Leaseurope — The Voice of Leasing and Automotive Rental in Europe

eurofinas — SPECIALISED CONSUMER CREDIT PROVIDERS IN EUROPE

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Leaseurope & Eurofinas response to the EBA consultation paper on PD estimation, LGD estimation and treatment of defaulted assets

Eurofinas and Leaseurope, the voices of consumer credit and leasing at European level, welcome the opportunity to respond to the European Banking Authority's (EBA) consultation paper on draft guidelines on Probability of Default (PD) estimation, Loss Given Default (LGD) estimation and treatment of defaulted assets.

General Observations:

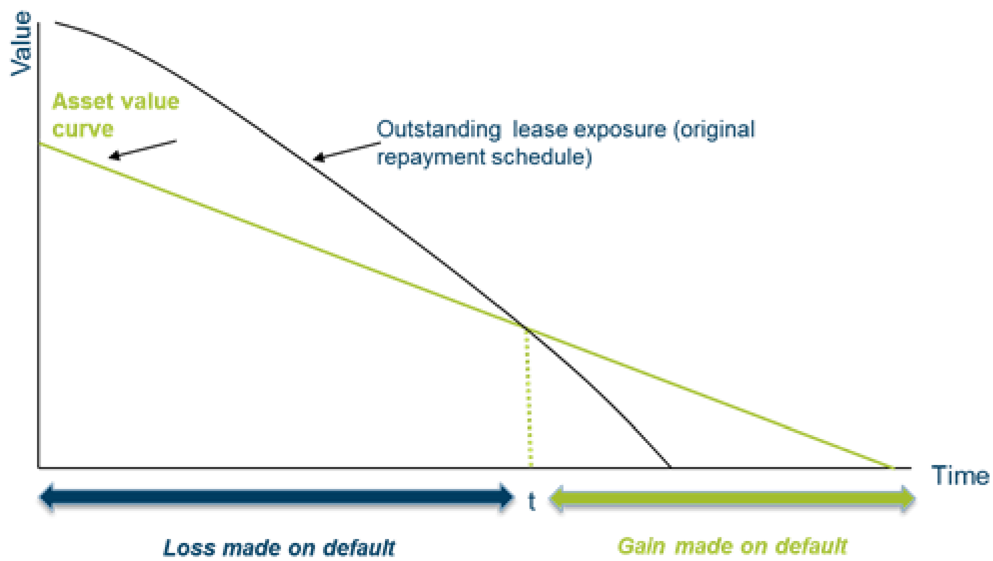
Eurofinas and Leaseurope support the work of the EBA in developing technical standards and promoting convergence of supervisory practices across Europe. We support the EBA objective of reducing unjustified variability in the internal ratings-based (IRB) approach. We see the mission of the EBA as critical and very much welcome the quality of its work as well as its constant dialogue with the industry. Nevertheless, we would like to emphasise that the EBA review of the IRB models entails significant changes for our current internal models. These changes will be time consuming and will imply significant costs for our industries. The proposed EBA date for implementing the IRB review is very challenging for our industries to meet and will pose an extra burden on 'business as usual' operations. Therefore, we urge the EBA to consider more adequate periods of implementation in line with the principle of proportionality.

- **Exposures secured by durable goods should be recognised as collateral**

As we have already pointed out in previous positions, we strongly advocate for the recognition of exposures secured by durable goods (e.g. equipment leases and motor finance) as physical collateral for credit risk mitigation purposes because the assets on which the lending is secured exist in liquid markets with transparent and publicly available pricing and can be realised quickly.

- **Treatment of cases with no loss or positive outcome (Paragraph 139)**

The current legislation requires that the estimated LGD used to calculate capital requirements must not be less than zero, which makes sense for modelling purposes. However, the EBA proposal to extend this floor to individual realised LGDs, is not justified in our opinion and would arbitrarily raise LGDs for types of lending which are generally low risk, such as leasing. In fact, the EBA recognises this potentially significant impact to leasing portfolios in the consultation on page 113. Elimination of netting effects does not seem to be a justifiable goal in and of itself, if that netting is in fact reflecting real outcomes. Lease payments are based on the valuation curve of the underlying asset and are systematically designed to result in a potential gain on defaults towards the end of the contract (please refer to the graph below illustrating this). Therefore the EBA proposal would artificially raise capital requirements for leasing portfolios in particular, which are an inherently low risk form of lending.



