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European Federation of Equipment Leasing Companies Association
Fédération Européenne des Associations des Etablissements de Crédit-bail
Europäische Vereinigung der Verbände von Leasing-Gesellschaften

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

Brussels, July 31st, 2003

MS 2/4.20/2

Dear Madam, dear Sir,

POSITION PAPER ON BASEL COMMITTEE ON BANKING SUPERVISION'S THIRD CONSULTATIVE PAPER (CP3) ON THE NEW BASEL CAPITAL ACCORD

With regard to the Basel Committee's third consultative paper (CP3), LEASEUROPE [1] appreciates the opportunity to express European Leasing Industry's opinion and concern on the current proposal. As a Federation representing 25 national associations, which in turn represent 1,150 leasing companies, LEASEUROPE wishes to contribute to the refinement and calibration of the new capital adequacy framework so as to foster an appropriate recognition of the characteristics of the Leasing industry, which – with new business of more than €199 billion in 2002 – accounts for about 15% of the total amount of gross fixed capital formation in Europe and is used as an external means of financing by about 39% of the European SMEs[2, 3].

In this context, it is the Federation's objective to underline the particular importance of certain amendments and modifications to be considered in order to attain optimal solutions. Following this approach, our focal point of interest clearly centres on the reassessment of physical collaterals, which so far only receive recognition in the case of Real Estate mortgage exposures, but not in the case of lease exposures. We are of the opinion that special characteristics, which differentiate lease exposures from other means of financing, are not fully recognised.

[1] LEASEUROPE is the European Federation of Leasing Company Associations
[2] See study by Exco Grant Thornton (2001)
[3] SMEs are more often confronted with difficulties in presenting adequate securities and thus opt for leasing as a more cost-effective financing option, which especially regroups companies with current low returns but considerable growth opportunities. (e.g. see Lasfer and Levis (1998))

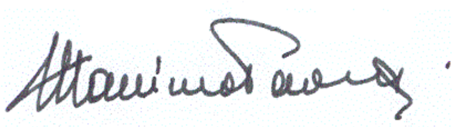
The one common denominator of all lease contracts is that the lessor keeps the legal title of ownership of the leased asset during the entire period of the lease. This specific characteristic of all lease contracts differentiates them from other types of financing and thus imparts the highest level of priority in the sense of a non-disputable asset, which contributes to make lease exposures relatively low risk as compared with other financing modes and therefore not only applicable to real estate leases, but to all lease contracts.

In full appreciation of the committee's intention to provide for an appropriate and proportionate capital requirement for financial institutions, the current proposition with regard to financing by means of leases remains particularly unsatisfactory. We shall therefore kindly ask for a careful reconsideration of the importance of physical collaterals in the weighting ratio calculations, which in our opinion has not yet been fully taken into account.

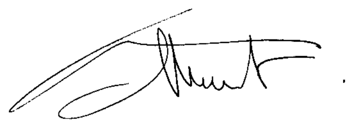
This position paper is structured as follows: Section I will give a clear overview of the key points developed in this paper. In Sections II and III, European leasing companies' main concerns are reviewed and paths for solutions identified, based on the results of the empirical studies[4] conducted by LEASEUROPE in cooperation with the academic world (namely the Bocconi University and the Solvay Business School – ULB). Sections II and III deal respectively with real estate lease exposures and lease exposures other than real estate. In final Section IV the issue of Specialized Lending is being discussed.

We are entirely at your disposal should you require further information or should there be a need for further discussion on any of the issues raised in the enclosed document. Please feel free to directly contact Mathias Schmit, LEASEUROPE, who can be reached at +32-2-778-05-68.

Yours sincerely,



Mr. Massimo PAOLETTI
CHAIRMAN OF LEASEUROPE



Mr. Marc BAERT
SECRETARY GENERAL

[4] DE LAURENTIS G. & M. GERANIO (2001), "Leasing Recovery Rates", Bocconi University, SCHMIT M. & STUYCK J. (2002), "Recovery Rates in the Lease Industry", SCHMIT M. (2002a), "Is Automotive Leasing a Risky Business?", and SCHMIT M. (2002b), "Credit Risk in the Leasing Business". DUCHEMIN, LAURENT, SCHMIT (2003), " To what extent are automotive lease exposures sensitive to systematic risk". These are available on LEASEUROPE's website at http://www.leaseurope.org/pages/Studies_and_Statements/Studies_and_Statements.asp.

I. HIGHLIGHTS

1. LEASEUROPE fully understands and supports Basel Committee's objectives to modernise the existing framework, to make it more comprehensive and risk-sensitive and to foster enhanced risk management amongst financial institutions, so as to maximise the effectiveness of capital rules in ensuring continuing financial stability, maintaining confidence in financial institutions and protecting customers.

2. Empirical studies conducted by LEASEUROPE in collaboration with the academic world confirm that *lease exposures are relatively low risk* as compared to other means of financing. The presence of **physical collaterals –** in the form of marketable assets owned by the lessor during the entire lease term – contributes to a large extent to this **lower risk level**. Still, as the Basel Committee's current proposal only provides for a partial recognition of physical collaterals as credit risk mitigants, this shortcoming might prevent capital requirements to adequately reflect leases' risk profile.

3. As far as the treatment of **real estate leases** is concerned for both CRE and RRE, it appears penalising that the legal ownership title to the leased asset does not allow 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. Therefore, it seems necessary to attribute a specific treatment to real estate lease contracts, both under the standardised and the IRBF approach as motivated in Section II of this paper.

