BDL Markgrafenstaße 19 10969 Berlin

European Banking Authority
One Canada Square (Floor 46)
Canary Wharf
London E14 5AA| UK

Sent by e-Mail

Kontakt:
Dr. Martin Vosseler
vosseler@leasingverband.de
Fon +49(0)30-206337-14
Fax +49(0)30-206337-30

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Draft EBA Guidelines on limits on exposures to shadow banking entities (EBA/CP/2015/06)

Dear Sir/Madam,

As Federal Association of German Leasing Companies (EU Transparency Register identification number 84917875724-73) we appreciate the possibility to respond to the above mentioned EBA consultation paper. Our association exclusively represents the interests of the German leasing industry to legislators, public authorities and the interested public at large. We act on behalf of some 180 leasing companies, ranging from small and medium-sized businesses to international leasing corporations. With a current annual investment volume of around € 56 billion, the German leasing market belongs to the biggest in Europe, along with the United Kingdom. Leases account for roundabout 23% of all equipment investments in Germany and more than 50% of all externally financed equipment investments. Thus leasing contributes significantly to overall economic investment needs, especially in small and medium-sized entities (SMEs).

We will concentrate on responding to *question 1* of the consultation paper. We are concerned that leasing in Germany could unjustifiably be treated as shadow banking activity and thus be affected by the EBA's proposal of introducing limits to institutions on exposures to shadow banking entities. This would unnecessarily hamper the leasing companies' funding opportunities and ultimately hinder the realization of investment in property, plant and equipment that is urgently needed from a macroeconomic point of view.

We will start our considerations by explaining the German leasing companies' business model. We will show that this business model does not generate any of the risks associated with shadow banking activities, is already subject to comprehensive regulatory requirements and thus does not give rise to any need of further regulation, either direct or indirect (see below sections 1 to 3). In light of this we will then substantiate our criticism on the EBA's definition of shadow banking entities (section 4) and present some suggestions to amend this definition (marked with boxes).

1. Business model of German leasing companies

There is no general definition for "leasing" in the European Union. A wide range of sometimes very different activities is associated with the notion of leasing in the several member states. Hence we will first of all describe the business model of German leasing companies.

Leasing companies purchase capital goods according to the specifications of their customers and confer the right to use these goods to the latter over a fixed period of time in exchange for consideration. The legal basis for this is the general German rental law. However, some types of risk associated with the leased asset are occasionally transferred to the lessee by contract. After the end of the lease term the lessor realizes the residual value of the leased asset by selling it on the market via established sales channels. Exceptionally the asset can also be sold to the lessee instead.

The focus of the whole business model – from the procurement through the transfer of use to the re-marketing – is the asset. Thus the very distinctive asset expertise of the lessor companies is the foundation for success. The companies have sound knowledge of the procurement markets and maintain established re-marketing channels. They know exactly the technical and commercial characteristics of their capital goods and are therefore able to predict their value over time. Besides the financial standing of the lessee, which is evaluated by established techniques, the recoverability of the leased asset is another key pillar for the business decisions of leasing companies.

The German leasing companies usually fund their leased assets at matching maturities via fully regulated banks. The common way is to take out bank loans that are adjusted to the lease transactions in terms of maturity and amortization. A supplementary way is to sell non-recourse and in advance any future lease payments as well as claims arising from residual value guarantees (if applicable) to credit institutions (*"forfeiting"*)[1]. Both methods have in common that the value of the leased asset provides additional security for the financing besides the creditworthiness of the lessor (loan) or the lessee (forfeiting).

2. No shadow banking specific risks occur in the German leasing industry

Chapter 3 Number 4 of the consultation paper identifies several specific risks typically associated with shadow banking activities that in the EBA's view may warrant regulatory attention. None of these risks can be related to the above mentioned business model of the German leasing industry:

No run risk/no liquidity problems

Since leasing companies do not take deposits, a *"run"* in the sense of a withdrawal of deposit-like assets can be excluded from the outset. These firms enter into an investment only at the instigation of their customers and only after having signed a lease contract, thus there is no demand risk. Since the lease transactions are usually funded at matching maturities, the resulting payment obligations can in principle be fulfilled by the cash flows arising from the lease contract. Neither a maturity nor a liquidity transformation takes place, and hence there is no liquidity risk in terms of the availability of a follow-up financing. A limited supply of debt financing could at worst hinder leasing companies in entering into new lease transactions but would be generally incapable of jeopardizing existing payment claims stemming from

[1] A particular form of forfeiting involving the capital markets are ABS transactions. This instrument is used as a supplement by a very small number of companies and accounts for only a tiny percentage of the whole volume of leasing transactions in Germany. It should be noted that regardless of the particular funding modalities of the ABS vehicle, forfeiting always guarantees hundred percent matching maturities from the perspective of the leasing companies (i.e. the sellers of the lease payments).

prior lease transactions. Therefore German leasing companies are not expected to face situations like those feared by the EBA, where they would be compelled to sell their assets at *“fire sale prices”* due to liquidity problems.

