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Your ref. : The New Basel Capital Accord, April 2003
Our ref. : Int2003_020/DG

Eindhoven, 30 July 2003

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Subject : Leasing-related comments on Consultative Paper 3

Dear Mrs Nouy,

Over the past year a number of major bank-owned Dutch leasing companies have had regular meetings and discussions about the New Basel Capital Accord (Basel II) and the impact of this Accord on the leasing industry. In view of these discussions we have also had contacts with Leaseurope.

In general we feel that Basel II, CP3 provides the basis for setting up a balanced risk measurement and management framework enabling finance companies to opt for an advanced way of conducting their core business activities. Nevertheless we would like to take the opportunity to submit a few, in the total context of the Accord minor, but for the leasing society rather important points of attention regarding leasing activities in view of CP3. These points refer to the annual review of ratings, the determination of minimum capital requirements for residual value risk exposures and the LGD determination for real estate lease in case of scarcity of default observations (lack of a sufficient number of data points).

This letter and comment paper to the third Consultative Paper of the Basel Committee on Banking Supervision is the joint result of discussions and meetings of the following Dutch bank-owned leasing companies.

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**Introduction, general characteristics of mainstream leasing business activities**

Mainstream leasing as a typical form of asset-based financing can be characterised by way of the following observations:

- leasing is much more transaction-driven than counterparty-driven. Particularly in case of small-ticket leasing (retail-like leasing activities) this will result in the need for very efficient acceptance processes which implies that ticket and ticket size are important for decisionmaking and risk management next to the risk profile of the customer/lessee;
- leasing is asset-based financing by way of "installment loans";
- leasing contracts have fixed terms and conditions;
- particularly in case of small-ticket leasing management of such leasing business is portfolio-driven and the individual transaction often is viewed as a "one-shot approach". Arrears management is a key element in portfolio management and the provisioning policy usually is based on arrears management in combination with ageing analyses;
- the end-user/lessee often has the perception that he rents a particular equipment device rather than having a financing arrangement. And in a number of cases the rent may be combined with specific services and support.

**Annual review of corporate ratings**

Paragraph 387 on page 75 of CP3 contains the guideline about the annual refreshment of corporate, sovereign and bank ratings. Particularly for corporate exposures current practice with leasing companies is that the review/rerating policy is much more liberal than Basel II requires. The specific characteristics of leasing transactions, as outlined in the introduction, always have played an important role in defining the review/rerating policies due to the fact that both the customer profile and the asset-side contribute to the review/rerating judgement.

<u>Alternative set of decisive parameters</u>
Rather than only taking into account the applicable rating for corporate exposures and its validity or age, the leasing approach would be to define an alternative set of parameters consisting of a combination of rating or PD information, exposure amounts and asset or collateral information. The following set of alternative parameters could serve as an example for getting the appropriate mindset with regard to the review/rerating policy for corporate leasing exposures:

1. for all exposures < EUR X million: do nothing unless there are clear signals pointing in the direction of deteriorating credit quality. The amount X normally will be substantially higher than the current Basel II amount of EUR 1 million;
2. for all exposures > EUR Y million: complete annual review and rerating of the customer's credit quality regardless of the risk profile;
3. for all exposures between EUR X and Y million: apply a two-step approach
   a) PD judgement (based on Rx = Rating Class judgement):
      - If PD < Rx: review once per every two years
      - If PD >= Rx: review every year

      see step b
   b) asset judgement
      - if the asset at least fully covers the outstanding on the basis of Book Value versus Value Line: no further action required;
      - in case of under coverage: complete review and rerating of the customer's credit quality;

4. if desired or felt necessary, for specific transactions or product forms more strict review and rerating criteria can be defined and established at the application or acceptance moment. Examples could refer to IT/software leases, leases to rental companies, etcetera;
5. additional remarks:
   - the availability of a PD and LGD migration matrix may provide additional information for the review/rerating judgement process;
   - if available reratings from the parent bank may be used in the rerating process;
   - leasing is an arrangement without the possibility to adjust contractual conditions during the term of the lease. In case of a default during the term of a lease, one can only try to establish as much as possible loss reduction or restriction and, if necessary, form a provision;
   - arrears management and portfolio management are essential elements of portfolio monitoring in case of leasing (performance of a particular exposure, payment behaviour, etcetera);
   - eventually the remaing term of a lease contract could be an extra criterion for establishing whether or not to review/rerate an exposure.

