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By: Electronic submission
European Banking Authority

Dear Sir/Madam

Consultation Paper EBA/CP/2019/01: Draft Guidelines on Credit Risk Mitigation for institutions applying the IRB Approach with own estimates of LGDs (the “Consultation Paper”)

We are writing this letter to comment on the Consultation Paper.

Milbank is one of the premier providers of legal services to the transportation industry worldwide. Over the years, we have innovated many of the structures and techniques that have become standard-bearers for the industry. Our clients represent a true cross-section of the major players, including leasing companies, airlines, investment banks, manufacturers, export credit agencies, lenders, governments, equity participants and private equity and hedge funds and a number of them will be affected by the proposals in the Consultation Paper. The views expressed below are Milbank’s views and a number of our clients will be making their own submissions in response to the proposals in the Consultation Paper.

We have reviewed the Consultation Paper and are writing to reply specifically to question 2: Do you agree with the proposed clarifications on the assessment of legal certainty of movable physical collateral? How do you currently perform the assessment of legal effectiveness and enforceability for movable physical collateral?

As you have noted in the Consultation Paper, identifying relevant jurisdictions for physical collateral and lease exposures treated as collateralised can be challenging for assets that are moveable. This is particularly so for ships and aircraft whose movements depend on the business needs from time to time of the operator. It is not possible to identify in advance all of the jurisdictions where any particular asset might be located during the term of the collateralised obligation. For an aircraft operated by a large airline, particularly if operating to countries with distinct state-level jurisdictions, the number of potential jurisdictions could be in the hundreds.

The same problems would also arise with other assets (such as containers, rolling stock and other methods of transportation) which are able to move cross-border.

The Consultation Paper suggests that these jurisdictions could be limited to those where the “collateral could move during the lifetime of the loan as specified in the collateral arrangement”. However, the customary and long standing market practice is for the contractual arrangements to specify where the assets may not be operated (for example, by reason of sanctions legislation

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or where they may not be adequately covered by insurances) rather than to prescribe a limited list of permitted destinations.

To change that practice would severely inhibit the operational flexibility of the asset operator to the point where they may well seek to obtaining finance or leasing facilities from entities not subject to the Guidelines contained in the Consultation Paper.

Alternatively, the Consultation Paper suggests that the opinions could be obtained from “the jurisdiction where the collateral is usually located for the purpose of its use”. Assets such as aircraft and ships will not be usually located in any single jurisdiction. An aircraft may have a habitual base - for example, a hub of the operating airline - but will fly to numerous jurisdictions. Vessels may not even have a habitual base but will sail round the world subject to the requirements of their charters.

To require legal opinions to be obtained from every jurisdiction where an asset may be located during the term of the collateralised obligation would be disproportionately expensive and probably unachievable logistically on a deal by deal basis. By way of illustration, the minimum cost of the simplest legal opinion in a cheap jurisdiction for the provision of legal services would be \$5,000. If 100 opinions were required, the aggregate cost would rise to a sum significantly in excess of \$0.5m. Banks in the EU requiring these would not be able to compete with other financial institutions and would be severely disadvantaged in competing for such deals with competitors who are not subject to these Guidelines.

You also recommend that an opinion be obtained from the jurisdiction in which the lending institution is incorporated. We do not think that would be a relevant jurisdiction. For example, a German bank taking security from an Irish obligor over an asset registered in Denmark would not need to establish the enforceability of those arrangements in Germany.

Similarly, we do not believe that an opinion should be required from the jurisdiction where the obligor (that is, usually, the borrower of the facility) is incorporated if that entity is not also the grantor of the security. For example, if Party A grants security over an asset to a bank as security for the obligations of Party B, the bank should only be concerned with the laws relating to Party A to establish the effectiveness and enforceability of the security.

