LEASEUROPE

LEASING OK GÜTESIEGEL

Verband Österreichischer Leasing-Gesellschaften - VÖL

BLV - ABL

Belgische Leasingvereniging
Association Belge de Leasing

leasing

Association of Leasing Companies of Czech Republic

Danske Finansieringsselskabers Forening

Danish Association of Leasing Companies

Finnish Finance Houses Association

asf ASSOCIATION FRANÇAISE DES SOCIÉTÉS FINANCIÈRES

Bundesverband Deutscher Leasing-Unternehmen e.V.

HUNGARIAN LEASING ASSOCIATION

IFHA

Irish Finance Houses Association Limited

ASSILEA ASSOCIAZIONE ITALIANA LEASING

FINANSIERINGS SELSKAPENES FORENING

Association of Norwegian Finance Houses

KONFERENCJA PRZEDSIĘBIORSTW LEASINGOWYCH W POLSCE

Association of Leasing Companies in Poland

UNSLR Uniunea Naţională a Societăţilor de Leasing din România

Romanian Leasing Association

Association of Leasing Companies of Slovak Republic

Asociacion Espanola de Leasing

Association of Swedish Finance Houses
AFINA - Finansbolagens Förening

F L A
FINANCE & LEASING ASSOCIATION

Original document sent by postmail

Madam NOUY
Secretary General
Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz, 2
CH-4002 Basel

Brussels, April 15th, 2003

Dear Madam,

Re: Review of Regulatory Capital Requirements for Banks and Investment Firms'

The abovementioned signatories – i.e. European Leasing National Associations along with Leaseurope – fully support the Basel Committee and the Commission Services' objective to modernise the existing framework on capital adequacy to make it more comprehensive and risk-sensitive; and acknowledge the progress made so far.

With the **Joint Position Paper** you will find here enclosed, the signatories would like to share their common experience on best business practices and credit risk issues related to the leasing sector, so as to contribute to the refinement of the new proposal both at the international and European levels.

Results of empirical studies carried out by Leaseurope in collaboration with the academic world confirm that leasing is a **relatively low risk activity** and show that **physical collaterals** play a major role in reducing the credit risk related to lease portfolios. In light of these results, it appears that one of the main objectives of the Basel proposal – i.e. to provide banks with reasonable incentives in terms of capital requirement relief to switch to a more advanced approach – would not be fulfilled for the leasing sector unless some important characteristics of lease exposures – such as the presence of physical collaterals – are given adequate recognition. In this context, the enclosed Position Paper outlines **common concerns on the likely impact of the new framework for the leasing business** (which is estimated to represent about 15% of investments in Europe, notably by SME's) and proposes **practical recommendations**.

We are entirely at your disposal should you require further information or to further discuss any of the issues raised in the enclosed document.

Yours sincerely,

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Chairman of Leaseurope

Mr. Franz HAGEN
President of the Austrian Leasing Association

Mr. Jacques CORNETTE
President of the Belgian Leasing Association

Mr. Vratislav VALEK
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POSITION PAPER ON THE WORKING DOCUMENT OF THE COMMISSION SERVICES ON CAPITAL REQUIREMENTS FOR CREDIT INSTITUTIONS AND INVESTMENT FIRMS

Following the European Commission's invitation to open a structured dialogue with representative organisations at the EU level, LEASEUROPE[1] has the honour and pleasure to enclose European leasing industry's view on the Working Document published on November 18th, 2002.

These past years, LEASEUROPE has acquired an extensive knowledge on credit risk issues relating to leasing portfolios, based not only on best practices in the European leasing industry but also on empirical studies carried out in collaboration with the academic world[2]. Thanks to this information, the Federation expressed the European leasing industry's view on the latest adjustments of the new proposal on capital requirements (as set out in QIS 3) to both representatives of the Basel Committee and the European Commission on December 20th, 2002.