4. Looking at **other physical collaterals**, leased assets should meet the minimum requirements to be eligible as a collateral. Indeed, a large number of leased assets can be qualified as 'standardized assets' that have the following properties: (i) are part of a liquid secondary market even in economic downturns; (ii) are easy to bring on the secondary market and at a low cost; (iii) can be remarketed on different markets by many players and in different countries; (iv) are not subject to rapid technological development in comparison with the duration of the lease portfolio. This class of assets includes cars, trucks, fork-lift trucks, excavators, printing presses, medical equipment, etc. However, many questions remain as to which extent the risk mitigating effect should be taken into account for these physical collaterals:

    a. Section III.2 points out that the 75% weighting ratio assigned to leases qualifying as retail exposures is very conservative. As shown in III.3, this results in significant **differences in capital requirements** according to the approach selected by a leasing company and is thus contrary to the Basel Committee's objective to provide *modest* incentives for institutions moving to a more advanced approach.

    b. Section III.3 also points out that leased assets are among the collaterals for which the highest number of requirements are to be met so that their **credit risk**

mitigating effects can be recognised. This is out of proportion not only with the marginal capital relief granted in the IRB foundation approach but also with the relatively low-risk profile of lease exposures. The Federation thus proposes to adjust those minimum requirements, notably in order to prevent them from penalising retail exposures.

c. Section III.4 concerns the fact that the point of reference for financial institutions establishing internal requirements for collateral management, operational procedures, legal certainty and risk management process is not designed for retail asset-based exposures but for financial-based and corporate exposures. This shows the crucial need for an **appropriate supervisory assessment** of leasing companies' inputs according to their characteristics and risk profile. This would avoid possible confusion in interpretations of the regulatory text.

5. In § 487 of CP3, the Committee includes a capital requirement calculated on market risk in addition to the one calculated on credit risk for lease contracts exposed to **residual value risk**. This is penalizing since both risks cannot occur simultaneously for lease exposures. In order to avoid this situation, clearer definitions of LGD and EAD should be given. Also, when returns on leased assets are carefully monitored and residual values set conservatively, as it should be the case given the minimum requirements for the recognition of physical collaterals, the weighting ratio should be adapted to a more realistic level than the proposed 100% weighting ratio. This concern is dealt with in part III.5.

6. The obligation of an annual revision of **corporate borrowers and facilities' rating** is the result of a systematic approach to detect indications for possible deficiency but it imposes an excessive burden on the leasing companies (e.g. the inspection of a fleet of cars). The Federation therefore proposes to establish a number of criteria that are to determine when a punctual review is necessary; a concern to be treated in section III.6.

7. As leases are asset-backed transactions that incorporate various inherent specificities they provide for a more meaningful **differentiation of risk** than the characteristics of the borrower for the retail business and we thus suggest that only the relevant borrower and/or transaction risk characteristics should be taken into account in the process of assigning exposures to a pool as specified in section III.7

8. As explained in Section IV, Leaseurope is strongly concerned with the provisions set out in relation to 'physical assets' intended for **specific uses** as well as to IPRE and HVCRE. The possible application of the treatment required with respect to these asset classes to leases would be entirely inappropriate, complex and unreliable.

9. Many European financial companies are subject to strict **Central Bank supervision**, even if not formally considered as banks. It is therefore inconsistent to consider them as corporates instead of banks for their own funding.

II. CAPITAL REQUIREMENTS FOR REAL ESTATE LEASE EXPOSURES

➔ Principles

Under the *standardised approach*, claims fully secured by *mortgages on residential property* that is or will be occupied by the borrower, or that is rented, will be risk weighted at 35%, subject to strict prudential criteria[5]. *Claims secured by commercial real estate* do not in principle justify other than a 100% weighting of the loans secured. However, at national discretion and for well-developed and long-established markets, mortgages on office and/or multi-purpose commercial premises may have the potential to receive a preferential risk weight of 50%, subject to very strict conditions[6].

Under the *IRB foundation approach*, specified commercial and residential real estate may be recognised as eligible collaterals, subject to minimum requirements. LGD adjustments stemming from this recognition are limited by a regulatory floor set at 35% (with a required level of over-collateralisation of 140% for full LGD recognition)[7].

➔ Leasing Industry's Concerns

Contrary to mortgage exposures, real estate leases are not dealt with in a distinct set of principles in the new framework. Leases are indeed assimilated to a loan guaranteed by an asset belonging to the borrower. However, under a lease contract, privileged lenders do not prevail over the lessor (whereas this is the case for a 'classical lender' whose guarantee is an asset belonging to the obligor) because the lessor remains the legal owner of the asset during the entire lease term and may to this respect recover the economic property of his asset whenever the lessee faces difficulties in honouring his debt (recovery procedures being more flexible and faster than those existing for assets left as securities).

➔ Recommendation

Given the specific risk profile of real estate lease exposures as compared to other real estate contracts, it seems necessary to attribute a specific treatment to real estate lease contracts, both under the standardised and the IRBF approach.

Under the *standardised approach*, we are not in favour to leases being brought in line with traditional loans secured by commercial real estate. Indeed, Directive 98-32 of June 22, 1998, provides the possibility of applying a 50% risk weight to leases without setting any limit to the weighting basis[8], whereas for loans secured by mortgages on offices and commercial property used for multiple purposes, this risk weight only comes into play for the lowest of the following limits: 50% of the market value of the property or 60% of its mortgage lending value, while a 100% risk

[5] Cf. Consultative Document – The New Capital Accord (CP3), §45, p. 11.
[6] Cf. Consultative Document – The New Capital Accord (CP3), §47 and footnote 22, p. 18
[7] Cf. Consultative Document – The New Capital Accord (CP3), §264, p. 54.
[8] Cf. article 62 §1 and §2 of Directive 2000/12 of 20 March 2000.

weight is applied to the part of the loan that exceeds these thresholds. In view of the above, leases should continue to benefit, at the very least, from a 50% risk weight applicable to the lease agreement in its entirety, as experience in the European context has shown to be justified. Should the European Commission opt for a 50% risk weight for commercial mortgage loans, applicable to the lender's commitment as a whole, it would be appropriate, for the reasons explained above, for leases to benefit from a lower risk weight, which we would propose setting at 40%.

