Leaseurope

The Voice of Leasing and Automotive Rental in Europe

Brussels, 26 December 2019

Leaseurope response to the European Commission consultation on implementing the final Basel III reforms in the EU.

Leaseurope, the voice of leasing at European level, welcomes the opportunity to comment on the European Commission consultation on implementing the final Basel III reforms in the EU.

GENERAL COMMENTS:

We hereby call on the European Commission to support a form of finance that has been proven over the years to be both low risk and sustainable, critical for future growth, European SMEs and the move towards achieving Europe's environmental goals.

Leasing supports investment in greener and less polluting assets

We believe that leasing plays an important role in achieving sustainable growth in Europe by helping European businesses access productive and greener assets. Leasing allows businesses and other types of lessees to manage their working capital more effectively by spreading payments to use the asset over the contract period. Leasing also enables clients to upgrade their assets easily to the latest technologies so that they may remain competitive. It is often more affordable and quicker to obtain than other forms of finance and provides greater operational flexibility in comparison to the outright purchase of an asset.

Leasing is ideally placed to finance productive investment in a vast range of sectors and activities (including R&D and innovation, infrastructure, industrial technology, capital-intensive projects, healthcare, environmental technologies, etc.) as well as the investment of enterprises, and throughout all stages of a firm's development (from young start-ups to companies that are far along their life cycle). It is also useful to support the public sector (e.g. leasing to schools, hospitals, etc.).

As Europe reduces its carbon footprint in line with the Paris Agreement on climate change, the focus on producing and using energy efficient assets has increased. Consequently, businesses demand and need more energy efficient assets. Leasing can help firms gain access to such assets. For instance, by allowing and encouraging the uptake of clean vehicle technology, the leased car fleet in Europe has become steadily less polluting over the past few years. Leasing has also contributed to the rejuvenation of European commercial vehicle and bus fleets in order to adopt necessary fuel-saving and safety technologies. By bringing the cleanest, newest and safest vehicles to the market, leasing companies not only rejuvenate Europe's vehicle fleet, but also ensure the assets they finance keep strong remarketing values as national and local regulators are increasing penalising usage of older vehicles.

Additionally, leasing addresses one of the general barriers that inhibits the development of sustainable energy production, i.e. a lack of access to capital. In fact, leasing already facilitates the financing of equipment such as wind turbines, biofuel processing plants, photovoltaic panels, long lasting battery cells and so forth, allowing Europe to produce cleaner and more sustainable energy.

Leasing not only helps in replacing old, polluting equipment with cleaner and more energy efficient assets, it can also encourage the efficient use of scarce natural resources. The fact that lessors are the owners of the assets they lease incentivises them to ensure that resources and materials that go into asset production are of high quality. Moreover, lessors are also incentivised to ensure that production materials and the individual parts making up an asset can be re-leased, refurbished, reused or recycled. Lessors have specialised asset knowledge and sophisticated asset management capabilities to deal with the often complex asset management issues that arise with asset ownership. Thus, leasing enables a more efficient allocation of resources than when (non-specialist) businesses own assets outright.

By allowing asset use without asset ownership, the leasing instrument could enable a fundamental shift in our traditional consumption and production models. These new models of economic value creation have been referred to as “the circular economy” and are being examined seriously at European and international levels as a way forward in our environment of scarce resources.

Leasing is particularly well suited to supporting SMEs

Based on the research findings of an Oxford Economics report released in 2015[1], it is shown that, relative to bank loans, which experienced significant constraints during the most recent economic crisis, leasing remained a reliable and robust form of SME finance. Oxford Economics estimates that, at the EU level, leasing was responsible for financing around €104 billion of SME investment in fixed assets in 2013 and has increased in the following years.

According to the latest European Central Bank (ECB) SAFE survey 2019[2], leasing is a relevant source of finance for 45% of SMEs in the EU. This is in fact corroborated by the aforementioned Oxford Economics report, which found that 42.5% of SMEs used leasing in 2013, demonstrating that leasing is an increasingly vital source of finance for many European SMEs.

Leasing is an excellent financing tool to support European long-term investment. Therefore, given the demonstrated importance of leasing for supporting investment, SMEs and sustainable finance in Europe, we hereby call on the European Commission to work on a prudential regulatory framework that does not disincentivise credit institutions from offering leasing, which is in the best interest of European business. Therefore, we propose a recognition of the low risk nature of leasing for those entities offering leasing that are subject to capital requirements.

Impact of the finalisation of Basel III for leasing

The impact of the finalisation of Basel III for leasing companies varies depending on the approach used for calculating capital requirements (Standardised Approach (SA), Foundation Internal Ratings-Based (F-IRB) or Advance Internal Ratings-Based (A-IRB)) as well as geography and product specialisation. Industry reports show that low risk activities are in general the most penalised by the introduction of the new rules, which is clearly the case for leasing. Leasing

[1] Oxford Economics, The Use of Leasing Amongst European SMEs, 2015.
[2] European Central Bank, *Survey on the Access to Finance,* 2019.

companies under the SA are less affected by the impact of the new rules as the current framework is already punitive for them.