We would therefore recommend that the EBA remove the proposed paragraph 139 from the final guidelines. We are aware that some Member States have already been applying this rule, going beyond the current requirements of the CRR. If the EBA wishes to promote further harmonisation, we would suggest it be clarified that the current rule on applying a zero floor to estimated LGD for capital requirements does not extend to the individual exposure level, for the reasons already outlined.

Responses to the EBA Questions:

4.1 : Do you agree with the proposed requirement with regard to the application of appropriate adjustments and margin of conservatism? Do you have any operational concern with respect to the proposed categorization?

We would like to point out that most of the deficiencies identified in the proposed guidelines are included in the institution's estimations and the appropriate adjustments are applied. We therefore question the necessity to quantify margin of conservatism (MoC) by applying an 'unbiased' adjustment and a conservative one.

The overlapping of two levels of MoC (by type and global), in the case there are several layers of MoC required, would be complex to apply, and could reintroduce variability in the different models. In addition, there could be a potential duplicative effect of applying several conservative adjustments.

The proposed approach with a very granular and analytical vision on MoC may lead to the aggregation of several MoC, which would have a significant impact on capital requirements. It will also question the value of operationality of risk parameter. A wider application and definition of the MoC will not lead to less variability in RWA.

Therefore, to avoid duplicates institutions should have to possibility to assess and apply a global MoC. We also suggest that if an institution can demonstrate that the deficiency itself leads to a conservative outcome, it should be exempted from applying a MoC.

The proposed methodology for the estimation of the MoC raise operational concerns since we understand that two calculations will be required: the estimation with the available data and the estimation with the corrected data. This would be burdensome, time consuming and difficult to implement.

We would also welcome further clarification of the Category C (general estimation errors).

Finally, we would like to emphasise that not every deficiency has a material impact on modelled estimates.

5.1 : Do you see any operational limitations with respect to the monitoring requirement proposed in paragraph 53?

It will be difficult for our industries, from an operational point of view, to comply with the proposed requirement to calculate the one-year default rates at least quarterly. Given that parameters are back-tested and updated on an annual basis, we would propose to have an annual review, but based on quarterly data.

5.2 : Do you agree with the proposed policy for calculating observed average default rates? How do you treat short term contracts in this regard?

Most consumer credit contracts are short term, therefore the requirement of an additional MoC would introduce undue divergence and variability in the models for this industry compared to other credit activity.

5.3: Are the requirements on determining the relevant historical observation periods sufficiently clear? Which adjustments (downward or upward), and due to which reasons, are currently applied to the average of observed default rates in order to estimate the long-run average default rate? If possible, please order those adjustments by materiality in terms of RWA.

Paragraphs 59 to 61 might be problematic as the PD estimation framework does not take into account the most recent tendencies of the default rates. This would introduce complexity in back testing analyses (for instance when the latest default rate observed is higher to PD estimation).

5.4: How do you take economic conditions into account in the design of your rating systems, in particular in terms of:
d. definition of risk drivers,
e. definition of the number of grades
f. definition of the long-run average of default rates?

It is currently common practices for our industries to take into account economic conditions only in the calculation of the long-run average of default rates.

5.5: Do you have processes in place to monitor the rating philosophy over time? If yes, please describe them.

It is currently common practices for our industries to conduct studies to observe migration between the different risk pools.

5.6: Do you have different rating philosophy approaches to different types of exposures? If yes, please describe them.

For most specialised financial services providers, the types of credit granted are usually monoline, which means that there is only one type of portfolio or type of exposure. For example, retail portfolio for consumer credit. The rating philosophy is mostly the same for all the exposures.

