Captives Forum

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Secretariat of the Financial Stability Board
c/o Bank for International Settlements
CH-4002
Basel
Switzerland

7th April 2014

Dear Sirs

Re:- Comments on Consultative Document regarding Assessment Methodolgies for Identifying NBNI G-SIFIs

We welcome the opportunity to comment on the above paper.

We have concern that Consultative Document lumps all "Finance Companies" together, and fails to recognise that equipment finance companies should not be confused with the wide range of other activities that come under this broad definition. We do not believe that true Manufacturers' Captive Finance entities pose any systemic risk and our submission concentrates on this.

We would draw attention to the fact that our response specifically addresses the issues from the perspective of Manufacturers' own Finance Companies (Captives) and not from the perspective of the leasing industry as a whole. Leaseurope is the representative body for the wider European leasing industry.

Some manufacturers' have chosen to establish banks within their finance entities and those will already be subject to banking regulations.

Background to Captives

Before addressing the individual questions contained in the Consultative Document, we believe it is important to set out some background on what we mean by a Captive. A Captive is a division or a subsidiary of a manufacturer established to assist the manufacturer in its trade of making, marketing and selling equipment. Such assistance can take the form of arranging deferred terms for customers and can include such items as leases, rental agreements, hire purchase, credit sale and other forms of deferred payment. Agreements can be short term rental or for all or part of the normal expected life of an asset.

Manufacturers may also accept deferred payment from their dealers and distributors and some may pay their suppliers early to ensure stability of the supply chain.

First and foremost they are manufacturers and sellers of equipment; they are not financiers whose trade is dealing and negotiating in finance and financial instruments for gain. Because they are owned by manufacturers, they are likely to be subjected to much stricter constraints by the parent. Unlike a bank or finance company, money is not the primary tool of the trade; it is very much a secondary matter which is one among many of the aids and tools they use to help sell their equipment. Manufacturers trade in hard assets not intangible financial assets, so when considering the risks involved, one is looking at something totally different to banks, insurance companies and some other forms of financial institutions. They do of course employ knowledgeable and extremely specialised equipment finance staff.

General equipment finance companies will finance a range of equipment supplied by different manufacturers etc, whereas a Captive lessor is there solely for the purpose of providing finance to customers enabling them to acquire the equipment which their group sells.

Occasionally some manufacturers may finance ancillary equipment produced by another manufacturer if it is being sold as part of the same transaction. This will only be done in order to secure the sale of the manufacturer's own equipment, not to write extra finance business. It would only constitute a very small part of the Captive's total business. We would not consider a finance company that is owned by a manufacturer, but which has developed into a general finance company by offering finance for a wide range of unconnected products unrelated to winning sales of the parents equipment, to still be a Captive from the perspective of our submission.

Like other financiers of equipment, Captives have a great deal of experience and understanding of this market and know how manage and track any exposure to risks using advanced computer systems. Because they are owned by manufacturers, they are likely to be subjected to much stricter constraints by the parent. Plus it is normal for equipment financiers to have security over the financed asset. A manufacturer has additional comfort from the fact that they are likely to be in regular contact with their customers as they provide services, supplies and other ongoing support. This makes them well placed to assess and monitor the credit stability of their customer base and able to manage any risks at an earlier stage. Additionally, they know the assets intimately and have the ability to be able to maximise the value from any recovered assets due to being in the business of selling and trading in those assets.

In the extremely unlikely event of a manufacturer's finance company getting into financial difficulties, it is highly likely that the parent company will "bail it out" as it is likely to be smaller than the parent. The losses are less likely to hit businesses or entities outside of the group, whereas in the case of an independent finance company there could well be no large parent behind it to absorb the debt. Should other creditors be impacted, the creditors can choose (via an administrator or appropriate official) to let the lessee retain possession of the equipment and collect and receive the rentals on the underlying contracts.

The size of finance company assets will likely be totally unrelated to the size of the total group assets, which will normally be significantly larger. Also unlike in a finance company, the liabilities are less likely to be related to the size of the portfolio.

We would also point out that Captives, as do most equipment finance companies, make prudent use of interest rate and currency swaps in order to reduce risk to their portfolios. They do not deal in such instruments for speculative gain, but to protect the portfolio.

A further point worthy of appreciating is that all Captives will also have a relationship with a 3rd party lessor for a variety of reasons. Generally the cost of establishing a Captive is such that manufacturers will only do so where the volume of business in a particular country is sufficient to justify an in-house operation. In such countries they will work with a 3rd party vendor lessor to support their sales. Not only does the size of the parents business in a given country influence this, but also manufacturers will consider how large they wish to grow their Captive business in relation to their total business. Additionally, like any other financial institution, Captives look at concentration of risk and will have credit limits on end users, and once these are reached they will work with a 3rd party lessor even if they do have their own Captive. Captives will have a number of different 3rd party lessor relationships so that they are not reliant on any single 3rd party lessor should that lessor reach their concentration limit for any lessee. These established relationships mean that a Captive can always direct an increased level of business to 3rd party funders.

Q1-1. In your view, are the three transmission channels identified above most likely to be the ones transmitting financial distress of an NBNI financial entity to other financial firms and markets? Are there additional channels that need to be considered?