The EBA report on the impact of the finalisation of Basel III shows that banks under the A-IRB are generally the most affected by the rules. For leasing companies under the A-IRB then, the impact of the finalisation of Basel III is even more acute than it is for the banking sector as a whole. The reason for this is two-fold. Firstly, the rules for leasing do not reflect its low risk nature. Specifically, the fact the output floor is based on SA calculations and the introduction of input floors that fail to take properly into account the value of the physical asset being leased are highly problematic. Secondly, the inability to use A-IRB for certain asset classes will have a detrimental impact on A-IRB lessors.

Based on industry observations the increase on capital requirements for European lessors under the A-IRB approach can be double or even higher in a number of cases. Lessors using the F-IRB approach will be also impacted by the output floor as leasing is highly penalised under the SA compared to the historically observed risk of this form of financing.

Leasing demonstrated low risk is not recognised by the prudential framework

Credit risk weights under prudential standards (i.e. Basel III and CRR) should reflect the real underlying risks. Failure in this could lead to otherwise healthy, beneficial lending being disincentivised in terms of capital allocation and cost of funding. We suggest there is a strong case to be made for differentiating lease finance (where the asset is owned by the finance company during the life of the agreement) with a specific risk weight. We also advocate for a better recognition of leasing finance as physical collateral for credit risk mitigation purposes.

Losses within the leasing activity are low[3] because the lessor is funding a physical asset crucial to the client's core business activities. As the asset is a key working tool for the lessee, many defaulted leases regrade back to a healthy situation with zero loss. Additionally, the lessor can then sell or re-lease the asset in order to decrease any losses on the default, resulting in low loss rates.

A report prepared for Leaseurope by the University of Cologne in December 2019[4], which is based on a dataset of detailed contract-level information by twelve major European leasing companies operating across 25 countries, demonstrates that leasing is unjustifiably penalised by the current prudential regulatory framework. The research shows what would be an adequate calibration for leasing exposures compared to its real risk profile. The research is based on the current CRR rules.

Table 1 below presents the main results of the Cologne University research calculations for the current CRR. For all three regulatory credit risk approaches, capital requirements are much higher than the unexpected losses in a simulation of a downturn. As expected, the Standardised Approach yields the highest regulatory capital requirements followed by the F-IRB approach, with the A-IRB approach leading to the lowest regulatory capital requirements[5]. However even the

[3] See "The risk profile of leasing in Europe: the role of the leased asset", Deloitte, October 2013.
[4] See "Capital requirements for leasing: A proposal adjusting for low risk", University of Cologne, December 2019.
[5] The results, presented in the following table ignore any output floor.

A-IRB approach requirements are still almost five times higher than the unexpected losses in the simulation.

The realised losses were never higher than the regulatory capital requirements in any of the simulations performed (10,000 per year). Note that the realised losses include expected as well as unexpected losses, whereas capital requirements are designed to cover only unexpected losses. In this respect, the comparison of realised losses and capital requirements is extremely conservative. This result underpins the main conclusion that current regulatory capital requirements do not account for the low risk profile of leasing exposures in an appropriate way. Therefore, introducing even more conservative changes in the prudential framework will have a significant negative impact for the leasing industry.

Table 1: Comparison of regulatory capital requirements and unexpected losses split by years

	2007	**2008**	**2009**	**2010**	**2011**	**Total**
Standardised	8.17%	7.97%	8.33%	8.44%	8.50%	8.31%
IRB-Foundation	5.29%	5.41%	5.92%	5.94%	5.92%	5.76%
IRB-Advanced	4.03%	4.57%	5.56%	6.12%	6.50%	5.55%
Unexpected loss	1.03%	1.45%	1.29%	0.65%	0.52%	1.09%

For the reasons expressed above we are convinced that leasing should have a differentiated prudential treatment as its business model and risks are completely different than other types of lending. To adjust the prudential framework to the real risk of leasing we would propose the following:

Table 2: Leaseurope proposals for better recognition of leasing's low risk

a) STANDARDISED APPROACH	
Amend Art. 122 & 123 CRR to include new leasing risk weights	Proposed risk weights for leasing exposures: 50% Retail leasing / 65% Corporate leasing
IRB-FOUNDATION	**IRB-ADVANCED**
b) Add specific haircut for leasing collateral of 20% OR equivalent overcollateralization of 125%	
c) Specific leasing collateral in Art. 230(2) Table 5 CRR: 20% leasing LGD	d) Specific LGD input floors for leasing portfolios (both Corporate & Retail): 10% secured leasing / 20% unsecured leasing

In addition to the considerable impact of the finalisation of Basel III for the regulatory capital required for leasing, due to the expected increase in capital required for banks in Europe, lessors who utilise bank loans will see their funding restricted and more costly, reducing the capacity of the leasing industry to provide its services to businesses and consumers.