5.7: Would you expect that benchmarks for number of pools and grades and maximum PD levels (e.g. for exposures that are not sensitive to the economic cycle) could reduce unjustified variability?

We believe that it is not necessary to apply benchmarks for number of pools and grades and maximum PD levels as regard to the heterogeneity of risk profiles and business models across the EU. This approach will penalise low risk institutions.

To reduce heterogeneity through benchmarks, they would have to be applied by type of exposure, business models or localisation. This will be too complex to put it into practice.

Specialised business models such as consumer credit or leasing might be significantly impacted by the introduction of benchmarks of pools and grades and maximum PD levels. If the same grades apply to all business lines, specialised credit activities will be concerned by very few grades. Therefore, it would be difficult to duly monitor the large scale of institutions business models or activities with a low number of grades.

Finally, we would like to highlight that there is no definition of homogeneity in the EBA paper. It is important to have a clear definition in order to achieve homogeneity.

6.1: Do you agree with the proposed principles for the assessment of the representativeness of data?

The reference to « recovery policies » would entail burdensome IT developments. This will make it difficult to comply on time with the new rules.

The proposed wording in paragraph 90 implies that multiple defaults would be treated differently for PD and LGD. This would have two main consequences: i) it would be redundant in regard of the default probation period; ii) the data collection and management would become significantly complex.

6.2: Do you agree with the proposed treatment of additional drawings after default and interest and fees capitalized after the moment of default in the calculation of realized LGDs?

Regarding paragraph 113, the proposed formula for the calculation of economic loss does not seem relevant for operations quitting the status of default.

For example, in the case of a 3-month unpaid instalment loan, which is repaid in the following month, we observe the following:

- A recuperation would equal 0;
- An economic loss would equal EAD at the date of entry in default (if there is no fees);
- The LGD would be a 100% while there is eventually no loss.

6.3: Do you agree with the proposed specification of discounting rate? Do you agree with the proposed level of the add-on over risk-free rate? Do you think that the value of the add-on could be differentiated by predefined categories? If so, which categories would you suggest?

The proposed discount rate (Euribor 1 year + 5%) will make the framework less risk sensitive, will include a lot of variability and will create a disadvantage for low risk exposures. We consider the proposed discount rate disproportionate for our low risk business models. We therefore request the EBA to consider the negative impact of this proposal on low risk activities. To avoid this situation we strongly advocate for the removal of a fix discount rate or at least to have some differentiation by category of exposure.

The methodology updating rules should be clearly stated in order to avoid instability of the LGD. For instance Euribor 1-year should be used at the time of origination or entry into default and not as of today.

Regarding paragraphs 123-127, in some credit activities, for example consumer credit activity, there are often no “direct and indirect costs”. Costs are considered as global costs. As consumer credit is a retail activity, it is not possible to affect direct costs on each facility.

More generally, the inclusion of management costs in the calculation of LGD is a concern. It seems difficult to affect management cost before the default occurs.

6.4: Do you agree with the proposed approach with regard to the specification of historical observation period for LGD estimation?

The EBA proposal to determine the « sufficiently broad sample » of closed defaults (in absolute and relative terms) within the calculation of the average long run LGD will be difficult to comply for our industries.

We would also welcome further clarification on the required samples to be used by institutions.

To be consistent with the methodology proposed to calculate the probability of default, institutions should have the possibility to adjust the historical observation period based on the criteria described in the explanatory box related to question 5.3 (sustained tightening of underwriting standards, changed relevant legislation, changed business environment, mergers & acquisitions and changes of internal processes).

6.5: Do you agree with the proposed treatment of incomplete recovery processes in obtaining the long-run average LGD?

We consider that the proposed treatment could eventually lead to a bias in the result of the long-run average LGD per exposure classes.

We would request further clarification on how to build homogenous loss classes without taking into account the estimation of incomplete recovery processes.

In general we feel that the proposed treatment is conservative. The treatment of incomplete recovery processes introducing a maximum recovery delay would not work for us. Delays are sometimes only due to resistance by the debtors in the processes of recovery. It is of most importance that the expected amounts to be recovered in those situations are recognised.

