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European Banking Authority
Jo Swyngedouw
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Isabelle Vaillant
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One Canada Square (Floor 46) Canary Wharf London E14
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24th May 2019

Dear Sirs,

Re: Consultation Paper - Draft Guidelines on Credit Risk Mitigation for institutions applying the IRB Approach with own estimates of LGDs (**the Consultation**)

Introduction

The Rail Working Group is a Swiss not-for-profit rail and finance industry group constituted at the request of the International Institute for the Unification of Private Law (UNIDROIT). It is focused on the adoption and implementation of the Luxembourg Protocol¹ to the Cape Town Convention on International Interests in Mobile Equipment (generally known as the Luxembourg Rail Protocol)². Our group's worldwide membership comprises, directly, about 90, and indirectly, through member organisations, many hundreds of stakeholders in the industry. They include banks lending in the rail sector, lessors leasing rolling stock and which are financed by banks, as well as operators receiving private sector finance through secured credit or leases.

We are grateful for the opportunity to respond to the Consultation on behalf of our members.

¹ <https://www.railworkinggroup.org/wp-content/uploads/docs/railprotocol.pdf>

² <https://www.unidroit.org/english/conventions/mobile-equipment/mobile-equipment.pdf>

The Rail Working Group is a not-for-profit association constituted under Swiss law representing a broad cross section of the global railway community.

For a complete list of our members and more about us, please visit our website at www.railworkinggroup.org



The Cape Town Convention

The Cape Town Convention entered into force in 2006 and has been adopted by 79 states. It introduced a new global system for recognition, prioritisation and enforcement of creditor and lessor rights under security lease or conditional sale agreements (collectively **security agreements**) in relation to certain types of moveable equipment, which rights are registered in an international registry accessible to everyone over the internet 24/7. The Aircraft Protocol, applying the Convention to aircraft, also entered into force in 2006 and is now in operation in 76 states, including several EU states. The international registry for aircraft is based in Dublin, Ireland.

The Luxembourg Rail Protocol applies the Convention to all rolling stock, broadly defined, so it covers not just conventional rail equipment but also light rail, trams, cable cars and even people movers at airports. The international registry for rolling stock will be based in Luxembourg. The Protocol permits the creditor and debtor under a security agreement to choose the law applicable to such agreement.³ It also provides, for the first time, a global system for uniquely identifying railway rolling stock⁴ with identification numbers issued by the international registry. Accordingly, it will provide a considerably enhanced level of security for secured creditors and lessors when debtors are located in a contracting state.⁵

The Protocol is not yet in force but Luxembourg, Gabon and Sweden, as well as the European Union within its competencies, have ratified it. Germany, Italy, the United Kingdom and Switzerland have also signed the Protocol and are working towards ratification. Other states across the world, including in Europe Spain, Malta, Denmark, the Czech Republic and Hungary are also actively considering the adoption of the Protocol which is expected to come into force during 2020. The RWG works actively with the European Commission, the European Bank for Reconstruction and Development, and the EU Agency for Railways (ERA) which all support the implementation of the Protocol.

Private Finance of Railways

Within Europe there is a common long term commitment, now embodied in the EU 4th Railway Package⁶, to the expansion and liberalisation of the rail sector. Moving passengers and freight onto the railways will deliver important social, environmental and economic benefits to the community. This requires significant new investment into the rail sector. But with governments under strong budgetary constraints, funding has to come increasingly from the private sector. But the level of this funding is disappointingly low.

A recently published report prepared for the Rail Working Group by consultants Roland Berger shows that currently in Europe only 23% of all rolling stock procurement is financed by the private sector. However, these findings reaffirm the clear correlation between the deregulation of rail markets and private finance: the more markets are opened, the greater the need for private capital.

³ Under Article VI subject to a declaration by a contracting state

⁴ Pursuant to regulations to be issued under Article XIV

⁵ For more on the Luxembourg Rail Protocol and the Rail Working Group, please see

www.railworkinggroup.org

⁶ <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016L0797&from=DE>



The rail sector is defined by its stability. It is not consumer led and, unlike many other industries, it is only affected in a limited way by any economic downturn. Even existing structures collateralising private sector credit for railway rolling stock have a long history of success. In Europe, banks report that the incidence of credit defaults from secured lending on rolling stock is virtually zero. Nonetheless, globally, there is little or no legislative or judicial support for lenders and lessors of rolling stock defining, prioritising and protecting their property rights. Whatever there is, is not harmonised with other countries.