Finally, we would suggest the European Commission to receive the results of the EBA report on Basel III implementation very carefully. The assessment of the capital impact of the Basel reform in our opinion needs further analysis and additional data, to account in particular for the diversity of the European banking sector and for the specificities of the European economy. More specifically, we think that the EBA report does not cover sufficiently the impact of the new international rules on the leasing business, which we expect to be significant for our sector.

SPECIFIC QUESTIONS:

1. CREDIT RISK

1.1 STANDARDISED APPROACH (SA-CR)

1.1.3 Exposures to corporates
1.1.5 Retail exposures

14) What other measures, if any, could be taken to increase the risk-sensitivity of the standardised RW treatment of corporate exposures which currently have no external rating? Please elaborate and provide relevant evidence.

32) In your view, which other aspects, if any, should be considered in the context of revising the treatment of retail exposures? Please elaborate and provide relevant evidence.

59) In your view, which other aspects, if any, should be considered in the context of revising the SA-CR? Please elaborate and rank your answers from the most important to the least important aspect.

A differentiated prudential capital treatment for leasing

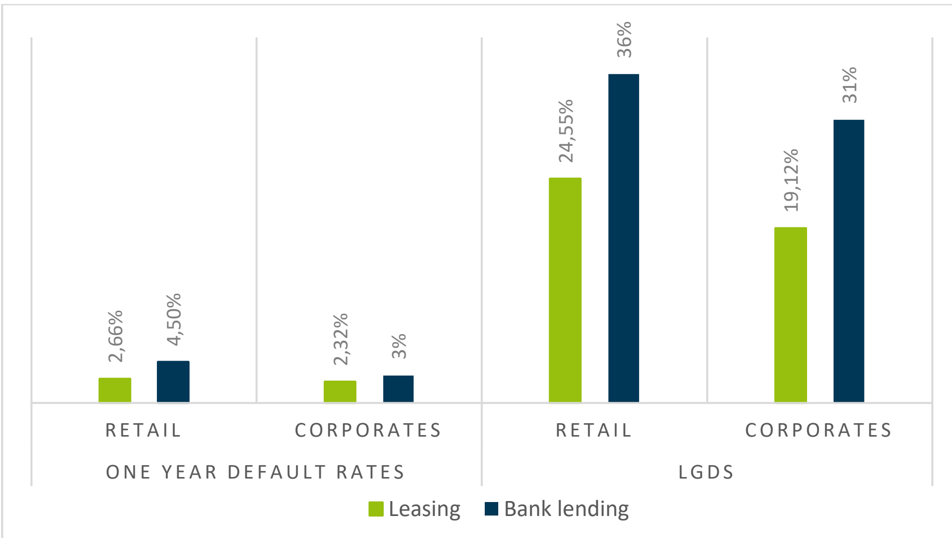
Credit risk weightings under prudential standards should reflect the real underlying risks, without adding undue complexity. Failure in this could lead to otherwise healthy, beneficial lending being disincentivised in terms of capital allocation and cost of funding. With this in mind, we suggest there is a strong case to be made for differentiating lease finance (where the asset is owned by the finance company during the life of the agreement) with a specific risk weight.

The unique feature of a lease is the lessor's ownership of the leased asset. These ownership rights provide lessors with a valuable and efficient form of in-built security which makes leasing extremely low-risk. Asset ownership represents a major advantage for lessors compared to other financial products such as traditional loans, which are typically not secured on physical assets but rather with financial collateral or personal guarantees.

Loss rates within the leasing activity are low[6] because the lessor is funding a physical asset crucial to the client's core business activities. Businesses therefore prioritise lease payments because they need these assets to run their business. As the asset is a key working tool for the lessee, many defaulted leases regrade back to a healthy situation with a zero loss. Additionally, ownership of the asset makes repossession relatively fast and straightforward for the lessor (if it is necessary at all). The lessor can then sell or re-lease the asset in order to decrease any losses on the default, resulting in low loss rates. If the value of the asset exceeds the amount outstanding at default, the lessor can actually make a gain in the case of a default.

[6]See "The risk profile of leasing in Europe: the role of the leased asset", Deloitte, October 2013.

In Europe, Deloitte undertook extensive research on our behalf which demonstrates that the leasing business model leads to significantly lower risk compared to traditional lending.[7] The graph below shows the results of the research, which was based on a portfolio of 3.3 million lease contracts in 15 European countries. The graph below shows that default rates and LGDs for leasing Retail and Corporate exposures are significantly lower compared to bank lending averages. These leasing LGD figures are for stressed conditions, average loss rate figures are even lower. European capital requirements under the SA are also shown to be 10 times higher than the real risks for SME leases within the Retail class.