6.7: Do you agree with the proposed treatment of repossessions of collaterals? Do you think that the value of recovery should be updated in the RDS (reference Data set) after the final sale of the repossessed collateral?

In leasing contracts the “leased asset” is recorded in the lessor’s balance sheet since the beginning. 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 (paragraph 151 of the consultation). 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.

If we look at the leasing asset as a specific type of collateral, where the bank/leasing company is the 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).

On the contrary, in paragraph 151 of the CP it is specified that "the value of repossession should be considered a value of recovery at the date of repossession and should be included in the calculation of the economic loss and realised LGD in accordance with section 6.3 …". In addition, paragraph 153 states that "In any case the repossession of collateral should be recognised at the moment of repossession and should not prevent the institution from closing the recovery process in accordance with paragraph 136."

In the following explanatory box for consultation process, the pros and the cons to the above mentioned approach are analysed. For the nature of the collateral represented by the leased asset, we think that in those cases where the number of sales are quite representative of the leasing defaulted portfolio, only the sale value should be taken into consideration for the calculation of the LGD, as the haircut at the repossession date could be too prudential or too far from the real resale value. Of course, the repossession date should be adequately recorded in the RDS for the correct calculation of the representativeness of the sales and of the time to recovery, but not necessarily accompanied by an evaluation of the value at the repossession date with the prudential haircut.

For leasing contracts, the repossession is not characterised by a cash inflow, but rather it corresponds to the phase in which the ownership and the factual possession of the asset coincide again. In the case in which the sales (that is, the "closing" of the process of recovery of the leased assets) were representative of the defaulted portfolio, applying a haircut to the repossession may not represent a truly prudential approach.

6.8: Do you think that additional guidance is necessary with regard to specification of the downturn adjustment? If yes, what would be your proposed approach?

We encourage the EBA to consider the relation between MoC and downturn adjustment from two angles:

- some MoC related to the representativeness of data already include downturn elements, so entities should have the possibility to consider and present MoC and downturn adjustment as a whole to avoid redundancy;

- historical data shows that some specific portfolios may be not sensitive to risk drivers, therefore entities should have the possibility exclude any downturn adjustment from those portfolios.

7.1: Do you agree with the proposed approach to the ELBE and LGD in-default specification? Do you have any operational concerns with respect to these requirements? Do you think there are any further specificities of ELBE and LGD in-default that are not covered in this chapter?

Regarding the consistency of LGD in-default and LGD for non-defaulted exposures, it would be useful to have access daily information on the behaviour of the customer. Most specialised credit institutions (e.g. consumer credit, leasing, guarantees) do not manage current bank accounts. Therefore, they do not have access to precise customer behaviour information. Models for LGD for non-defaulted exposures would be less precise than the models for LGD in-default.

For this reason, it would not be consistent to apply the same risk drivers for defaulted/non-defaulted status. We suggest the EBA to acknowledge that there are differences between defaulted and non-defaulted status.

Regarding paragraph 161, for those specialised credit institutions that do not have direct access to current bank accounts, or even to the credit management (residential guarantees institutions), it is not possible to anticipate LGD upward movements before defaults occur.

7.2: Do you agree with the proposed reference date definition? Do you currently use the reference date approach in your ELBE and LGD in-default estimation?

The possibility to adopt fixed reference date may lead to inconsistencies in cases of changes of recovery processes or exceptional events. Instead of a reference date, we propose a statistical approach based on cluster analysis in order to identify proper segmentation by time into default.

7.4: Which approach do you use to reflect current economic circumstances for ELBE estimation purposes?

Some consumer credit institutions currently use a short-term average approach. For others, at the time of parameters update, analyses are made in order to assess if vintages included in parameter calculation are representative of current situation, and depending on the outcome of the analyses adjustments on the historical timeframe may be performed.

7.5: Do you currently use specific credit risk adjustments as ELBE estimate or as a possible reason for overriding (ignorer) the ELBE estimates? If so how?