Unlike in aviation or shipping, there are no national title registries for rolling stock, where owners and secured parties can register their property interests and there is no global system for identifying railway equipment. When the equipment can potentially cross borders, the position is even worse with the possibility of different laws applying to, and the ability of states or rival claimants to block, creditor rights. As a result, lenders and lessors cannot be certain that the courts in the jurisdiction where a financed asset is located will respect those creditors' rights to repossession on debtor default or insolvency. In fact, the practice of many banks is to place financed assets into a special purpose company the shares of which would be pledged to the creditor. But in many respects, both in terms of cost and effectiveness, this is not an ideal solution.

Once it comes into force, the Luxembourg Rail Protocol will facilitate banks and other financiers to support much needed new rolling stock procurement at rates reflecting the greater value of the collateral, obviating the need for, and the cost of, special corporate structures and leading to lending to operators even where their balance sheet net worth is limited. As such, it will lower the barriers to entry for operators and lead to a more competitive and dynamic rail industry worldwide. Andreas Schwillig, Partner at Roland Berger and one of the authors of the report has stated that both “the absolute level of rolling stock procurement and the share privately financed are likely to increase further with the adoption of the Luxembourg Rail Protocol.”⁷ In summary, there will be an increasing demand for private sector finance of railway rolling stock and the Luxembourg Rail Protocol will deliver a significant new level of security for lenders and lessors which will in turn underwrite the increasing private finance of rolling stock.

The Consultation

It is against this background that we comment on the Consultation focusing on Paragraphs 19 to 21 of the draft guidelines and therefore we specifically reply 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?**

We fully support the EBA's objective in setting risk weighting rules of striking a balance between simplicity and risk sensitivity. However the proposals set out in the Consultation insofar as they relate to secured finance of tangible assets (the **Proposals**) cause our members great concern, particularly because they do not take into account the additional security provided by an international treaty designed precisely to lower creditor risk. European policy makers are focused on the strategic expansion of the rail industry for sound social, environmental and economic reasons and to meet the Graz Declaration's goals of “clean, safe

⁷ RWG Press Release, Zug 20th May 2019



and affordable mobility for Europe.”⁸ In addition, they are committed, through the Single European Rail Area, to more international rail traffic but, whether under the Juncker Plan⁹ or otherwise it is accepted that this will require easier and cheaper finance from the private sector. The Proposals will act as a serious constraint on such investment and therefore be in conflict with such objectives.

In particular, we are concerned by proposed guidelines that in respect of movable physical collateral, such as rolling stock, ships and aircraft, legal opinions should be obtained for “the set of jurisdictions where the collateral could move during the lifetime of the loan according to the collateral agreement.”¹⁰ Accordingly we comment on the Proposals on two levels on the basis that the introduction of more stringent legal requirements for banks to gain capital relief in respect of mobile assets as collateral would significantly raise the cost of bank financing for rail assets.

When the Protocol does not apply

Whilst the Proposals recognise that obtaining legal opinions from each jurisdiction where the collateral could potentially be located during the lifetime of the financing would be challenging and overly burdensome, the fallback position, identified in Paragraph 20 of the guidelines remains itself extremely onerous.

Some railway rolling stock in Europe such as freight or passenger wagons can travel from the Polish border in the East to the Spanish border in the South West. The restrictions are the rail gauge and, in the case of locomotives, the power supply, signalling and other local rules. Manufacturers are already beginning to offer hybrid and multiple voltage locomotives. In the foreseeable future manufacturers will introduce variable gauge rolling stock which would allow wagons to travel from Düsseldorf to Yiwa on the Chinese Pacific coast. Operators will ask for the freedom to move rolling stock within the continental rail system and financiers will wish to grant such request. These innovations need institutional support, not obstacles.