This result is consistent with data for other equipment finance markets, for example in the US and Canada, confirming that businesses across any jurisdictions will prioritise paying for equipment finance because they need these assets to continue to run their businesses.

As far as international standards are concerned, we think that attention should be paid to the appropriate calibration of capital requirements and to the need for implementing international standards in a way that makes sense for Europe's diverse financial landscape.

The above-mentioned Deloitte findings on losses of lease transactions have been brought to the attention of the Basel Committee on Banking Supervision (BCBS) and of the European Banking Authority (EBA) in the context of their work on, respectively, "the Finalisation of Basel III", "the Review of the Standardised Approach for Credit Risk" and the "Future of the IRB approach". We have also shared the findings with the European Commission in our response to the consultations on "the finalisation of Basel III", "the Possible Impact of the CRR and CRD IV on Banking Financing of the Economy" and "the Call for Evidence on the EU Regulatory Framework for Financial Services".

While the Basel Committee admittedly needs evidence from other regions of the world before considering suggesting any changes, we consider that the European Union can, and should, take the lead on this issue of better recognition of physical collateral other than real estate as far as leasing transactions are concerned. A proper calibration of the risk weights applied to leases

[7] See "Implicit risk weights for SME leasing in Europe", September 2013 and "The risk profile of leasing in Europe: the role of the leased asset", Deloitte, October 2013.

would provide the right incentives and result in European SMEs investing more, to the benefit of the European economy. This should be the priority.

We believe that the risk sensitivity of the prudential regulatory framework in Europe can be further increased without introducing unnecessary complexity. As the Basel Agreement does not properly reflect the real risks of leasing exposures in Europe and does not recognise physical collateral for credit risk mitigation, we share with the European Commission a proposal below to increase the risk sensitivity of the framework.

Leaseurope proposal

Table 3 presents leasing risk weights for the total portfolio analysed by the University of Cologne. These risk weights are sufficiently conservative in the sense that they lead to regulatory capital requirements far above unexpected losses. In addition, these risk weights ensure that on average the capital requirements under the SA are at least 5% above the capital requirements under the A-IRB approach.

These leasing risk weights are derived from a leasing factor calculated as a multiplier that equalises capital requirements under the SA to capital requirements under the A-IRB approach.

Based on the outcome of the research the table below shows the regulatory risk weights that would reflect the real risk of leasing:

Table 3: Adequate leasing specific risk weights under the Standardised Approach:

Leasing risk weights	
Retail	Corporate
50%	65%

Leaseurope calls on the European Commission to consider the above proposal, which is backed by strong evidences in Europe. This can be introduced in the CRR by adding a new category of leasing or by amending articles 122 and 123 (exposures to corporates and retail exposures).

1.1.6 Real estate (RE) exposures

34) Views are sought on the relative costs and benefits of the LS approach and the WL approach provided by the final Basel III standard. In particular, how do the two approaches compare in terms of risk-sensitivity, impact on RWAs and operational burden? Please provide relevant evidence to substantiate your views.

We have the following concerns regarding the risk weight treatment of real estate leasing:

- In general, the increasing use of the “loan to value” parameter in the revised framework is detrimental to leasing compared to classical banking loans, since banking loans granting processes require usually a higher initial self-financing part than leasing. Then leasing is penalised by the new LTV parameters, whereas it usually presents a lower risk profile - due the direct ownership of the asset by the lender – than usual loans.

- Most real estate assets financed through leasing are buildings for own use activities such as factories, workshops, sales spaces, offices, etc. They should not be considered as property generating cash flows for capital requirement purposes. Strictly applying the new Basel III classification, the RWA of those exposures – treated as "user estate" - would result in a significant increase in required capital for real estate lessors.

- For instance, some credit institutions specialised in real estate leasing estimate RWA would increase by 16 bp due to new parameters regarding corporates real estate financing treatment. This may increase the price of financing by 18 bp for corporates.

1.1.6.3. Eligibility of property under construction

39) What are your views on the costs and benefits of implementing the preferential treatment for certain properties under construction as provided by the Basel III standards? Please provide relevant evidence supporting your view.

The exclusion of real estate under construction leasing from the credit risk mitigation would increase the cost of financing for SMEs when they build new factories, workshops, sales spaces, offices etc. We therefore propose to include real estate leasing under construction within the scope of application of tables 13 and 14 in the European transposition of the new Basel III standards.

1.1.6.6. Land acquisition, development and construction (ADC) exposures

49) Would you deem further refinements or clarifications necessary concerning the scope or definition of ADC exposures, and if yes, what would those be and what would be their prudential rationale? Please elaborate and provide relevant evidence.

Given leasing's low-risk nature, we propose to exclude leasing from the scope of application of ADC. Alternatively, it would also be workable to extend the provisions of paragraph 75 of the Basel III document to commercial real estate leasing for residential properties as the prospects for servicing the lease materially depends on the capacity of the borrower to make use of financial resources deriving from its production activity.

