



From Regulatory Compliance to Value Creation: The case of residual value management

This article focuses on the treatment of residual values when a financial institution applies for one of the IRB approaches and on the implications in terms of risk management.

The rules have changed in the EU

From 1999, Leaseurope has been representing the interests of the European leasing industry in relation to the elaboration of the Capital Requirement Directive (CRD), the European legislative text of the Basel II accords. This long process culminated in September 2005 when the CRD was adopted by the EU Parliament¹ and a large number of Leaseurope's proposed amendments were accepted.

According to the Basel II Accord, a residual value has to be risk-weighted at 100%, which implies that capital requirements should amount to 100% of the target ratio (i.e. 8%) times the residual value amount be it guaranteed or not. The major improvement introduced by the EU framework is the focus on the economic substance and the risk profile of the lease, depending on the type of residual value involved (i.e. guaranteed or not). Indeed, the CRD makes a clear distinction between guaranteed and unguaranteed residual values. The guaranteed residual value should be risk-weighted as a credit risk if adequately guaranteed. The conditions for an guarantee to qualify for use are explained below. The rationale behind this rule is that the only risk a lessor incurs is the simultaneous default of the obligor and the guarantor. Hence, in the EU framework, the prescribed regulatory capital is much more in line with economic capital than it is in the Basel II Accord. This is illustrated in Table I, which shows an example of the difference in capital requirements between the Basel II Accord and the CRD when a

¹The text of the Directive, as agreed by the European Council and the European Parliament, is now available on the website of the European Commission at the following address: http://europa.eu.int/comm/internal_market/bank/regcapital/index_en.htm#capitalrequire

guaranteed residual value varies from 0% to 40% of the initial investment. The underlying risk borne by the lessor does not change because of the guaranteed nature of the residual value. The capital requirement under the Basel II accord varies from 2.6% to 4.8% whereas under the CRD it remains constant. Considering an average residual value of 20% and a maturity of 3 years, we estimate that European leasing companies could potentially save between €424 and 565 million of capital on their car leasing portfolios under the new CRD.

Table I: Comparison of capital requirements under Basel II and the CRD

Guaranteed Residual Value (%)	Outstanding Amount (%)	Capital Requirement	
		Basel II	CRD
0	100	2.60%	2.60%
20	80	3.70%	2.60%
40	60	4.80%	2.60%

The assumption are Probability of Default (PD)=1% and Loss Given Default (LGD)=30%

In the case of an unguaranteed residual value, the exposures are subject to market risk only at the end of the contract term. Ideally, the regulatory capital to cover residual value risk should be made available in the last year of the contract and not at the inception of the lease like in the Basel II accord, since the capital only needs to be provisioned for a one-year horizon. At the EU level, the regulatory capital should be calculated as $1/t \times 100\% \times exposure\ value$, where t is the number of years of the lease contract term. Hence, the provision of regulatory capital is spread over the term of the lease, rather than being established at its inception. The EU provision would allow savings of between 25% (leases with a maturity between 2 and 3 years) and 50% (very long term contracts) of the capital set aside to cover residual value risk in comparison to the Basel II accord.

An adequate risk management framework is the key success factor...

When looking particularly at guaranteed residual values, lessors must fulfil the conditions set out in Annex VIII, Part 2, paragraphs 14 and 18 as the minimum requirements provided. The principal requirements for guarantee recognition are: the credit protection must be direct, there must be no clause in the contract outside the direct control of the lender, the extent of the protection must be clearly defined and payment by the guarantor must not be subject to the lending institution first having to pursue the obligor. Additionally, strict conditions are set out in Annex VIII, Part 1, paragraphs 14 and 18 on the type and quality of the guarantor (e.g. credit quality step 2 or above). Therefore, in order to benefit from the more adequate treatments provided in the CRD, specific tailored-made structures and methodologies should

be put in place by the lessor in a manner consistent with his general risk management framework. This implies that the lessor has to consider the definition and design of business requirements compliance, data collection, modelling choices, modelling specifications, policies, use tests, maintenance, reviewing practices in respect to environment changes, roll-out plans and validation rules. These steps contribute to ensuring that all procedures, processes and regulatory requirements are properly implemented. Additionally, consistency in the definitions and risk management frameworks should be reached across other elements included in Pillar I (i.e. PD, LGD and EAD configuration) and Pillar II requirements.

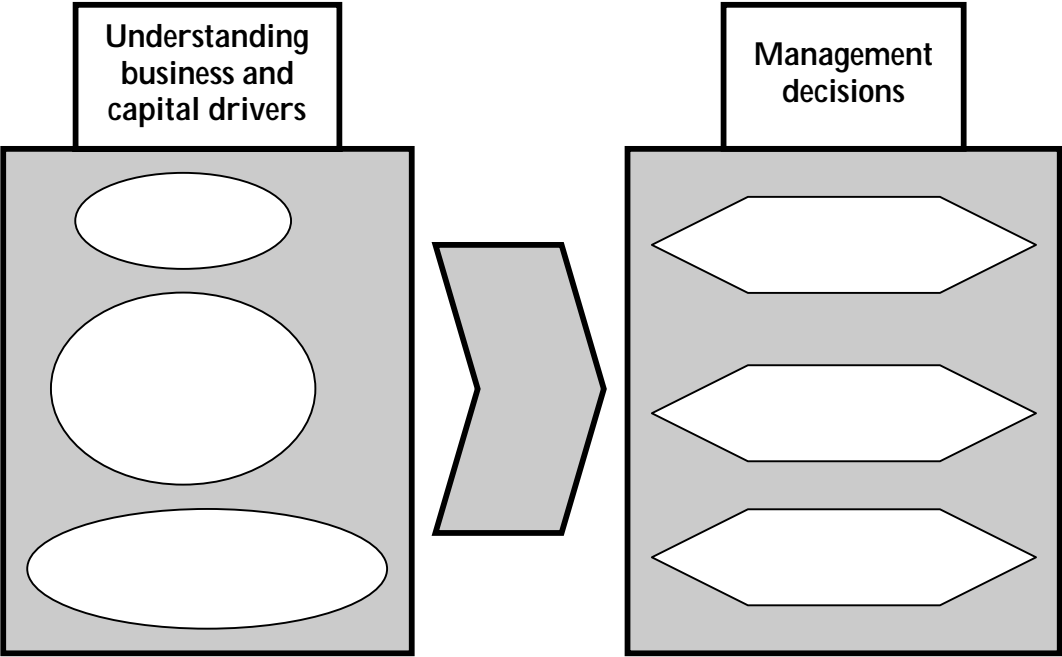
... to increase the long-run performance!

It is essential not to view the burdensome CRD requirements as only pure compliance objectives but rather as components of an innovative approach embedding risk processes into a firm-wide risk management framework as illustrated in figure I. Indeed, it is the essential tool to define the way to leverage the CRD mandatory requirements as to enrich the business vision and to create value, by:

- differentiating customer relationship management,
- sustaining the business and structuring new products,
- optimising regulatory compliance and improving performance.

Additionally, adequate risk management frameworks will support the CRD project management to reach the required level of awareness, visibility and credibility for the project both for internal buy-in and external endorsement.

Figure I: Leveraging the CRD for optimizing business benefits



The CRD offers to the leaders in implementing risk management frameworks attractive competitive benefits in the medium term. Indeed, building on suitable methodologies, structures and organisations, the management of leasing institutions will find out more about the new business opportunities driven by financial regulatory pressure.

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