Under the *IRBF approach,* we propose a 30% LGD – lower than that prescribed for lending secured by commercial real estate – and the non-introduction of any over-securitisation measures. Note that in light of the above-mentioned studies, the proposed LGD is still very conservative for most lease exposures.

III. CAPITAL REQUIREMENTS FOR LEASE EXPOSURES OTHER THAN REAL ESTATES

III.1 Definition of Default

➔ **Principles**[9]

For the purposes of the Internal Ratings Based Approach to credit risk minimum capital requirements a 'default' shall be considered to have occurred *with regard to a particular obligor* when either or both of the two following events has taken place:

- The institution considers that the obligor is unlikely to pay its credit obligations to the institution in full, without recourse by the institution to actions such as realising security (if held).
- The obligor is *past due more than 90 days on any material credit obligation to the institution*. Overdrafts shall be considered as being past due once the customer has breached an advised limit or been advised of a limit smaller than current outstandings.

➔ **Leasing Industry's Concerns**

More than the length of the period after which a contract is considered as defaulted, it is the fact that default on one contract triggers default on all contracts of an obligor which raises concern in the leasing industry. Indeed, under the current definition of default, most large corporate customers of leasing companies – and notably governments – would be considered as in default. But, in most cases, the default is only a *'technical default'* as it relates to the high probability – for an obligor with a large amount of small contracts with the same lessor – of experiencing technical problems (e.g. direct debit system) delaying the payment on one of its leases. These technical defaults have very significant consequences in terms of capital requirements under the current proposal while, in reality, they have very little negative impact on leasing companies, as – ultimately – there is often no loss.

[9] Cf. Consultative Document – The New Capital Accord (CP3), §414, p.80.

➔ Recommendation

The period of time after which a contract is considered as defaulted varies significantly according to the best business practices among countries. We therefore think that it is important to allow national supervisors to lengthen the 90 days period provided for by the framework. Alternatively, one might consider to charge an independent credit function within the leasing company to assess whether a client, having a 90-day overdue payment, is "technically" in default or "economically".

Consequently, there is also a crucial need to establish a set of criteria defining *'technical default'*, i.e. a situation where default on a credit obligation relates to the high probability – for an obligor with a large amount of small contracts with the same lessor – of experiencing technical problems delaying the payment on one of its leases, and thus by no means indicating a default of the obligor and hence of all its contracts.

III.2 Capital Requirements for Lease Exposures under the Standardised Approach

➔ Principles

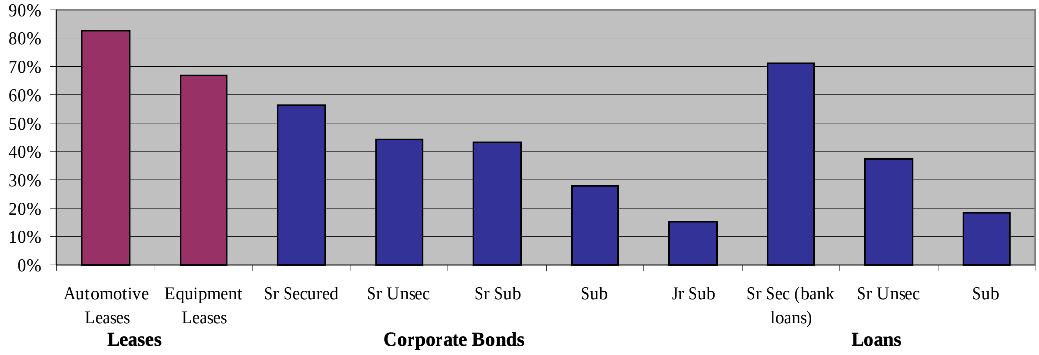
Under the standardised approach, lease contracts falling under the definition of *retail* exposures would be assigned a 6% regulatory capital ratio (i.e. 75% risk weight times 8% weighting ratio).

➔ Leasing Industry's Concerns

In light of the results of studies LEASEUROPE conducted in collaboration with academics, it appears that a 6% regulatory capital ratio is a very conservative rate for most leasing activities. Indeed, the presence of physical collaterals as well as the high level of priority of lease exposures result in the fact that leases are relatively low risk as compared with other means of financing. For instance, empirical results on lease exposures – based on a sample of more than 37,000 defaulted contracts from six European countries – show that recovery rates are as high as those of the best senior secured loans (bank loans) (see *graph 1*). Still, the current proposal does not recognise the credit risk mitigating effect of physical collaterals (others than residential and commercial real estate) under the standardised approach.

Graph 1: Average Recovery Rates by Seniority of Corporate Bonds and Loans

Comparison with Leases



Source: Schmit (2002b), *Tables 5a and 5b*,. *http://www.leaseurope.org/pages/Studies_and_Statements/Studies/PDLGDFINAL.pdf*

Table 1 supports LEASEUROPE's conclusions. Based on the principle that the three approaches should be consistent in terms of capital requirements, implied PD are calculated for various LGD levels[10] with a 75% risk weighting ratio. Given the size of the studied samples (more than 37,000 defaulted lease contracts), we can reasonably and reliably estimate that the weighted average LGD in the leasing industry is between 15% and 35% (see *table 1*). These LGD correspond to implied PD lying between 5% and 25%, which is much higher than actual PD. A 75% weighting ratio thus appears as being *particularly conservative* for exposures with a low LGD such as leases.