1.2 INTERNAL RATINGS BASED APPROACHES (IRBA)

We are deeply concerned that the changes proposed in the Basel Agreement will raise the required levels of bank capital, which have already seen substantial increases through previous Basel agreements.

Our experience in Europe is that credit risk models have proven to be reliable and supervisory authorities have invested years of hard work and careful consideration into controlling and validating them. Constraints on the use of the A-IRB to some types of exposures, and the introduction of parameter floors, would lead to less risk sensitivity, not increased comparability. Conceptually, referring to measures and practices under the SA as a benchmark for internal modelling under the IRB Approaches does not contain a clear rationale.

We suggest that the new Basel Agreement should be reconsidered in Europe in the context of decreasing heterogeneity unrelated to risk, rather than limiting the use of internal models and raising capital requirements. The European Banking Authority work on internal model parameters - where the definition of default has been identified as a major source of variability - is a good example of attempting to improve comparability while maintaining risk sensitivity.

Lease finance is an important low risk mechanism for funding the real economy, particularly for SMEs. We therefore urge the European Commission to ensure that any further changes to the calculation of regulatory capital do not result in lenders restricting the provision of finance, particularly through asset finance.

1.2.1 IRB (A-IRB) approach removed for certain asset classes

62) What are your views on the costs and benefits of reducing the scope of internal modelling as described above? In particular, how would this reform impact the robustness and levels of RWAs for the affected portfolios? Please provide relevant evidence to substantiate your views.

We are concerned by the BCBS decision to remove the A-IRB approach for exposures to large and mid-sized corporates, and exposures to banks and other financial institutions.

We question the BCBS views that exposures to banks, other financial institutions and large corporates are best regulated under the F-IRB approach. There is significant market data available on these type of exposures for ratings purposes. Low numbers of defaults should not present difficulties in modelling concerning leasing. Any difficulties experienced in modelling should rather be addressed with clear guidelines and institutions working closely with their supervising authority. We think that for lease assets do not apply the idea that LGDs to large corporates on secured recoveries do not follow observed estimates in the SME market. For instance, if a lessor has to liquidate a truck leased to a large corporate and sell it on the market, the proceeds will be the same as if it is owned by an SME. Different observed LGDs between SMEs and larger corporates are mainly caused by the unsecured part via the cure or no-loss rate or unsecured recovery. Leasing companies under A-IRB are by definition very well equipped to estimate these for large companies, banks and financial institutions.

In addition, large corporates and Institutions could see a significant impact on their financing if exposures to these entities are moved to the F-IRB. Increases in funding costs for firms that have a large footprint in multiple economies could have unintended negative side effects.

We would urge the Commission not to disallow the application of the A-IRB approach on the previously mentioned exposures in Europe based on assumptions regarding their ratings status.

1.2.3 LGD – Input floors under A-IRBA

70) As regards the different types of exposures and collateral, to what extent do you consider that the LGD input floors maintain an adequate level of risk sensitivity with respect to the wide range of practices of EU institutions?

The Basel Agreement proposes applying floors to PDs, LGDs and the credit conversion factors (CCFs) used to determine Exposure at Default (EAD) for off-balance sheet items. We challenge the need for parameters floors in principle as these types of limits on internal modelling under the

IRB approaches only serve to artificially raising capital requirements, rather than encouraging comparability. We therefore urge the Commission to reconsider the introduction of any floors in Europe.

However, if floors are to be introduced they should take into account the risk profiles of various different business models and should not unduly penalise low risk forms of lending such as leasing. Failure in this could lead to otherwise healthy, beneficial lending being disincentivised in terms of capital allocation and cost of funding.

LGD floors for corporate and retail under A-IRB

The level of over-collateralisation required for an exposure to be considered secured could be problematic for leasing companies. As a result, some leasing exposures could be classified as unsecured and be subject to an even higher LGD floor of 25% for corporates and 30% for retail, despite the fact that this is an asset based form of lending. The LGD floor for A-IRB do not take into account the strong expertise leasing companies have in assessing the risk in the asset based finance, where the financed amount is related to the estimated value of an asset during its economic lifetime.

In addition, for those lessors specialised in operational leasing of vehicles, corporate and retail exposures are all unsecured as the residual value of the leased vehicle is not considered collateral under the CRR. This means that the effect of the LGD floors will be even bigger for this type of leasing companies.

This issue could be solved by introducing a separate floor for the full leasing exposure, which have a completely different risk profile and business model compared to bank lending secured by physical collateral, both for secured and unsecured retail and corporate exposures - of 15% for leasing exposures - or alternatively a 10% and 20% floor for the secured and unsecured part respectively would also reflect the risk profile of leasing. As the objective in introducing the floors is to eliminate low value outliers, and not to prejudice entire low risk forms of lending, this recommendation would make the regulation in Europe better fit for purpose.

