is to be calculated on the basis of a 12-month time horizon, assuming an EAD equal to the exposure obtaining at the time of estimation would be penalising in the case of leases and of transactions with principal repayments at fixed dates in general vs., for example, exposures to revocable overdraft accounts. It is unclear whether, in these particular cases, the use of statistical models is permitted in estimation of EADs.

Paragraphs 373
Much as the principle that "*banks must take all relevant available information into account in assigning ratings to borrowers*" and that "*information must be current*" may well be shared in theory, it appears appropriate, in the case of leases and other finance transactions not revocable by the bank, to provide for a different depth of the analysis for rating assignment depending on the specific stage of such analysis, whether when granting a rating or when merely monitoring creditworthiness. Incurring exceedingly high costs to update all the data and information which was just reasonable to collect at the time of lending would otherwise be inconsistent with the different, comparatively minor, purposes of merely monitoring the performance of a loan outstanding.

Issues relating to operating leases

Paragraph 487
The requirement here is that a specific treatment should be applied to operating leases (as defined by IAS 17), i.e. leasing transactions in which "*residual value risk*" rests with the lessor.

As for the treatment of "residual value risk" recommended by the Basel Committee, it should be pointed out that, in order for capital charges to be correctly measured against the risk actually assumed, it appears more appropriate to apply a 200% risk weight to the portion of residual value in excess of 50% of the presumable fair value of the asset at the time of expiry of the lease term. In this way – the measure of the average capital requirement set out by the Basel Committee being kept unchanged – the lessors that are the more "prudent" in predicting final residual values will be "rewarded", whereas those that assume residual values which are close to, or the same as, presumable fair values at lease expiry will be "punished".

Issues relating to supervised leasing companies

Paragraph 39 (SA) – 198 (IRB)

In Italy most leasing companies are supervised direct by the national supervisor, whether out of their status as banks or because they are entered in the Special List provided for by Article 107 of the Italian Consolidating Banking Act (t.u.l.b.).

In the same way as provided for with respect to claims on supervised securities firms, it now appears anachronistic and penalising not to treat claims on supervised leasing companies in the same manners as claims on banks – at least with respect to leasing companies that are members of banking groups, thus already subject to compliance with "consolidated" capital requirements and supervisory regulations.