In addition to the above-mentioned document, LEASEUROPE's intention with this Paper is to outline its members' main concerns as regard to the likely impact of the new framework on their industry, and to propose practical amendments for optimal solutions. We hope that these comments will contribute to the refinement and calibration of the new capital adequacy framework and will encourage the European Commission to further recognise the characteristics of the leasing industry, which – with new business of €193 billions in 2001 – accounts for about 15% of the total amount of gross fixed capital formation in Europe.

The present document is structured as follows: Section I will give a clear overview of the key points developed in this paper. In Section II, key results of the empirical studies conducted by LEASEUROPE in cooperation with the academic world (namely the Bocconi University and the Solvay Business School – ULB) are outlined while highlighting the main characteristics of lease exposures in order to provide the reader with an adequate framework for the following discussion. And finally, in Section III, European leasing companies' main concerns are reviewed and paths for solutions are identified.

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1 LEASEUROPE is the European Federation of Leasing Company Associations, with currently 25 National Member Associations covering more than 1,150 individual leasing companies in Europe. According to LEASEUROPE statistics, new leasing businesses in real estate and equipment accounted for over €193 billion in the year 2001.

2 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". 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 the Commission Services' objectives to modernise the existing framework, to make it more comprehensive and risk-sensitive and to foster enhanced risk management amongst financial institution, 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 an opinion prevailing in the industry: 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. The Federation's feeling is that this specificity of the leasing industry has not yet been fully taken into account in the proposed framework.

3. As far as the **standardised approach** is concerned, we argue that the 75% weighting ratio assigned to leases qualifying as retail exposures is very conservative. Indeed, because leases are low-LGD exposures, this weighting ratio suggests implied PD that are significantly higher than actual PD. This difference results in capital requirements varying *significantly* according to the approach selected by a leasing company and is thus contrary to the Commission Services objective to provide *modest* incentives for institutions moving to a more advanced approach. In order to prevent the new framework from penalising leasing companies, LEASEUROPE proposes to extend the capital relief provided in the current proposal to other types of physical collaterals, by reducing risk weighting ratios for certain types of assets, subject to adequate minimum requirements.

4. Regarding the **IRBF approach**, the absence of capital requirement adjustment for retail exposures and the low capital requirement relief granted for physical collaterals (LGD adjustment is limited to 5%) suggest that this approach may not be economically sound for a significant portion of leasing companies. This is in contradiction with the Commission Services' view on the IRBF approach as *a core feature* of the new Accord. LEASEUROPE also wishes to point out that leased assets are among the collaterals for which the highest number of requirements are to be met for their credit risk mitigating effects to be recognised. This is out of proportion not only with the capital relief granted but also with the relatively low-risk profile of lease exposures. The Federation thus proposes to adjust minimum requirements, notably in order to prevent them from penalising retail exposures.

5. Regarding the **IRBA approach**, LEASEUROPE is concerned 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 assessment of leasing companies' inputs according to their characteristics and risk profile.

6. 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. KEY EMPIRICAL RESULTS

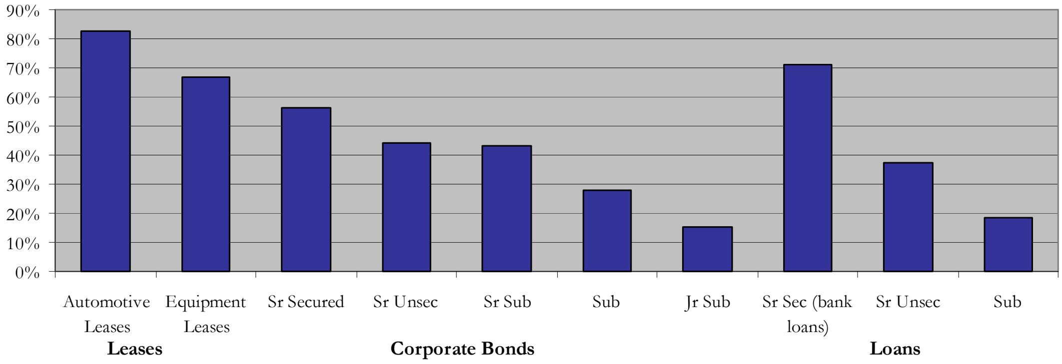
This Section summarises the key results of empirical studies recently conducted by LEASEUROPE – in collaboration with the academic world – with a view to provide a better understanding of the risk incurred for leasing portfolios. These results also reflect our members' concern that the proposed new framework might result in penalising leasing enterprises by imposing very conservative regulatory capital requirements, and by limiting the options available to them.