The Consultative Document states in the Introduction that:- "The framework recognises that SIFIs vary in their structures and activities and that systemic importance and impact upon distress or failure can vary significantly across sectors." It goes on to say that:- "The assessment methodologies to identify G-SIFIs need to reflect the nature and degree of risks they pose to the global financial system." We recognise that there is a desire to maintain broad consistency with the methodologies already in place for banks and insurers.

The criteria may be appropriate for some finance related businesses. However we would question the degree to which it is appropriate in the case of a manufacturer's captive to use criteria that are consistent with those proposed for other financial entities. As explained above a manufacturer providing goods and services on a variety of deferred terms of sale is a totally different type of business to one who's sole business is "selling finance" and then collecting it back again.

We would argue that the risk of contagion due to failure of a Captive is not an issue for several reasons:-

1.1. Exposures / Counterparty channel

Since a Captive only obtains business if its parent sells equipment, then for a Captive to be substantial enough to be of concern, it must by definition have a parent with greater sales standing behind it. In the event of a manufacturer's finance company getting into difficulties, one would expect that the parent company will "bail it out" as it is likely to be smaller than the parent. The losses are less likely to hit businesses or people outside of the group, whereas

an independent finance company may have no large parent behind it to absorb the debt. We are not aware of any Captive finance company getting into financial difficulties and causing failure of the parent (although there have been cases of the parent getting into financial trouble and being saved because they have been able to realise the value of their finance company by selling it). Additionally, to the extent that a Captive places leases or sells any income streams, those transactions are no longer on their balance sheet and no liability for credit risk is normally retained.

1.2. Asset liquidation / Market channel

History has shown that 3rd party lessors will buy Captive portfolios from Manufacturers. Because portfolios are made up of large numbers of underlying agreements, there is no concentration of risk, making such portfolios attractive. We do not therefore believe there is any risk of Captives disrupting markets.

1.3. Critical function or service / Substitutability

The leasing industry is very competitive and there are ample opportunities to find substitute funders and administrators.

Q2-1. Does the high-level framework for identifying NBNI G-SIFIs (including the five basic impact factors) adequately capture how failure of NBNI financial entities could cause significant disruption to the wider financial system and economic activity? Are there any other impact factors that should be considered in addition to those currently proposed or should any of them be removed? If so, why?

The fact that different indicators will be identified to different impact factors for different types of business is encouraging and recognises the fact that different types of business pose different risks for different reasons. However, until they are seen it is not possible to say whether they will adequately take account of the considerable variation of how the different impact factors will reflect the risks in different types of business.

They are reasonable generalisations of the types of risk, but different factors will be more relevant to different types of businesses. For example in the case of a Captive, global diversity may be seen as a positive as the Captive will only be following their parent to countries where the parent has a significant business. The greater number of countries the less concentration on specific sovereign risk. Equally, risk related to size can vary considerably with different types of finance business. Leasing with its strong policies and procedures developed over decades and the security in the asset can be a far less risky business than one trading in financial assets. As mentioned elsewhere, substitutability is not a major issue in equipment finance as it is a competitive industry with many players.

Each of these indicators needs to be very specifically target to the nature of finance business if they are to be meaningful.

Other impact factors the FSB may wish to consider are the risk of mismatched funding, both in term of borrowings and interest rate.

Q2-2. Is the initial focus on (i) finance companies, (ii) market intermediaries, and (iii) investment funds in developing sector-specific methodologies appropriate? Are there other NBNI financial entity types that the FSB should focus on? If so, why?

We believe that the definition of "Finance companies" is very wide and the initial focus should be more specific and reflect on whether equipment finance genuinely raises systemic concerns.

We are encouraged to see that the Consultative Document states that it "…. is also important to avoid designation of an NBNI financial entity that does not truly raise systemic concerns ….".

Q3-1. Is the proposed scope of assessment outlined above appropriate for operationalising the high-level framework for identifying NBNI G-SIFIs? Are there any practical difficulties associated with the proposed scope of assessment?

Looking at the highest level of the firm that is a financial entity and on a globally-consolidated basis, may not bear any relationship to the global systemic importance, or more specifically the lack of it. Doing so takes no account of the size of the group which the financial entity is part of and therefore is not a true reflection of whether there are systemic risks. See further comments at Q3-2 below.

Q3-2. In your view, are the above proposed materiality thresholds (including the level) for the NBNI financial entity types appropriate for providing an initial filter of the NBNI financial universe and limiting the pool of firms for which more detailed data will be collected and to which the sector-specific methodology will be applied? If not, please provide alternative proposals for a more appropriate initial filter (with quantitative data to back-up such proposals).

However convenient it may be for regulators, we do not believe that using the same threshold for such a wide variety of companies (except hedge funds) that fall within the definition of "Finance Companies" is appropriate. The risks that each attracts can be totally different.