Recommendation
In order not to disturb the logical setup of CP3, we would like to recommend to include a footnote with paragraph 387 stating that "the review/rerating requirements for leasing companies will be agreed in consultation with the supervisor". The set of alternative parameters as above presented could serve as an example for regulators and supervisors to start discussions about the leasing-specific review/rerating framework for corporate exposures.

**Determination of minimum capital requirements for residual value risk exposures**

Paragraphs 486 and 487 of CP3 explicitly deal with leasing-related requirements in view of residual risk exposures. Especially paragraph 487 contains guidelines with regard to the calculation of the minimum capital requirement in case a leasing company is exposed to residual value risk. The specific workout of this residual risk guideline effectively boils down to applying the current Basel I calculation rules, i.e. any residual value will be risk weighted at 100%. For leasing companies, typically being specialised asset-based financing companies, asset management at contractual end date of a leasing contract is a core part of the business activities. In this respect we also would like to refer to the document of ABN-AMRO Lease Holding NV submitted to the Basel Committee on 28 May 2001 and containing comments to the Basel II proposals with regard to the collateral protection to reduce credit risk in case of vehicle leasing. And also studies of Leaseurope have revealed that lease assets generally provide very good collateral protection in order to mitigate credit risk.

Bearing in mind the scope and tenor of the New Basel Capital Accord characterised by the emphasis put on modeling exercises for appropriate risk measurement and management, the guideline of paragraph 487 seems to be in contradiction to this basic principle since the proposed calculation of minimum capital requirements for residual risk exposures is the same as the currently applied Basel I calculation method.

Recommendation
Like for rating processes also for residual asset valuation processes modeling exercises can be carried out in order to determine the volatility of residual value results and hence the minimum capital requirements according to the basic Basel II principles. We would like to recommend to redefine the concept of residual value risk and allow leasing companies to apply modeling activities in order to determine the real or net residual value risks. For calculation of the minimum capital requirement this amount of real or net residual value risk then should be weighted with the established weighting factor.

## LGD determination for real estate lease in case of scarcity of default observations

When applying the IRB Advanced Approach in case of a real estate lease portfolio and establishing a statistically sound LGD parameter, the issue could be that too few defaults or data points are "available" in order to get to this statistically sound parameter determination. Bearing in mind that the preference will be to apply LGD modeling activities in line with the basic principles of the Basel II Accord and also bearing in mind that the "slotting approach" as described in annex 4 of CP3 for Specialised Lending provides some guidelines to deal with this type of issue, the question has come up whether an alternative approach would also be permitted to determine LGD parameters in case of scarcity of default observations.

Recommendation
For determining LGD parameters in case of a real estate lease portfolio in combination with too few default data points available, one could start with an expert judgement-based market value estimate at origination date of the transaction. This estimated market value will annually be depreciated for technical obscolence and in addition to this annual technical depreciation, a correction could be applied in line with market indices for real estate as determined and published by real estate expert firms (e.g. Jones Lang LaSalle).

For practical purposes this recommendation could be included in the final Accord by way of a footnote to paragraph 430 stating that lack of a sufficient number of data points for LGD parameter determination under the IRB Advanced Approach for real estate lease activities may be resolved in consultation with the local supervisor by way of applying an expert judgement-based market value estimate in combination with regular depreciation for technical obscolence and a correction for market value developments as indicated by an appropriate real estate lease index.

## Final remarks

For us as bank-owned Dutch leasing companies it is a challenge to put the Basel II proposals into practice in a leasing environment in which also non-regulated competitors play a dominant role. Nevertheless we clearly see the benefits of the proposed framework since the impetus for professional improvement in risk management can only lead to more sound business practices. In implementing the framework in our respective companies however, we would be very grateful if the abovementioned attention points would be honoured and included in the final New Basel Capital Accord.