Table 1: Implied Probability of Default

Weighting Ratio	LGD	Implied PD	Weighting Ratio	LGD	Implied PD
75%	100%	0.43%	75%	35%	6.53%
75%	90%	0.52%	75%	30%	9.19%
75%	80%	0.64%	75%	25%	12.37%
75%	70%	0.82%	75%	20%	16.84%
75%	60%	1.15%	75%	15%	24.57%
75%	50%	1.85%	75%	10%	42.61%
75%	40%	4.17%			

In order to assess the 'conservatism' of the 75% weighting ratio, *table 2* shows the weighting ratio calculated under the IRBA approach for different levels of PD and LGD. Considering an actuarial probability of default of less than 3% and weighted average LGD of about 25% in the automotive leasing sector, the maximum weighting ratio calculated in the IRBA approach is 43.15% while in the standardised approach it is set at 75%. The same reasoning can be used for other types of standardised leased assets[11]. This is clearly in contradiction with the Basel Committee's objective to provide *modest incentives in terms of capital requirements for institutions moving to the more advanced approaches.*

[10] Following the formula provided for under the IRBA approach for 'other retail exposures'.

[11] 'Standardised assets' have the following properties: (i) are part of a liquid secondary market even in economic downturns; (ii) are easy to bring on the secondary market and at low cost; (iii) can be remarketed on different markets by many players and in different countries; (iv) are not subject to rapid technological development in comparison with the duration of the lease portfolio.

Table 2: Risk Weighting (in %) in function of PD and LGD *(as under the IRBA approach for 'other retail exposures')*

LGD \ PD	1%	2%	3%	4%	5%	6%	7%	8%	9%	10%
10%	**11.76**	**15.38**	**17.26**	18.56	19.68	20.81	22.01	23.32	24.72	26.21
15%	**17.63**	**23.07**	**25.89**	27.83	29.52	31.21	33.02	34.97	37.08	39.32
20%	**23.51**	**30.76**	**34.52**	37.11	39.36	41.62	44.02	46.63	49.44	52.42
25%	**29.39**	**38.44**	**43.15**	46.39	49.20	52.02	55.03	58.29	61.80	65.53
30%	35.27	46.13	51.78	55.67	59.04	62.43	66.04	69.95	74.16	78.63
35%	41.15	53.82	60.41	64.94	68.88	72.83	77.04	81.60	86.52	91.74
40%	47.03	61.51	69.04	74.22	78.72	83.23	88.05	93.26	98.87	104.84
50%	58.78	76.89	86.30	92.78	98.40	104.04	110.06	116.58	123.59	131.05
60%	70.54	92.27	103.56	111.33	118.08	124.85	132.07	139.89	148.31	157.26
70%	82.30	107.65	120.82	129.89	137.76	145.66	154.08	163.21	173.03	183.47
80%	94.05	123.02	138.08	148.44	157.44	166.47	176.09	186.52	197.75	209.68
90%	105.81	138.40	155.34	167.00	177.13	187.28	198.11	209.84	222.47	235.89
100%	117.56	153.78	172.60	185.56	196.81	208.09	220.12	233.15	247.19	262.10

Conservative levels of PD, LGD and weighting ratio estimated for automotive leases qualifying as retail.

Weighting ratio (with corresponding PD and LGD) over 75%

➔ Recommendation

LEASEUROPE is very concerned by the fact that the lack of adequate physical collaterals recognition under the standardised approach could result in the above-mentioned '<u>modest</u> incentive' objective not being met for the retail leasing industry. In light of the above results, we propose a weighting ratio of less than 50% for the automotive leasing industry and of 65% for the equipment sector as being an adequate benchmark.

Extending the capital relief provided for in the Basel proposal (for lending secured by financial collaterals, or mortgages on residential and commercial property) to other types of physical collaterals would indeed prevent leasing enterprises from being penalized with unduly conservative capital requirements when compared with capital requirements of claims that are comparable in terms of risk profile.

Such an adjustment for physical collaterals in capital requirement calculations should be governed by an adequate framework, which could be based on the minimum requirements set out by the Basel Committee for recognition of physical collateral under the IRBF approach, *subject to some amendments as outlined in Section III.3*.

III.3 Capital Requirements for Lease Exposures under the IRB Foundation Approach

➔ Principles

Under the IRBF approach, lease contracts are assigned a PD according to the internal borrower grade and a LGD of 45%[12].

[12] All subordinated claims on corporates, sovereigns and banks will be assigned a 75% LGD (cf. Consultative Document – The New Capital Accord (CP3), §257, p. 52.

There is no capital adjustment for retail exposures.

LGD may be adjusted to recognise the mitigating effect of collaterals (including physical collaterals) subject to operational requirements and a regulatory floor (set at 0% for financial collaterals, 35% for receivables, CRE and RRE and at 40% for other physical collaterals).

For 'other physical collaterals' to be recognised as eligible, the following minimum requirements must be met[13]:

(i) Only first liens on, or charges over, collateral are permissible. As such, the institution must have priority over all other lenders to the realised proceeds of the collateral *(cf. CP3, §485, p. 93, first bullet point)*.

(ii) The loan agreement must include detailed descriptions of the collateral plus detailed specifications of the manner and frequency of revaluation *(cf. CP3, §485, p. 93, second bullet point)*.