We believe that using a threshold relating to "balance sheet total assets" may not always be an appropriate measure. The level of assets may have no relationship to the level of liabilities and hence may not be a good gauge on which to base the identification threats of financial firms which could potentially impact global financial stability. In particular, the size of a Captive finance company's assets will likely be totally unrelated to the size of the total group assets, which will normally be significantly larger. Also unlike in some finance company, the external liabilities are less likely to be related to the size of the portfolio. The finance arm may be just a small part of a group and the parent will take the hit, unlike a purely finance business who may have no substantial parent.

Additionally, using the same measure for all finance companies makes no distinction between those that have security over valuable assets and those without such security. In the case of leasing the finance company has ownership of the asset and therefore a substantially better security than simply having a charge on the asset.

It is important to avoid a threshold which catches businesses where the risk will be significantly lower due to the nature of the business. It should not be necessary for a business to have to be put through the time and cost of a detailed assessment, when it is clear that it is a different type of business with lower risks.

We understand that the inclusion of Captives as finance companies within the meaning of these proposals is not open for debate. However, we would suggest that it should be possible to look at a second threshold that also needs to be met in order to establish if a company should be included in the pool of firms for which more detailed data will be required. Bearing in mind the concerns expressed in the Consultation Document regarding what information may be readily available; we would suggest that in addition to exceeding USD 100 billion, the Captive's "balance sheet total assets" must also be greater than 75% of the ultimate Group consolidated "balance sheet total assets". Although this figure may sound high, it takes into account the fact that there would always be substantial recoverability in respect of the underlying assets and in the value of the portfolio should the need arise. Both criteria should be met before an entity falls into the Assessment Pool.

Another justification for this is that in many of the newer growing markets, manufacturers are unable to repatriate their cash surpluses and therefore direct it into forming a Captive. This means assets (cash) that would have been on the parent's balance sheet are now in the financing entity. It is important that a group is looked at as a whole.

Q3-3. Are there any practical difficulties in applying the materiality thresholds?

From a practical perspective only, we are not aware of any difficulties

Q3-4. In your view, what is the appropriate threshold level, taking into account the range given above (USD 400-600 billion in GNE), for hedge funds? Please also provide reasons with data to back it up.

N/A

Q3-5. Do you think that it would be beneficial to set additional materiality thresholds based on "global activity"? If so, please explain the possible indicator and the level on which materiality thresholds should be set (with reasons for selecting such indicator, the level and any practical challenges).

As explained in answer to Q2-1 above we see "global activity" as a positive in the case of Captives as it spreads any concentration of risk. A company operating in only one country and meeting the proposed threshold of USD 100 billion would have a greater impact on that market than if it is spread across a number of countries and markets. Choosing the level at which to set thresholds can be rather an arbitrary matter, but the FSB may wish to consider increasing the Threshold based on the number of countries the entity is active in. Increasing the Threshold by say 5% for every country, up to a maximum of USD 200 billion, bearing in mind that the Captive will only be in countries where the parent has substantial sales volume to sustain a finance company

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Q4-1. In your view, does the proposed definition of finance companies provide a practical basis for applying the specific methodology (i.e. indicators) to assess the systemic importance of NBNI financial entities that fall under the definition?

We do not believe that the definition adequately distinguishes between the differing risks arising between secured lending (and the quality of the security) and unsecured lending. Neither do we believe it further recognises the lower risk arising from a manufacturer's Captive.

Q4-2. Do you think that the above description of systemic importance of finance companies adequately captures potential systemic risks associated with their financial distress or disorderly failure at the global level?

We believe there is an overestimation of the issues arising from the withdrawal of an equipment finance company from a market. It is a competitive market and history shows others are only too keen to "fill the gap" if a player withdraws from the market for any reason. The reference in the Consultative Document to "… may take some time to develop sector knowledge and expertise." is not one that usually arises in practice since other potential lenders, if they do not already have sufficient expertise, will recruit the existing staff of the withdrawing entity in order to gain that knowledge and expertise

Q4-3. Are the proposed indicators appropriate for assessing the relevant impact factors? For example, for consistency purposes the methodology uses "intra-financial system assets" and "intra-financial system liabilities" as defined in the G-SIB framework, but should it consider other indicators that are more tailored to a finance company's business model and risk profile? Also, should the methodology focus not only on OTC derivative exposures but also centrally-cleared derivatives in assessing "interconnectedness" and "complexity"?

The indicators do not put any focus on identifying the nature of the finance companies assets from the perspective of how secure and collectable they are. We have commented elsewhere on Substitutability, which we do not see as a major issue. Global Activities have also been referred to earlier.

Q4-4. Are there additional indicators that should be considered for assessing the relevant impact factors? If so, please also explain the possible indicators and the reasons why they should be considered.

The nature of the business undertaken by the financial entity.

Q4-5. Would collecting or providing any of the information included in the indicators present any practical problems? If so, please clarify which items, the practical problems, and possible solutions including possible proxies that could be collected or provided instead.

We are unable to provide a definitive comment, as this may vary from entity to entity depending on how they are structured.

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Q4-6. Should certain indicators (or impact factors) be prioritised in assessing the systemic importance of finance companies? If so, please explain which indicator(s) and the reasons for prioritisation.

NC

We remain at your disposal should you wish to discuss any aspects further.

Kind regards

Alan Leesmith
Secretary General