Two key aspects of credit risk are analysed: recovery rates and loss distribution simulations. In order to estimate appropriate capital requirements for lease exposures according to their risk profile, these results are then compared with capital requirements from the three approaches described in the Basel Committee's new proposal (according to the Technical Guidance to QIS3).

As far as recovery rates of lease exposures are concerned, results – based on a sample of more than 37,000 defaulted contracts from six European countries – show that they are relatively high as compared to other means of financing. For the automotive segment, for example, it is shown that recovery rates are comparable to those of best senior secured bank loans (see *graph 1*).

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*

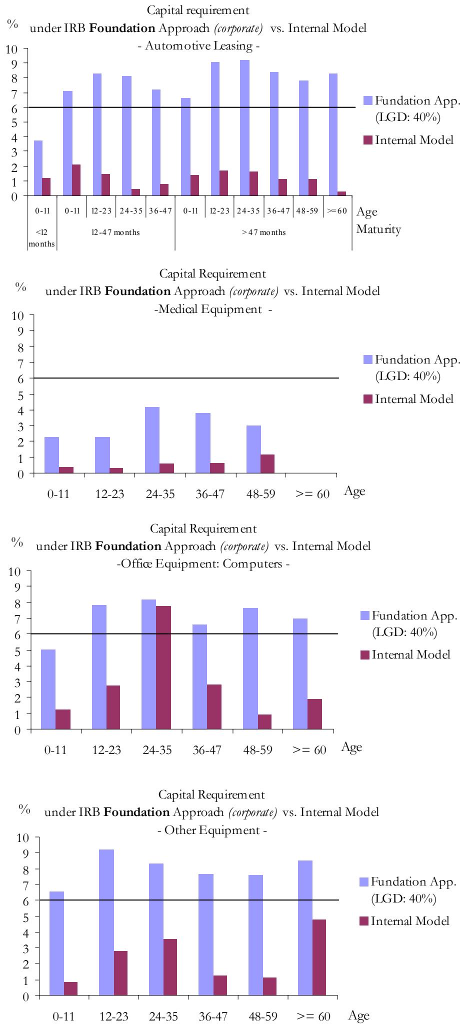
When looking at risk estimations, results show that the differences in capital requirements resulting from the choice of one or the other approach would be significant for leasing companies. *Graphs 2a* and *2b* illustrate the simulations on capital requirements as calculated on the basis of LEASEUROPE's studies internal model (darker bars) and of the Basel proposal (lighter bars). They show that:

- For most of the segment studied, capital requirements calculated according to the studies' internal model are far below the 6% requirement stemming from the application of the reviewed standardised approach (i.e. 75% risk weight times 8% weighting ratio).
- Capital requirements calculated following an IRB approach are almost systematically higher that those calculated with the internal model. This is particularly marked when considering