(iii) The types of physical collateral accepted by the institution, policies and practices in respect of the appropriate amount of each type of collateral relative to the exposure amount must be clearly documented in internal credit policies and procedures and available for examination and/or audit *(cf. CP3, §485, p. 93, third bullet point)*.

(iv) Institution credit policies with regard to the transaction structure must address appropriate collateral requirements relative to the exposure amount, the ability to liquidate the collateral readily, the ability to establish objectively a price or market value, the frequency with which the value can readily be obtained and the volatility of the value of the collateral *(cf. CP3, §485, p. 93, fourth bullet point)*.

(v) Both initial valuation and revaluation must take fully into account any deterioration and/or obsolescence of the collateral (e.g. effects of the passage of time on fashion- or date-sensitive collaterals) *(cf. CP3, §485, p. 93, fifth bullet point)*.

(vi) In cases of inventories and equipment, the periodic revaluation process must include physical inspection of the collateral *(cf. CP3, §485, p. 93, sixth bullet point)*.

For leases to be recognised as credit risk mitigants, the following standards must additionally be met[14]:

(vii) Robust risk management on the part of the lessor with respect to the location of the asset, the use to which it is put, its age, and planned obsolescence *(cf. CP3, §486, p. 94, first bullet point)*;

(viii) A robust legal framework establishing the lessor's legal ownership of the asset and its ability to exercise its rights as owner in a timely fashion *(cf. CP3, §486, p. 94, second bullet point)*; and

(ix) The difference between the rate of depreciation of the physical asset and the rate of amortisation of the lease payments must not be so large as to overstate the credit risk mitigation attributed to the leased asset *(cf. CP3, §486, p. 94, third bullet point)*.

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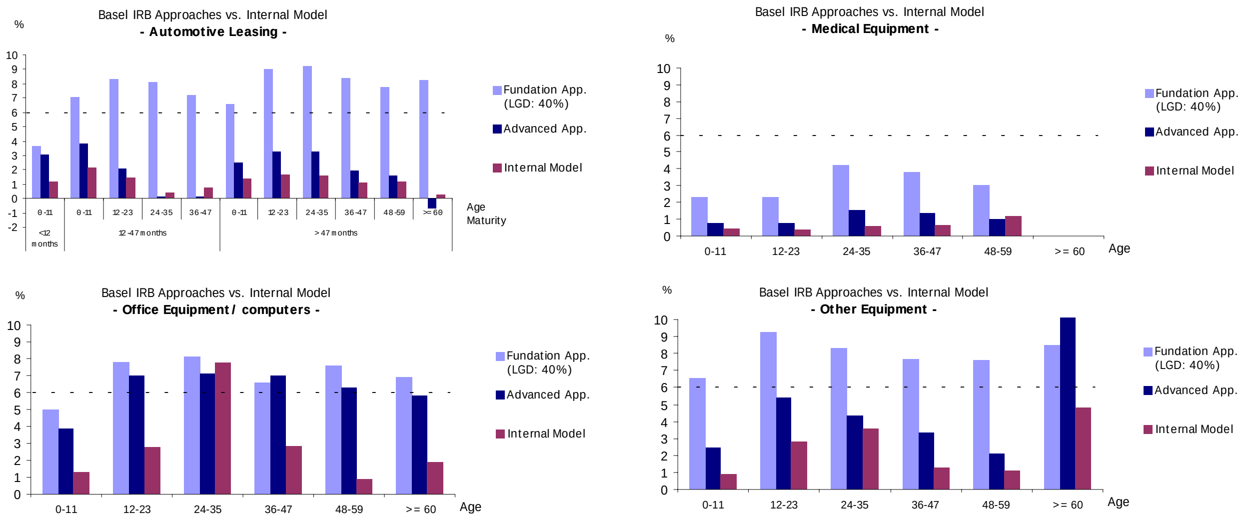
[13] Cf. Consultative Document – The New Capital Accord (CP3), §485, p. 93.
[14] Cf. Consultative Document – The New Capital Accord (CP3), §486, p. 94.

➔ Leasing Industry's Concerns

Graph 2 illustrates the simulations on capital requirements as calculated on the basis of LEASEUROPE's studies[15] internal model (in violet) and of the Basel proposal's IRB approaches (in light and dark blue). It shows that the differences in capital requirements resulting from the choice of one or the other approach would be significant for leasing companies.

Graph 2: Comparison between IRB regulatory capital requirements and capital requirements derived from internal model (retail lease portfolios)



Source: Schmit (2002b), *Table 10*, *http://www.leaseurope.org/pages/Studies_and_Statements/Studies/PDLGDFINAL.pdf*

The results of this comparison show that the choice of the IRBF approach would not be an economically sound decision for a significant portion of leasing companies. Indeed, *graph 2* clearly shows that, for most of the segments studied, capital requirements stemming from the IRBF approach – in lighter blue – would exceed 6% (i.e. the capital weighting for such exposures under the standardised approach) and would also be much higher than the capital requirements stemming from the IRBA approach – in darker blue. This is contrary to the Basel Committee's objective to *provide modest incentives in terms of capital requirements for institutions moving to the more advanced approaches.*

Two key characteristics of leases can explain these large discrepancies in capital requirements observed not only between the capital requirement stemming from LEASEUROPE studies' internal model and the proposal's IRBF approach, but also between the capital requirements derived from the IRBF approach and the two other approaches of the new framework: (i) the presence of **physical collaterals** (such as real estate properties, cars, trucks, machinery, etc.) and (ii) the fact that – in Europe – a sizeable portion of the lease contracts can be classified as **retail exposures**.