Some of our companies currently use specific credit risk adjustments (SCRA) as ELBE estimate. In addition, for some others, SCRA is not used as ELBE estimate, but could be used in the context of IFRS 9, in which a higher convergence between Basel standards and provisioning methodology should be achieved.

8.1: Do you see operational issues with respect to the proposed requirements for additional conservatism in the application of risk parameter estimates?

The current models already apply a MoC, therefore, we would like to emphasise that this MoC should be included in the existing framework.

Moreover, the proposed approach with a very granular and analytical vision on MoC might provoke an aggregation of numerous MoCs which would have a significant impact on capital requirements. This will question the value of operationality of the risk parameter.

To avoid duplicates, we propose that entities should have the possibility to assess and apply MoC in a global way, or even not to apply any MoC at all, if it can be demonstrated that the deficiency itself results in a conservative outcome.

11.1: How material would be in your view the impact of the proposed guidelines on your rating systems? How many of your models do you expect to require material changes that will have to be approved by the competent authority?

For our companies the impact of the proposed regulation on current models would be very material. Therefore, they will have to modify their methodology and implement new models considerably. The significant evolution of the institutions' models will require constant validation processes by the regulators.

In particular, the LGD estimation (in default and non -default) part of the proposed guidelines would have the biggest impact on us, as it requires the collection of new statistical series of data and the establishment of new models, which, above the main points of operational cost on IT systems, it raises the issue of planning and complying with the deadlines, considering implementation and validation delays.

While we support the EBA efforts to harmonise IRB models in Europe it should be emphasised that the EBA proposals will require an extra burden for our industries both in terms of cost and time for our companies. The proposed deadline for implementing the new framework by 2020 seems constringent, given the amount of work required to implement the new IT systems, therefore we would advocate for a more flexible and proportionate framework to comply with the new proposed requirements.

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About us

The membership of our two Federations covers institutions specialised in one or more of the following activities:

- Lending to consumers, for instance via personal loans, credit cards or lease/hire purchase agreements
- Leasing to businesses of all asset types, including machinery and industrial equipment, ICT and others assets
- Motor finance, granted to individuals or businesses, either in the form of loans or leases

The consumer credit, 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 Federations include specialised banks, bank-owned subsidiaries, the financing arms of manufacturers as well as other, independently-owned institutions.

In 2015, the leasing firms represented through **Leaseurope's membership helped European businesses invest in assets worth more than 315 billion EUR**, reaching 755 billion EUR of outstandings at the end of the year[1]. Leasing is used by more European SMEs than any individual category of traditional bank lending taken altogether (around 40% of all European SMEs make us of leasing which is more than any other individual form of lending)[2] and is also extremely popular amongst larger corporates[3]. It is also extremely useful to support the public sector (e.g. leasing to schools, hospitals, etc.).

In 2015, consumer credit providers that are members of **Eurofinas helped support European consumption by making more than 423 billion EUR goods, services, home improvements and private vehicles available to individuals**, reaching 981 billion EUR of outstandings at the end of the year[4]. Consumer lending is procyclical and is highly positively correlated with households' disposable income[5]. By providing access to finance to individuals and households, consumer credit supports the social and economic well-being of millions of consumers across Europe.

Eurofinas and Leaseurope are entered into the European Transparency Register of Interest Representatives with ID n° 83211441580-56 and 16013361508-12

[1] Leaseurope 2015 Annual Statistical Enquiry

[2] Oxford Economics, *The Use of Leasing Amongst European SMEs,* 2015; Eurostat, *Access to Finance Statistics,* 2011; International Finance Corporation *Leasing in Development: Guidelines for Emerging Economies,* 2009; European Investment Fund *The importance of leasing for SME finance, 2012*; and UEAPME, *UEAPME Newsflash,* 2012

[3] European Central Bank, *Survey on the Access to Finance of Small and Medium-Sized Enterprises in the Euro Area* , April 2013

[4] Eurofinas 2015 Annual Statistical Enquiry

[5] Eurofinas, *Consumer Credit, Helping European Households Finance their Tomorrow,* 2015