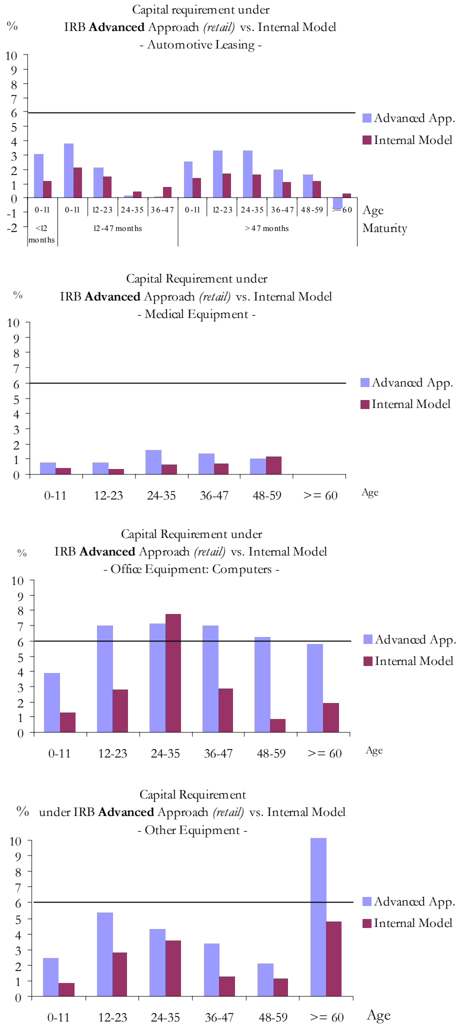
the IRBF approach, as capital requirements are on average 3 to 5 times higher than those calculated under the internal model (see *graph 2a*).

- The difference in capital requirement between the IRB approaches is significant for most segments studied (*see comparison of lighter bars between graphs on the left-hand and right-hand sides*).

Graph 2a:



Graph 2b:



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

Two key characteristics of leasing can explain these large discrepancies in capital requirements observed not only between LEASEUROPE studies' internal model and the proposal's approaches, but also between the three different approaches of the new framework:

- First, by its very nature, leases are characterised by the presence of **physical collaterals** (such as real estate properties, cars, trucks, machinery, etc.). 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 place 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 leasing exposures.

- Second, a sizeable portion of the European leasing business deals with private customers or small entities and should therefore be classified as **retail exposures** under the new framework. The absence of capital requirement adjustment for retail portfolios under the IRBF approach therefore explains in part the difference between capital requirements under the IRB approaches.

III. DISCUSSION

The empirical results summarised in the previous paragraphs show that the Commission Services' proposed framework on capital adequacy could be further refined and calibrated so as to take into account the characteristics of exposures such as leases. Indeed, because leases are not dealt with in a distinct set of principles in the new framework (such as mortgage lending, for example), characteristics that differentiate lease exposures from others lead to some incoherence and/or confusion. In the following Section, a number of the leasing industry's main concerns will be highlighted. Practical solutions will also be proposed, based both on the above-mentioned empirical studies and knowledge of best practices in the leasing industry.

III.1 Definition of Default

➔ Principles[3]

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 lease 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

[3] Cf. Article 1 (definition 52) of the Working Document and Annex D-5, §53.

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.

➔ **Recommendation**

The period of time after which a contract is considered as defaulted varies significantly according to the best business practices among European countries. We therefore think that it is important to allow Member States 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 (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 (see *graphs 2a* and *2b*), it appears that a 6% regulatory capital is a very conservative rate for most of leasing activities. Indeed, as mentioned in Section II, the presence of physical collaterals as well as the high level of priority of lease exposures result in the loss given default of leases being as high as that of the best senior secured loans (bank loans). Still, the current proposal does not recognise physical collaterals (others than residential and commercial real estate) under the standardised approach.

Table 1 supports LEASEUROPE 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[4] with a 75% risk weighting ratio. Given the size of the studied samples (the database on LGD consists of more than 37,000 defaulted lease contracts), we can reasonably and reliably

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

estimate that the weighted average LGD in the leasing industry is between 15% and 35% (see graph 1). These LGD involve 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.

In order to assess the 'conservativeness' 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[5]. This is clearly in contradiction with the Commission Services objective to provide *modest incentives in terms of capital requirements for institutions moving to the more advanced approaches*[6].