The effect of the floors, if not adjusted is shown in the example below, where the introduction of a floor overestimates the actual risk profile with 30%:

Assuming the following LGD model and parameters:

$$LGD = \frac{(1\text{-no loss rate})*(EAD - (\text{secured recovery} + \text{unsecured recovery}))}{EAD} + \text{costs}$$

- No-loss rate 50% (includes cured cases and (early) full repayments)

For the litigated cases:

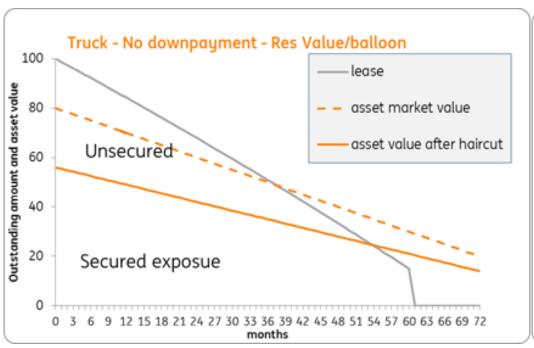
- Unsecured recovery rate 25% (includes all proceeds repaid by lessee or receiver after default). Unsecured part of outstanding is the remaining part of the outstanding amount during the lease, minus the secured exposure. The 25% recovery rate is applied to the unsecured part only.

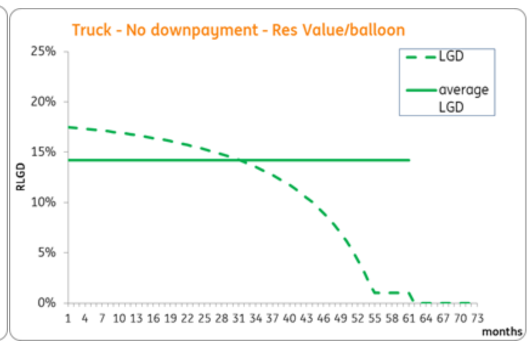
- Secured exposure is minimum of the actual outstanding amount and estimated market value of the asset during lease, after haircut. This amount is usually (at least) recovered in a liquidation process.

- Haircut on asset market value 30%[8], where asset market value depreciates on average from 80% of the initial value to 0 in 8 years. (e.g. a truck). At t = day 1, the market value is 80% of the investment value or purchase price of the asset. After 4 years, the asset has a value of 40% of the initial value. After application of the 30% haircut, the secured exposure at day 1 is (1-30%)*80% = 56%. After 4 years the secured value is capped at (1-30%)*40% = 28% of the initial investment/lease amount. (no down payment)

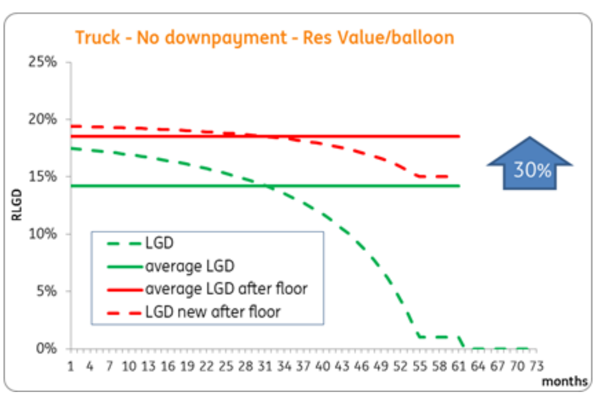
- Costs 1% of EAD

Assuming a lease of 5 years (starting at 100, equal to the investment in the leased asset), no down payment and a residual value/balloon of 15%. Based on the model estimates, LGD diminishes over time from 17.4% to a minimum level of 1% at the end. During the transaction LGD without the floors results in an estimated exposure weighted average of almost 14.2% on average, as shown below:





If we now introduce the floors, the secured exposure, during the lease is represented by the area below the orange line, being the estimated market value during the lease, after haircut. This part obtains a minimum LGD of 15%. The rest is unsecured and gets a minimum LGD of 25%. This increases the exposure weighted average LGD in this conservative example with 30% from 14.2% to 18.5%.



[8] Basel III finalised agreement introduce a higher haircut of 40%. Therefore, this example underestimates the impact.

The LGD floor under A-IRB and the prescribed F-IRB parameters for large corporates will have a significant negative impact on a low risk form of financing, which is critical for promoting sustainable growth in Europe. Given the relevance of leasing for SMEs and the expertise within leasing on estimating the risk on asset based finance, the LGD floor do not consider the expertise of leasing companies following the A-IRB. Also for large companies, the increase of assigned risk weights under the F-IRB approach will have a substantial impact (it could double or even triple, due to the prescribed LGD of 25% for secured and 40% for the unsecured part).

1.2.4 LGD – Regulatory values under F-IRB

73) Views are sought on the costs and benefits of the revised regulatory LGD values to be used under the FIRB Approach. In particular, how does the approach provided by the Basel III standards compare with the Basel II standards in terms of risk-sensitivity, impact on RWAs and operational burden? Please provide relevant evidence to substantiate your views.