The Consultation Paper provides that “Institutions should obtain a legal opinion confirming the legal effectiveness and enforceability of the collateral arrangement in all relevant jurisdictions for the purposes of paragraph 16. This legal opinion should be: (a) obtained at least for each type of collateral arrangement; and (b) provided in a written form by a legal counsel.”

Some legal opinions (for example, those of the state of registration) will address certain legal issues which are of general application and not transaction specific: for example, whether the relevant courts will recognise the law chosen to govern the collateral arrangements and enforce the judgment of the courts given jurisdiction to determine any dispute. To the extent that the institution has a legal opinion covering these non-transaction specific questions and that it is appropriately updated, it should be entitled to rely on that one opinion for each transaction which falls within its scope.

We would also point out that the constitution of the security package on a secured financing can vary (for good reason) depending on the type of financing. For example when providing finance

to aircraft lessors the financiers would frequently require share security over the borrower but the question of local law security (State of Registration) over the metal is more heavily negotiated and financiers would frequently take the view that a New York law mortgage over the aircraft coupled with the relevant International Registry filings under the Cape Town Convention on International Interests in Mobile Equipment and the Protocol thereto on matters specific to Aircraft Equipment will suffice without the need to take or register local law security (State of Registration) over the aircraft. Reasons for opting to not take / register local law security include costs (expensive in a number of jurisdictions) and flexibility required by the lessors as the State of Registration for the aircraft could change during the term of the financing (e.g. aircraft is subleased to a different operators) and it is not logistically feasible to have to do a new local law mortgage on each such occasion. Similar considerations would apply where the financing is direct to an airline.

Based on the foregoing, we would recommend that banks be required to conduct an analysis at the time the financing or leasing is completed, based on the specific facts relating to that transaction and on the opinions they already have, as to what further legal opinions they require to best ensure the effectiveness and enforceability of their collateral arrangements in the different possible default and insolvency scenarios. Depending on the scope of the collateral in respect of such transaction, those legal opinions could be required from to be obtained from the following jurisdictions, which would be identified at the time the financing or leasing is completed:

- The jurisdiction in which the grantor is incorporated;
- The jurisdiction in which any other person having a significant and relevant possessory or proprietary interest over the asset (such as a lessee or sub-lessee) is incorporated;
- If any of the above is a natural person, the jurisdiction in which it has its place of residence;
- The jurisdiction of the chosen governing law of the collateral agreement; and
- If relevant, the jurisdiction where the asset is registered or (in the case of vessels) flagged.

On rare occasions (for example, where an aircraft is wet leased by one airline to another for a substantial period of time) the habitual base of an aircraft may differ from its state of registration and/or the state of incorporation of the lessee operator. In those cases, institutions should be encouraged to consider the necessity of obtaining a legal opinion as to the laws of the jurisdiction of the habitual base to the extent that their risk analysis makes those laws relevant.

We would make two final comments:

Banks and leasing companies looking to repossess physical objects over which they have security are well experienced in establishing the optimal procedures for doing so. They will track the movements of the asset until it is in a favourable jurisdiction for them to exercise their rights. It would be very unusual for the exercise of those rights to be impaired by the laws of

the jurisdiction where they wish to exercise those rights unless it happens also to be one of the jurisdictions set out in the bullet points above.

Finally, for collateral over certain aircraft-related objects, the Cape Town Convention on International Interests in Mobile Equipment and the Protocol thereto on matters specific to Aircraft Equipment provides for a robust international framework for the enforcement by creditors of their rights over that collateral. The Convention has now been ratified by 76 jurisdictions, including the European Union and several of its member states. Most of the member states that have not ratified the Cape Town Convention have, however, ratified the Geneva Convention on the International Recognition of Rights in Aircraft which also provides for an international framework for the enforcement by creditors of their rights over their collateral in aircraft.

We hope that this letter is helpful to you and would be available to discuss any of the issues raised herein at your convenience. Any response to this letter should be directed for the attention of James Cameron and Siddharth Sharma at Milbank LLP.

Yours faithfully,

Milbank LLP

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