15 Cf. SCHMIT M. (2002a) and SCHMIT M. (2002b).

Given that leased assets remain the ownership of the lessor during the entire lease term and that lease specialists' good understanding of secondary markets generally places them in a favourable position to repossess the leased assets in case of default, physical collaterals largely contribute to the reduction of the credit risk associated with lease exposures. However, their recognition under the IRBF approach is limited. Indeed the capital requirement relief granted for physical collaterals is constrained by a regulatory floor on LGD, which limits its adjustment to 5% (from 45% to 40%) for 'other physical collaterals'. Additionally, financial institutions should comply with a large number of minimum requirements so that certain types of risk mitigating tools are recognised. However, these requirements may **not be adequate** for leases and other exposures characterised by the presence of collaterals. For instance, an individual assessment of leased assets – whether in the form of a periodic physical inspection (cf. CP3, §485, p. 93, sixth bullet point) or in the form of the taking into account of obsolescence (cf. CP3, §485, p. 93, fifth bullet point) – would indeed be totally inefficient in the context of leases. On the one hand, this requirement would induce undue costs (most of all for mobile leased assets such as automotive for rental, containers, etc.) and on the other – because it relates to an idiosyncratic risk – it would only marginally reduce a leasing company's global credit risk exposure.

The absence of capital requirement adjustment for retail portfolios under the IRBF approach also explains in part the observed difference in between capital requirements. It implies that for leasing companies wishing to move from the standardised to a more sophisticated approach, there would be no other option than (i) to adopt the IRBF approach as a transition approach despite the significant increase in capital requirements involved for retail portfolios, or (ii) to directly move to the IRBA approach. Note that, given the amount of resource and data needed to complete IRBA implementation and supervisor's approval, it is unlikely that European leasing companies will be able to opt for the second option as from 2006.

➔ Recommendation

The IRBF approach is clearly not the most appropriate one for financial institutions whose portfolio is characterised by a large portion of retail exposures. Still, as this approach might be a necessary transitional step for banks moving from a standardised to an IRB approach, it would be wise not to exclude the IRBF approach from the options available to the leasing companies by providing some crucial amendments to the current proposition.

We strongly insist on the need not to penalise retail exposures in the process of risk mitigation recognition. As mentioned above, to treat lease exposures on a case-by-case basis is most often inappropriate. We therefore propose that the new framework specify that the minimum requirements for 'other physical collaterals' (especially in *CP3, §485, p. 93, second, fifth and sixth bullet point*) be applicable on a *pooled basis* for retail exposures.

As far as the specific requirements for leases are concerned, we think that some minor adjustments in vocabulary might improve their general understanding and compatibility with the sector's best practices. In this context, we propose:

- In *CP3, §486, p. 94, first bullet point*, to replace the term ‘location’ by ‘nature’ so as to allow this requirement to be applicable to leased assets of which the location is often not even exactly known by the lessee (such as short-term car rental fleet, containers, etc.);
- In *CP3, §486, p. 94, second bullet point*, to replace the term ‘ownership’ by ‘rights’ so as to include a notion of ‘pledge’ and ‘security interest’; and
- In *CP3, §486, p. 94, third bullet point*, to give a clearer definition of what ‘not so large’ means.

We also think that it would be wise to allow national supervisors to set regulatory floors to LGD adjustment for ‘other physical collaterals’, according to national characteristics of the leasing market. Provided that national supervisors have at their disposal adequate historical data for statistic references, they could indeed consider to set more favourable LGD adjustment limits for certain asset segments.

III.4 Capital Requirements for Lease Exposures under the IRB Advanced Approach

➔ **Principles**

Under the IRBA approach, leasing companies shall provide their own estimates of PD, LGD and EAD.

The IRBA approach does not provide for *explicit* minimum requirements for collateral recognition (as under the standardised or the IRBF approach). Still, some *implicit* requirements are contained within the requirements specific to own-LGD estimates[16]:

(i) An institution shall estimate a long-run average LGD for each facility. This estimate shall be based on the average economic loss of all observed defaults within the data source (referred to elsewhere in this part as the default weighted average) and should not, for example, be the average of average annual loss rates. (…)

(ii) In its analysis, the institution shall *consider the extent of any dependence between the risk of the borrower with that of the collateral or collateral provider*. Cases where there is a significant degree of dependence shall be addressed in a conservative manner. Any *currency mismatch* between the underlying obligation and the collateral shall also be considered and treated conservatively in the institution’s assessment of LGD.

(iii) LGD estimates shall be *grounded in historical recovery rates* and, when applicable, shall *not solely be based on the collateral’s estimated market value*. This requirement recognises the potential inability of institutions to expeditiously gain control of their collateral and liquidate it. To the extent that LGD estimates take into account the existence of collateral, *institutions shall establish internal requirements for collateral management, operational procedures, legal certainty and risk management process that are generally consistent with those required for the standardised approach*.

[16] Cf. Consultative Document – The New Capital Accord (CP3), §430-435, pp. 83-4.

(iv) For the specific case of facilities already in default, the institution shall use its best estimate of expected loss for each facility given current economic circumstances and facility status. Collected fees from defaulted borrowers, including fees for late payment, may be treated as recoveries in the institution's LGD estimation. Unpaid late fees, to the extent that they have been capitalised in the institution's income statement, shall be added to the institution's measure of exposure or loss.

