Deloitte.

Leaseurope

The Voice of Leasing and Automotive Rental in Europe

Implicit Risk Weights for SME Leasing in Europe

A report by Deloitte, prepared for Leaseurope

KEY FINDINGS

WHY STUDY THE RISKINESS OF SME LEASING?

> Around 20% of all business equipment investment in Europe is financed by leasing. European SMEs in particular rely on leasing to finance their assets.
> By introducing a scaling factor of 0.7619 to the capital requirements for SME exposures, the European legislator aims to ensure that SMEs' access to finance is not hampered by the implementation of Basel 3 in Europe.
> In order to assess the appropriateness of these requirements, the European Banking Authority (EBA) has been tasked with measuring the effective riskiness of European SMEs.
> Given that leasing is key in supporting European SMEs, understanding the riskiness of leasing will play an important role in the EBA's assessment.

CONTRIBUTIONS OF THE RESEARCH

> One of the first pan-European studies to specifically consider the riskiness of SME exposures, where SMEs are defined according to the European Commission's definition, as opposed to the typical Basel classification of Retail and Corporate exposures.
> An in-depth analysis of the role asset ownership plays from a risk mitigation point of view and how this makes leasing "capital efficient".
> A comparison of actual risks arising from leasing to SMEs with regulatory requirements.

KEY RESULTS

The study finds that the true level of riskiness of the SME leasing sample portfolio is equivalent to an implicit risk weight of **0.634%**[1], which shows that regulatory capital requirements over-estimate the riskiness of leasing to SMEs (see below).

Capital requirements for European leasing to SMEs*

Implicit Risk Weight 0.634%
based on internal model used in the report

7%	6%	4%
Standardised Approach	IRB-Foundation Approach	IRB-Advanced Approach

* On the basis of the report's sample portfolio, which covers SME leases that are classified either as Retail or Corporate exposures for capital requirement purposes

The sample portfolio used in the study

> Includes SME leasing portfolios of 10 major European leasing companies, covering their activities in 17 European markets
> Five year period (2007 – 2011), covering the depths of the European economic crisis
> Contract-level information for 1.5 million contracts, with an average outstanding portfolio worth €18 billion
> Covers both equipment (60%) and automotive (40%) assets
> Includes 108 198 defaulted contracts

1. Ie. Unexpected loss. The report uses a Monte Carlo simulation to estimate the 99.9th percentile value of the total loss distribution (credit Value-at-Risk = 1.369%), from which the expected loss (PD x LGD = 0.735%) is subtracted in order to obtain the unexpected loss of 0.634%.

LOW DEFAULT RATES

The average one-year default rate on the sample portfolio is **2.64%**. This is very low when compared to equivalent default rates on the Retail SME portfolios of EU banks[2]. For instance, the sample portfolio's default rate for 2010 is 2.8% compared to the EBA's EU-wide rate of 4.5%.

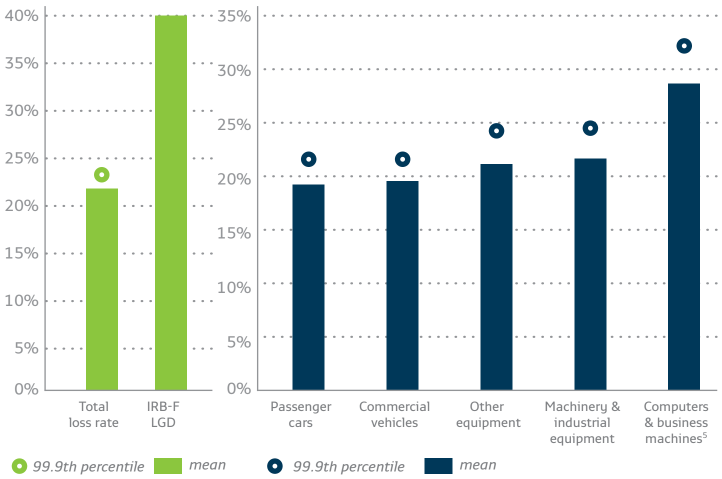
Why > Default rates within the leasing activity are low because the asset is crucial to an SME's core business activities. SMEs therefore prioritise lease payments because they need these assets to run their business.

LOW LOSS RATES

Loss rates are low with a 99.9th percentile loss rate of **23.1%** overall. They remain low for all asset types (see chart). The IRB-F regulatory LGD of 40% therefore subscribes a level of loss to leasing that is unnecessarily high[3].

Why > The lessor's ownership of the leased asset plays a crucial role in keeping losses low. The benefits of ownership represent a major difference 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.

Low loss rates by asset type[4]



- > As the asset is a key working tool for the lessee, many defaulted leases regrade to a healthy situation with a zero loss.
- > Ownership of the asset makes repossession 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.
- > If the value of the asset exceeds the amount outstanding at default, the lessor would actually make a gain in the case of a default.





HOW TO GET THE REPORT

For more information or to request a copy of the report, please go to Leaseurope's dedicated Basel 3 research webpage on www.leaseurope.org or e-mail us directly at h.mcewen@leaseurope.org.

COMING SOON

This report is the first in a series of papers on leasing in the new Basel 3 environment. The second report on **"The Risk Profile of Leasing in Europe"** will cover lease exposures to all types of counterparties, with a focus on losses and the risk mitigating impact that ownership of the asset represents for lessors. This second report will be launched in October at the Leaseurope Annual Convention in Rome.

Basel3

A research project by Leaseurope

THANK YOU TO ALL CONTRIBUTING COMPANIES

Leaseurope would like to thank all the leasing companies that took part in this project for their time and commitment to this very large data collection exercise.

2. EBA 2011 Stress Test. 3. A discount rate of 13% to 16% would need to be applied to the sample portfolio to achieve a 40% LGD. 5. only includes closed defaults. 4. Mean loss rates calculated through bootstrapping on closed & quasi-closed (defaults where the asset has already been sold are considered quasi-closed) defaulted contracts in our sample.