While we welcome the Basel Agreement proposal to decrease the F-IRB LGD value for “other physical collateral” to 25%, we believe that, if haircuts are also adjusted (see our proposal below), a 20% value would better reflect the reality of lease exposures. If haircuts are not adjusted a 15% LGD for leasing exposures is more appropriate.

Finalisation of Basel III new proposed haircuts

We have significant concerns regarding the decision to increase the haircut applied to “other physical collateral” from 28.6% to 40%. As mentioned previously, leasing firms are asset specialists who utilise physical assets for a large portion of their recoveries, 80% on average (refer to Deloitte research). We believe that a 40% haircut for leasing exposures would be far too conservative, particularly when applied to leases nearing the end of their maturity. We suggest that a haircut for leasing exposures be introduced at a 20% level.

1.3.1 CREDIT RISK MITIGATION – SA-CR

102) In your view, which other aspects, if any, should be considered in the context of revising the CRM framework under the SA-CR? Please specify and rank your answers from the most important to the least important aspect.

Exposures secured by durable goods should be recognised as collateral

We also advocate for the recognition of leasing for credit risk mitigation purposes because the assets on which the lending is secured exist in liquid markets with transparent pricing and can be realised quickly, when deemed necessary.

Given the demonstrated importance of leasing for European SMEs as well as the demonstrated relatively low risk profile of leasing in Europe, we invite the European Commission to promote a better recognition of physical collateral (other than real estate) as far as leasing transactions are concerned.

1.4. CREDIT RISK MITIGATION – IRBA

109) In your view, which other aspects, if any, should be considered in the context of revising the CRM framework under the IRBA?

The main articles within the CRR that leasing companies need to meet for collateral recognition are articles 199(6), 210 and 211. Lessors normally meet articles 210 and 211 due to the nature of our business. Lessors would normally also meet the requirements of Article 199(6), however the burden in terms of time and resources to prove that this is the case is often excessive as the rules are not structured well for this type of collateral. In particular, showing that the realised proceeds from the collateral shall not be below 70% of the collateral value in more than 10% of all liquidations for a given type of collateral does not have a clear rationale in the case of lessors managing physical assets, as opposed to financial assets where the value can be assessed on a daily basis.

The second hand market for leased assets is very diverse, including re-leasing in house, return or resale deals directly with manufacturers, partnerships with dealer networks or brokers, global auctions etc. This requires a great deal of asset specialisation, knowledge and networks, which lessors have. The requirements of article199(6) have been designed with financial markets in mind, with abundant external availability of information on current prices. Leased assets are not intended as being a form of wealth, to be traded when prices are high or when cash is needed. Lease assets are to be used in a production process or provision of services. Lessors are service providers, focusing on providing assets to be used. If a bank sells financial collateral, the business process will not be hampered. Selling a leased asset will have direct consequences on a customer's ability to run his business.

The EBA was mandated to publish a list of types of physical assets for which institutions can automatically assume that they qualify as eligible collateral[9]. Currently they choose to recommend that no assets automatically qualify, despite some sectors like vehicle leasing being ideal candidates meeting all the criteria. Therefore, we recommend that this exercise is revisited.

Leasing collateral for LGD estimation

The EBA guidelines on PD and LGD estimation[10] state that lessors cannot use repossessed assets as collateral for LGD estimation until the asset is sold, as technically the asset was never 'repossessed' if it was always on their balance sheet. In other cases, you can estimate the collateral value before the sale and use this to lower the LGD.

In leasing contracts the "leased asset" is recorded in the lessor's balance sheet from the beginning, i.e. the net present value of the future lease instalments. Thus, the moment in which the leased asset is returned to the bank by the lessee cannot be considered in the same way as the typical "repossession" of a collateral, which requires the inscription of the asset in the bank's balance sheet, when not immediately sold. Furthermore, in the LGD models built on the leasing financial activities, the resale of the leased asset is normally the main source of recovery from the defaulted exposures. Therefore it is important to properly consider it as part of the recovery process.

[9] See Art. 199(8) CRR.
[10] See EBA, Guidelines on PD estimation, LGD estimation and the treatment of defaulted exposures, London, November 2017, p. 80-82. Numbers in brackets refer to these guidelines.

If we look at the leasing asset as a specific type of collateral, where the bank/leasing company is the legal and/or economic owner of the asset, we have to consider that for this kind of collateral the actual cash flow should be recognised in the LGD calculation only at the time of liquidation of the asset (the date in which the asset is sold, re-leased or demolished).

3. OPERATIONAL RISK

143) In your view, which other aspects, if any, should be considered in the context of revising the operational risk framework? Please elaborate and rank your answers from the most important to the least important aspect.

We do not oppose the Basel Agreement to replace the current framework with a more solid and comparable regulation.