Table 1: Implied Probability of Default

Weighting Ratio	LGD	Implied PD
75%	100%	0.43%
75%	90%	0.52%
75%	80%	0.64%
75%	70%	0.82%
75%	60%	1.15%
75%	50%	1.85%
75%	40%	4.17%

Weighting Ratio	LGD	Implied PD
75%	35%	6.53%
75%	30%	9.19%
75%	25%	12.37%
75%	20%	16.84%
75%	15%	24.57%
75%	10%	42.61%

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%

[5] '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.

[6] Cf. Cover Document to the Working Document of the Commission Services on Capital Requirements for Credit Institutions and Investments Firms, § 17, p. 5.

➔ 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 'modest incentive' objective not being met for the retail leasing industry as shown below. 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 current 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 European Commission for recognition of physical collateral under the IRBF approach, *subject to some amendments as outlined in Section III.3*.

Additionally, as it is the case for real estate (cf. *§ 139 of the Cover Document to the Working Paper*), an option should be given to national supervisors to increase the weighting ratio in the standardised approach up to 75% when necessary, on the basis of their national specificities.

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%.

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[7]:

[7] Cf. Annex E-2, § 2.1.6, p. 11-12 of the Working Document.

(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. Annex E-2, § 2.1.6, 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. Annex E-2, § 2.1.6, 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. Annex E-2, § 2.1.6, 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. Annex E-2, § 2.1.6, 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. Annex E-2, § 2.1.6, fifth bullet point)*.

(vi) In cases of inventories and equipment, the periodic revaluation process must include physical inspection of the collateral *(cf. Annex E-2, § 2.1.6, sixth bullet point)*.

For financial leasing to be recognised as credit risk mitigants, the following standards must additionally be met[8]:

(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. Annex E-2, § 2.1.7, 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. Annex E-2, § 2.1.7, 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. Annex E-2, § 2.1.7, third bullet point)*.

➔ Leasing Industry's Concerns

Among the key objectives for the capital adequacy framework review, the Commission Services indicate that *"the incorporation of the Foundation Approach as a core feature of the new Accord, (…), is of particular significance in the EU, where it can be expected to be adopted by a large number of institutions seeking to improve their risk measurement and management techniques and to receive appropriate recognition for this in their capital requirements"*[9].

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[8] Cf. Annex E-2, § 2.1.7, p. 12 of the Working Document.

[9] Cf. Cover Document to the Working Document of the Commission Services on Capital Requirements for Credit Institutions and Investments Firms, § 16, p. 5.

However, it appears that the choice of the IRBF approach would not be an economically sound decision for a significant portion of leasing companies. Indeed, empirical studies conducted by LEASEUROPE[10] clearly show that, for most of the segments studied, capital requirements stemming from the IRBF approach 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 (see *graph 2a* and *2b*). This is contrary to the Commission Services objective to provide *modest incentives in terms of capital requirements for institutions moving to the more advanced approaches*.

Two characteristics of the IRBF approach can explain the prohibitively high capital requirements it entails for lease exposures as compared to the standardised and IRBA approaches. The first is the absence of capital requirement adjustment for retail exposures. The second lies in the low capital requirement relief granted for physical collaterals. Indeed, the regulatory floor on LGD limits its adjustment to 5% (from 45% to 40%) for 'other physical collaterals'. The latter is particularly disturbing for leasing companies that are required to commit significant resources in order to comply with the above-mentioned series of minimum requirements for **only a very limited LGD adjustment and hence capital relief**.

Furthermore, some of the minimum requirements imposed for recognition of physical collaterals are totally **inappropriate** for the leasing industry. An individual assessment of leased assets – whether in the form of a periodic physical inspection (cf. *Annex E-2, § 2.1.6, sixth bullet point*) or in the form of the taking into account of obsolescence (cf. *Annex E-2, § 2.1.6, fifth bullet point*) – would indeed be totally inefficient in the context of leasing. 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.