➔ **Leasing Industry's Concerns**

Requirements specific to own-LGD estimates indicate that *institutions shall establish internal requirements for collateral management, operational procedures, legal certainty and risk management process that are* ***generally consistent with those required for the standardised approach****.*

This involves that in order to be 'consistent' with the requirements laid out in the standardised approach, leasing companies opting for the IRBA approach would have to comply with requirements that are not designed for retail exposures characterised by physical collaterals but by financial collaterals.

➔ **Recommendation**

The frameworks needs to provide an **adequate point of reference** for institutions to establish internal requirements for collateral management, operational procedures, legal certainty and risk management process; and for national supervisors to evaluate these institutions' inputs.

This highlights the need for national supervisors to develop a set of criteria that would ensure an adequate consideration of physical collaterals when assessing a lease exposure's risk profile. **Appropriate assessment of leasing companies' own PD and LGD** under the IRBA approach will indeed be crucial for the achievement of the Basel Committee's objective to *make a framework that is more comprehensive and risk-sensitive and to foster enhanced risk management amongst financial institutions.*

III.5 Residual value risk for leases under the IRB approach

➔ **Principles**

The residual value risk for leases will be risk weighed at 100% as a result of the bank's exposure to potential loss due to the fair value of the equipment declining below its residual estimate at lease inception[17].

[17] Cf. Consutative Document – The New Capital Accord (CP3), §487,p.94

➔ Leasing Industry's Concerns

The proposition to risk-weight the residual value at 100% as outlined in CP3 takes exclusive reference to its market value and has to be considered in two distinct cases for a given time horizon (one year):

(i) Given the case that the lessee is in default before the end of contract and the asset had to be depreciated at a higher rate than foreseen. In this case, LGD is taken into account. Indeed, it is already accounted for by the calculated LGD as required by the IRBF approach (i.e. over-collateralisation, re-evaluation) and by the IRBA approach requiring taking into account the data of the past seven years.

(ii) Given the other case in which the lessee is not in default; the asset's residual value at the end of contract is exclusively subject to market risk (when it is expected to be at maturity for the period considered) without credit risk to be accounted for and thus does not have to be risk-weighted by credit risk. In fact, at the end of the lease contract the lessor is still owner of the asset (unless it has been resold) which as a result becomes part of the lessor's fixed assets. At this point the asset is already being risk-weighted at 100%, which has not been taken up by the CP3 (respectively CP2 and CP1) document at this part of the regulation on equity capital since it is not treated in the perimeter of the agreement's revision. Again in this case, if the residual value's risk at the end of contract is risk-weighted at 100% credit risk, it will be double weighted.

➔ Recommendation

Residual value management is a substantial part of the lessor's business. Indeed, lessors keep historical records on secondary markets and they also benefit from existing track records, which provide price guides for the majority of assets for which a well-established secondary market exists. Therefore, when returns on leased assets are carefully monitored and residual values set conservatively, as it should be the case given the minimum requirements for the recognition of physical collaterals, the weighting ratio should be adapted to a more realistic level than the proposed 100% weighting ratio.

In addition we propose the following definitions:

- The EAD must not only include the present value of all contractual lease payments, but also the sum of all late payments and the residual value on the day of the default
- The LGD in the event of the lessee being in default must include the loss on the residual value and be set into relation with the EAD as defined above.

Hence, the lessee's being in default before the end of the lease and the residual value risk at the end of the contract cannot coincide. Therefore, rather than adding the risk-weighting for the minimum lease payments and the weighting for the residual value (currently proposed at 100%), the maximum of the two should be applied instead.

III.6 Periodical Review of Ratings

➔ Principles[18]

Under the IRB approaches, the minimum requirements ensuring the integrity of the rating process provide that:

- *For corporate exposures*: Borrowers and facilities must have their ratings refreshed at least on an annual basis. Certain credits, especially higher risk borrowers or problem exposures, must be subject to more frequent review. In addition, banks must initiate a new rating if material information on the borrower or facility comes to light.
- *For retail exposures*: A bank must review the loss characteristics and delinquency status of each identified risk pool on at least an annual basis. It must also review the status of individual borrowers within each pool as a means of ensuring that exposures continue to be assigned to the correct pool. This requirement may be satisfied by review of a representative sample of exposures in the pool.

➔ Leasing Industry's Concerns

As far as *retail* exposures are concerned, the annual review of loss characteristic and delinquency of each risk pool is a widely used business practices. For *corporate* exposures however, an annual review of borrower and facility ratings appears to be in contradiction with the nature of the leasing business, i.e. a long-term relationship. Indeed, because a lease is a transaction driven, asset-based, fixed-term, non-cancellable operation, a review of the rating during the term of the contract would not only be in contradiction with the contract's nature but also most probably inefficient, unless forerunners of deficiency are observed.

➔ Recommendation

Rather than prescribing an annual review of corporate borrowers and facilities' rating, it would be more efficient to determine a series of criteria indicating forerunners of deficiency that should lead to a punctual review. This punctual review would indeed be totally integrated in the robust risk management practices suggested in *§486, first bullet point of CP3 (p. 94).*

III.7 Pooling of Retail Exposures

➔ Principles[19]

Rating systems for retail exposures must be orientated to both borrower *and* transaction risk, and must capture all *relevant* borrower and transaction characteristics.

Banks must assign each exposure that falls within the definition of retail for IRB purposes into a particular pool. Banks must demonstrate that this process provides for a meaningful

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[18] Cf. Consultative Document – The New Capital Accord (CP3), §392-395, p. 76.