Leaseurope welcomes Basel's proposal on how to determine the business indicator (BI). We think, it fixes current inconsistencies within the framework.

By netting leasing income and expenses – including depreciation, a level playing field is created, irrespective of national accounting standards, when determining the interest component of the BI. This is also determined with the structure of the "Definition of Business Indicator Components (BIC)" in the Annex.

The combination of leasing and credit in one category provides more consistency to the operational risk framework. Indeed, capital requirements should properly reflect the underlying risks. Failing to do so, disincentives appropriate capital allocations and create distortions in the financial system.

The Basel Agreement fixes this issue by providing an equal treatment for leasing and credit. We welcome this approach as when it comes to operational risks leasing and credit face similar risks and the rules governing the associated risk management process are similar.

As explained before in our response to the questions on credit risk, leasing is a low-risk form of financing and this should be recognised within the prudential regulatory framework.

6. OUTPUT FLOOR

177) What are your views on the relative costs and benefits of including in the calculation of the OF more own funds requirements than those explicitly mentioned in the Basel III standards? In particular, how would such broader material scope compare to the scope required by the Basel III standards in terms of impact on RWAs, risk-sensitivity, comparability, complexity and operational burden? Please provide relevant evidence to substantiate your views.

179) Views are sought on the relative costs and benefits of applying the OF at all levels of the banking group (i.e. individual, sub-consolidated and consolidated) or solely at the highest level of consolidation in the EU.

An important number of leasing companies have invested significant amounts of money and effort over the past years to implement internal models. This is because as explained before leasing is highly penalised under the SA approach. The proposed floor based on the SA calculations will be very punitive for lessors unless the SA calibrations are adjusted to reflect the real risks of leasing exposures.

Therefore, we believe that the 72.5% output floor on the IRB approach based on the SA approach may have a distorting effect depending on the business line type. For example, banks with portfolios that absorb more capital under the new rules (e.g. residential real estate) may be forced to reduce financing of other activities. As a result, the proposed floor does not provide a level playing field.

If the output floor is to be implemented in Europe for political reasons, the output floor should be implemented in the EU as foreseen in the Basel III final revision, i.e. at the highest level of consolidation. In our view, in fact, this would avoid an unlevel playing field, in which certain banking models would be at a disadvantage, because specialised subsidiaries with low risk business be floored at entity level, which would create a disproportionate impact from the floor.

Finally, we would like to point out that if Leaseurope's proposals in this response, both for standard and internal approaches, are not taken into account by the European Commission, leasing will be significantly hit by the new framework as the current LGD levels are very low compared to traditional unsecured lending products. We are happy to follow up with the Commission on our proposals and to provide further evidences you may require.

8. SUSTAINABLE FINANCE

191) In your view, which further measures, if any, could be taken to incorporate ESG risks into prudential regulation without pre-empting ongoing work as set out above?

As explained in our general messages on page 1 we believe that leasing plays an important role in achieving sustainable growth in Europe by helping European businesses access productive and greener assets. In order to allow leasing to continue playing a key role in the financing of greener and less polluting assets we call on the EC to consider our proposals (summarised in table 2 page 4) to reflect more adequately the risk profile of leasing within the prudential regulatory framework in Europe.

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About us

Leaseurope brings together 45 member associations representing the leasing, long term and/or short term automotive rental industries in the 32 European countries in which they are present. The scope of products covered by Leaseurope members' ranges from hire purchase and finance leases to operating leases of all asset categories (automotive, equipment, machinery, ICT and real estate). It also includes the short term rental of cars, vans and trucks. It is estimated that Leaseurope represents approximately 91% of the European leasing market.

Asset finance and leasing markets have developed to respond to business investment and consumption needs as well as to accompany the development of local industrial production and distribution. The types of institutions represented by the Federation include specialised banks, bank-owned subsidiaries, the financing arms of manufacturers as well as other, independently-owned institutions.

In 2018, the leasing firms represented through **Leaseurope's membership helped European businesses invest in assets worth more than 386 billion EUR**, reaching 833 billion EUR of outstandings at the end of the year[11]. Leasing is used by more European SMEs than any individual category of traditional bank lending taken altogether (around 45% of all European SMEs make us of leasing which is more than any other individual form of lending)[12] and is also popular amongst larger corporates[13]. It is also useful to support the public sector (e.g. leasing to schools, hospitals, etc.).

Leaseurope is entered into the European Transparency Register of Interest Representatives with ID n° 430010622057-05

[11] Leaseurope 2018 Annual Statistical Enquiry.
[12] Oxford Economics, The Use of Leasing Amongst European SMEs, 2015;
European Investment Fund, The importance of leasing for SME finance, 2012;
European Central Bank, Survey on the Access to Finance of Enterprises in the euro area, 2019.
[13] European Central Bank, Survey on the Access to Finance of Enterprises in the euro area, 2019.