➔ Recommendation

In order not to exclude the IRBF approach from the options available to the leasing companies that will fall under the scope of application of the new Accord, some amendments to the current proposition appear to be crucial.

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 *Annex E-2, § 2.1.6, second, fifth and sixth bullet point*) be applicable on a *pooled basis* for retail exposures.

[10] Cf. SCHMIT M. (2002a) and SCHMIT M. (2002b).

As far as the specific requirements for financial leasing 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 *Annex E-2, § 2.1.7, first bullet point*, to replace the wording 'location' by 'nature' so as to allow this requirement to be practical for leased assets which location is often not even exactly known by the lessee (such as short-term car rental fleet, containers, etc.);
- In *Annex E-2, § 2.1.7, second bullet point*, to replace the wording 'ownership' by 'rights' so as to include a notion of 'pledge' and 'security interest'; and
- In *Annex E-2, § 2.1.7, 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 LDG 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 assets 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 show through the requirements specific to own-LGD estimates[11]:

(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

[11] Cf. Annex D-5, §64-9.

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 laid down in Section III.*

(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 for the purpose of 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 laid down in Section III****.*

The Working Document's Section III (credit risk mitigation techniques under the standardised approach and the IRBF Approach) relates to minimum requirements set either for *financial collaterals* (as under the standardised approach) or for *corporate exposures* (under the IRBF approach). This involves that to be 'consistent' with Section III of the current proposal, leasing companies would implicitly have to comply with *requirements that are not designed for retail exposures.*

➔ **Recommendation**

The above strengthens the case for minimum requirements for collaterals recognition to be adapted so as not to penalise retail exposures under the IRBF approach (see Section III.3 of this paper). Indeed, only **adapted** requirements – i.e. requirements applicable on a pooled basis for retail exposures – could be used as 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 also 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 Commission Services' objective to *make a framework that is more comprehensive and risk-sensitive and to foster enhanced risk management amongst financial institutions.*

III.5 Periodical Review of Ratings

➔ **Principles**[12]

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

- *For corporate exposures*: Institutions shall update borrower and facility ratings at least annually. Certain credits, especially higher risk borrowers or problem loans, shall be subject to more frequent review. In addition, institutions shall undertake a new rating if material information on the borrower or facility comes to light.
- *For retail exposures*: An institution shall review the loss characteristics and delinquency status of each identified risk pool on at least an annual basis. It shall 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 leasing 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 *Annex E-2, § 2.1.7, first bullet point*.

III.6 Pooling of Retail Exposures

➔ **Principles**[13]

Rating systems for retail exposures shall reflect both borrower *and* transaction risk, and shall capture all *relevant* borrower and transaction characteristics.

Institutions shall assign each exposure that falls within the definition of retail for IRB purposes to a particular pool. Institutions shall demonstrate that the process of assigning exposures to a pool

[12] Cf. Annex D-5, § 26-9.
[13] Cf. Annex D-5, § 7.

provides for a meaningful differentiation of risk, provides for a grouping of sufficiently homogenous loans, and allows for accurate and consistent estimations of loss characteristics at pool level. Institutions shall take into account the following characteristics in the process of assigning exposures to a pool:

- *Borrower risk characteristics*;
- *Transaction risk characteristics*, including product or collateral types or both. Institutions shall explicitly address cross-collateral provisions where present.
- Institutions shall have at least two distinct and identifiable categories for pools of loans that are in arrears but not in default.

➔ **Leasing Industry's Concerns**

For most of leasing 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 'shall reflect both borrower and transaction risk, and shall capture all relevant borrower and transaction characteristics' by 'shall reflect and capture all relevant borrower and/or transaction characteristics'.
- To replace the wording 'Institutions shall take into account the following characteristics' by 'Institutions shall take into account one or more of the following characteristics'.