The principle of not taking deposits, which holds for all non-bank leasing companies in Europe, is crucial for assessing the risks associated with leasing and hence for estimating whether or not there is a need for additional regulation. Since leasing – as shown above – does not give rise to any risk for vulnerable depositors, we can see no need for further regulation on this field.

No interconnectivity and no spillovers

As described above, German leasing companies usually fund their activities via fully regulated banks. The subjects of these bank financings are vehicles, plants, office equipment, properties and similar types of assets that all have in common that they belong to the *“real economy”*. From a prudential point of view it makes no difference whether regulated institutions provide financing for these real-economy-items directly to the end-user or indirectly via leasing companies as their legal and economic owners. Since the institutions, as a matter of course, have to comply with the existing general large exposure framework of the CRR also when providing financing to leasing companies, there is no increased concentration risk, no increased risk of contagion and no spillover effect.

We would like to emphasize that none of the leasing companies in Germany would get close to fulfilling the currently proposed preconditions for “non-bank non-insurer global systemically important financial institutions”. Furthermore, the lessons learned from the worldwide financial crises indicate that the leasing industry did not get into financial distress and did not cause any defaults that would have been able to threaten the global financial system. On the contrary, leasing contributed vitally to stabilizing the aggregate supply of investment in property, plant and equipment during the crises and hence to mitigating the adverse impacts of the economic downturn.

No excessive leverage and no procyclicality

The German Banking Act prescribes that leasing companies have to establish prudential risk management systems that particularly require them to continually adjust their incurred risks to their risk-taking capability. Hence these companies are de facto obligated to maintain an equity base that matches their individual risk profile. Given this, an excessive level of leverage is excluded from the outset.

German leasing companies do not perform financial transactions in terms of “trading money in exchange for money”, but invest in real physical assets which they own legally and economically. Hence they are not financial intermediaries, but part of the “real economy”. Economic studies prove the very favourable risk profile of leasing[2]. On the one hand, the abstract power of the lessor to preclude the lessee from the use of assets that are necessary to run

[2] See for example Deloitte, The Risk Profile of Leasing: The Role of the Leased Asset, 2013

his business usually affects the payment performance of the latter positively. On the other hand, if the lessee nevertheless defaults, the lessor is able to achieve exceptional recovery rates due to his favourable legal position, his asset expertise and his established re-marketing channels. There is strong empirical evidence that this leads to LGD values that are much lower than those of bank loans.

No opaqueness and no complexity

The above mentioned business model of the German leasing industry is basically simple and uncomplicated. Like any other companies in the real economy, German leasing firms invest in real physical assets which they use to perform their business activities – that is the temporary transfer of use to their customers against payment. Likewise the funding of their activities does not show any structural peculiarities. The interconnectedness with the regulated banking sector does not differ substantially from conventional industrial companies.

By means of national and international lease accounting rules, it is ensured that all liabilities and all risks incurred by a leasing company are presented faithfully and transparently. What is more, German leasing companies are subject to supervision by the national competent authorities Bundesanstalt für Finanzdienstleistungsaufsicht (Federal Financial Supervisory Authority) and Deutsche Bundesbank that are legally enabled by the German Banking Act to obtain a comprehensive assessment of the risk situation of any leasing company at any time.

No regulatory arbitrage because of risk-adequate regulation on a national level

Besides the above mentioned matters, the EBA expresses in Section 3 Number 25 of the consultation paper their concern about regulatory arbitrage issues. However, even this risk cannot be associated with the German leasing industry. The German legislator decided in 2008 to bring leasing companies under the legal rules for the supervision of financial services institutions stipulated by the German Banking Act. In the course of this the applicable supervisory measures have been adjusted tailor-made to the business model and the risk profile of leasing in Germany. Given this, regulatory arbitrage in terms of a non-risk-adequate benefit can be excluded.

The German leasing supervision comprises comprehensive authorization-, reporting- and monitoring-requirements which are taken from the German Banking Act. The core rules are constituted by the requirements to risk management stipulated in Para. 25a Sec. 1 of the German Banking Act. As mentioned above these rules de facto oblige German leasing companies to maintain an equity base that matches their individual risk profile. While these rules are stipulated less formally than the capital adequacy requirements applied to banks, hence corresponding with the deviating business model of leasing companies, they are fully comparable in terms of robustness.

3. Preliminary conclusion: German leasing companies are not shadow banks

As we have shown above, the risk profile of German leasing companies is very low and their business model is related to the real economy rather than to financial intermediation. The activities carried out by German leasing companies do not generate any of the specific risks that the EBA associates with shadow banks. Therefore it is not justifiable to attribute them to the shadow banking sector. German leasing companies are already subject to prudential and supervisory requirements on a national level that are comparable to those applied to institutions in terms of robustness. Since they take no deposits, they do not give rise to any risk for vulnerable depositors, nor to the risk of a *"run"*. Thus there is no need for a stricter regulation of these companies, either direct or indirect. This is proven by evidence from the world financial crises, when leasing companies did not face serious financial distress but contributed vitally to diminishing the consequences of the economic downturn by stabilising the aggregate supply for investment in property, plant and equipment.