[19] Cf. Consultative Document – The New Capital Accord (CP3), §363-364, p. 71.

differentiation of risk, provides for a grouping of sufficiently homogenous exposures, and allows for accurate and consistent estimation of loss characteristics at pool level. At a minimum, banks should consider the following risk drivers when assigning exposures to a pool:

- *Borrower risk characteristics*;
- *Transaction risk characteristics*, including product or collateral types or both. Banks must explicitly address cross-collateral provisions where present.
- *Delinquency of exposure*: Banks are expected to separately identify exposures that are delinquent and those that are not.

➔ Leasing Industry's Concerns

For most lease contracts qualifying as retail exposures, secondary market characteristics – i.e. transaction risk characteristics – often represent better risk-drivers than borrower risk characteristics. Because leases are asset-backed transactions, the type of asset, the age and maturity of contracts for example provide for a more meaningful differentiation of risk than the characteristics of the borrower for the retail business. The requirement to consider borrower risk characteristics in addition to transaction risk characteristics would thus be inefficient and could represent an undue cost for leasing companies.

➔ Recommendation

In order to recognise that only the relevant borrower and/or transaction risk characteristics should be taken into account in the process of assigning exposures to a pool, we propose the following amendments to the current framework:

- To replace the wording 'must be orientated to both borrower and transaction risk, and must capture all relevant borrower and transaction characteristics' by 'must be orientated to both borrower **and/or** transaction risk and capture all relevant borrower **and/or** transaction characteristics'.
- To replace the wording 'banks should consider the following risk drivers' by 'banks should consider **one or more** of the following risk drivers'.

III.8 Asset return correlation and IRB approaches

➔ Principles

The Asset return correlation is an indicator of the sensitivity of exposures to systematic risk. As such, it is one of the key parameters determining the risk profile and thus adequate capital requirements for portfolios. Under the Basel II proposal, asset return correlations are defined as a decreasing function of PD, according to a formula that can be thought of as the weighted average of two extreme values:

- For *corporate exposures*, minimum asset return correlation is set at 12% while maximum is set at 24%[20]; and

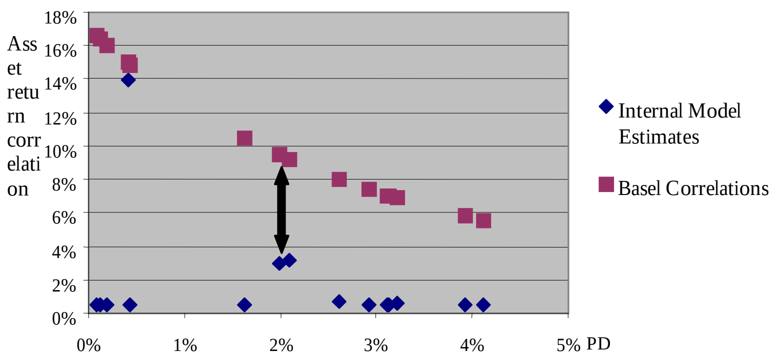
[20] Cf. Consultative Document – The New Capital Accord (CP3), §241, p. 50.

- For *other retail exposures*, minimum asset return correlation is set at 2% while maximum is set at 17%[21].

➔ Leasing Industry's Concerns

Empirical results show that estimated asset return correlations (as calculated in the study carried out by LEASEUROPE on the subject[22]) are significantly lower than those assumed under the Basel proposal for all segments studied[23]. One explanation for these differences is that, in line with the conclusions drawn by Dietsch & Petey (2002) for retail portfolios, asset return correlations are not necessarily a decreasing function of probability of default. This is contrary to the Basel Committee's assumption.

Graph 3: Comparison between regulatory asset return



Source: Duchemin, Laurent & Schmit (2003), *Tables 3*, http://www.leaseurope.org/pages/Studies_and_Statements/Studies/Correlations-FIN-REV.pdf

➔ Recommendation

Clearly, the assumptions made by the Basel framework serve the Basel Committee's objective of keeping the capital adequacy framework as simple and readily understandable as possible. However, the regulatory correlations should be lowered and reviewed for retail portfolios.

IV. SPECIALISED LENDING

➔ Principles

Within the corporate asset class, all lending that qualifies as sub-class of specialised lending (SL), that including OF, IPRE, and HVCRE classes, shall be treated according to the provisions set out therefore[24].

➔ Leasing Industry's concerns

21 Cf. Consultative Document – The New Capital Accord (CP3), §301, p. 60.
22 Cf. DUCHEMIN, LAURENT, SCHMIT (2003).
23 Note that only automotive lease contracts were taken into account in this study. Segments are defined according to the age and maturity of the contracts.
24 Cf. Consultative Document – The New Capital Accord (CP3), §187,191,194,195 pp. 39-41.

It is unclear, whether the provisions set out for project financing transactions should always be applied in relation to physical assets intended for specific uses (e.g. ships, aircraft, etc.), IPRE, and HVCRE. The possible application of the treatment required with respect to these asset classes to leasing would be entirely inappropriate and 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 unjustified) – the resulting adverse impact might even be more profound. This is, as HVCRE assets are excluded from the estimates under the IRB approaches[25] or only admissible with an extremely penalising "correlation"[26].

➔ **Recommendation**

All the five classes of Specialised Lending defined in paragraphs 190 to 196 should be unified in a simple class of "project finance", presenting the characteristics listed in §187 and corresponding to the generally recognised definition of project financing.

At national supervisor authorities' discretion, in those markets where the effects of the higher risks associated to specific classes of project finance transactions have been experienced, a more severe treatment of those specific exposures could be required.

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[25] Cf. Consultative Document – The New Capital Accord (CP3), §219,220 pp. 46-47
[26] Cf. Consultative Document – The New Capital Accord (CP3), §252 p. 52