4. EBA's shadow banking concept needs accurate re-definition

As mentioned at the beginning of this letter, we are concerned that leasing in Germany could unjustifiably fall under the EBA's definition of shadow banking entities. The notional stigmatization alone would give rise to severe disadvantages for our industry. What is more, we would have to face a serious encumbrance of the leasing companies' funding opportunities by way of unnecessary administrative burdens and occasionally in terms of quantitative limitations. As a consequence, we are afraid of a massive detrimental impact on the overall supply of investment goods to the German economy and particularly to the "German Mittelstand".

In a two-step approach the EBA defines shadow banking entities as undertakings that

(1) carry out one or more credit intermediation activities and

(2) are not excluded undertakings.

In principle we agree with this two-step proceeding. However, as regards content, these two criteria need to be redeliberated thoroughly in order to bring them in line with the objectives of the proposal.

Criterion (1) "credit intermediation activities"

According to the EBA's definition, credit intermediation activities means bank-like activities involving maturity transformation, liquidity transformation, leverage, credit risk transfer or similar activities. It is sufficient to perform only one of these activities to fulfil criterion (1) of the shadow banking definition.

In our opinion, this concept is much too imprecise and far-reaching. There exist no binding specifications for the named activities, so legal uncertainty and an inconsistent implementation practice on an international level are to be feared. Furthermore, quantitative aspects in terms of the volume of the considered activities and their contribution to the overall business model of the undertaking are totally disregarded. Hence it is to be expected that completely different business models, associated with completely different risk profiles, are lumped together only for regulatory purposes. As a result, a risk-adequate adjustment of regulatory measures will become more complicated or will even be completely impeded.

We therefore suggest a fundamental revision of criterion (1) of the shadow banking definition. The criterion should only be fulfilled if the sum of all activities performed by an undertaking, taking into account all relevant circumstances, is sufficient to shape its bank-like character. At the same time this undertaking must to a significant extent give rise to the named risks associated with shadow banking, in particular the risk of endangering depositors.

We utterly fail to understand why the EBA includes financial leasing, as listed in point 3 of Annex 1 of the CRD, in the credit intermediation activities without further explanation and without an examination of the individual case. As mentioned above, there is no legal definition of the notion financial leasing in the European Union and the activities associated with this term in different member states vary widely. While leasing in Germany is predominantly funded at matching maturities, there might be maturity transformation to some extent in other member states. While leasing in Germany is shaped by its predominant transfer of use character, it might be a prevalent financing nature in other member states. On these grounds alone, it is in our opinion inappropriate to extend from the outset the scope of credit intermediation activities to all activities that could potentially be conceived under the notion financial leasing. At least in Germany, the activities of leasing companies are much more similar to these of industrial service providers than to those of banks.

Therefore we urge the EBA to delete at least financial leasing from the list of activities that are necessarily assumed to be credit intermediation activities. In our opinion, it would even be preferable to withdraw the list entirely.

Criterion (2) “excluded undertakings”

In general, we consider it reasonable to exclude companies that are already subject to adequate regulation from the definition of shadow banking entities. As mentioned above, we are convinced that leasing in Germany already operates under a regulatory supervision stipulated in the German Banking Act that perfectly fits with its specific risk profile. We are also convinced that this regulation is comparable to that applied to institutions in terms of robustness. However, due to the vague wording in Chapter 4 Title I Number 6 Sub-Point (3)(e) of the consultation paper, which is open to interpretation, there remains a degree of uncertainty.

The appropriateness of a regulation on national level can only be evaluated, if the established rules and the risk profile of the regulated activities are considered simultaneously. These evaluations and considerations should best be performed by the national competent authorities, due to their comprehensive understanding of the local circumstances. In the light of this, a general “benchmarking” with the regulatory requirements applied to institutions, as suggested in the EBA paper, is in our opinion inappropriate. This is because that kind of benchmarking implies a similarity of the risk profiles between the considered activities and the activities of banks. However, that similarity may by no means be generally assumed, which is demonstrated by the example of leasing in Germany.

We therefore suggest formulating Chapter 4 Title I Number 6 Sub-Point (3)(e) as follows:

(e) financial institutions authorised and supervised by the competent authorities or third country competent authorities and subject to regulatory requirements (solo or at group level) that appropriately reflect their risk profiles in the competent authorities' view

We hope that the EBA will take into account our concerns and suggestions. We remain at your disposal for any questions or further information.

Yours faithfully,

Bundesverband Deutscher
Leasing-Unternehmen e. V.

Horst Fittler
Managing Director

Dr. Martin Vosseler
Director