The EU is working hard to create a homogeneous European rail system with common signalling and other protocols. It should also be borne in mind that, whereas aircraft fly over, and ships sail ‘past but not through’ jurisdictions, rolling stock has to move through such jurisdictions. Those territories therefore would be counted as an applicable jurisdiction in respect of which a legal opinion would be required. A basic legal opinion in a well-served jurisdiction will cost at least €5,000 plus significant management time. So, as rolling stock could conceivably travel in 20 or more jurisdictions during the term of the security agreement, these additional legal costs could render financings prohibitively expensive, particularly for small operators financing a limited number of assets. Moreover, it appears that if it is not possible to obtain a satisfactory legal opinion in just one of the jurisdictions through which the rolling stock must move, the creditor will be treated as not complying with the provisions of the proposed guidelines.

This produces a painful dilemma with few tangible advantages. The Proposals will either increase significantly the cost of credit for operators or force a creditor to contractually restrict the operation of the collateral to a limited number of jurisdictions where the required

⁸ <https://www.eu2018.at/latest-news/news/10-30-Graz-Declaration.html>

⁹ http://europa.eu/rapid/press-release_IP-18-4469_en.htm

¹⁰ Paragraph 20(d) and Paragraph 21(b)



legal opinions can be easily obtained. This is both impractical and, for valid strategic reasons, undesirable. In our view, the requirement to obtain legal opinions should be limited to:

- The jurisdiction in which the debtor is incorporated, or, if different, has its centre of main interests;
- The jurisdiction in which any other person having a possessory right over the asset (such as a lessee or sub-lessee) is incorporated, or, if different, has its centre of main interests;
- If any of the above is a natural person, the jurisdiction in which that person has its place of habitual residence;
- The jurisdiction whose laws govern the security agreement;
- and if the asset has a habitual base, the jurisdiction of its habitual base.

In particular, we see no reason to obtain an opinion as to the enforceability of the security in the jurisdiction where the creditor or owner is incorporated, since this has no influence on the legal enforceability of the collateral, and we note that currently there are no possibilities to register title interests in rolling stock.¹¹

When the Protocol does apply

As already explained, the Luxembourg Rail Protocol will significantly change the security position of secured creditors and lessors. Specifically, it will not just create a clear system of legal rights for creditors, including the ability to enforce repossession of the collateral on debtor default or insolvency, but also a common one operating across contracting states. For the first time, there will be a global unique identification system for all rolling stock, which will facilitate a creditor tracking in real time the status and location of the collateral, as well as a publicly accessible registry at which security interests held by secured creditors and lessors may be registered and inspected.

We strongly argue therefore that, regardless of whether our recommendations stated immediately above are accepted, the Proposals must take into account the significant mitigation of creditor risk arising where the Protocol applies. Indeed, there are already precedents for this. The Aircraft Sector Understanding¹², agreed under the auspices of the OECD, between multiple export credit agencies, provides that ECAs may reduce their risk premia by 10% when the Aircraft Protocol to the Cape Town Convention applies.¹³ Financings through banks and securitisations have also been cheaper where the Aircraft Protocol applies. In both cases we expect a similar result for the rail industry once the Luxembourg Rail Protocol enters into force next year.

¹¹ For the rail sector, the guideline in Paragraph 20 (c) is ambiguous. Rolling stock will be registered for the purposes of operability at national safety agencies and, from next month, at the ERA, but there are currently no national nor supranational registries for title or security interests in railway rolling stock.

¹² <https://www.oecd.org/trade/topics/export-credits/arrangement-and-sector-understandings/aircraft-specific-rules/>

¹³ The detailed conditions are set out in the ASU



Under its terms, the protections afforded by the Protocol arise where the debtor has its principal place of business in a contracting state at the time the collateral is provided to the creditor¹⁴. If that is the case, an international interest will be constituted in relation to the collateral¹⁵ provided to the creditor under a security agreement and this interest will be registrable, and searchable, at the international registry in Luxembourg.

Accordingly, bearing in mind that the Luxembourg Rail Protocol should enter into force before the EBA's proposed guidelines, we propose a more restricted list of required opinions if the collateral is created when the debtor has its principal place of business in a contracting state. In such a case the requirement for legal opinions would be reduced to:

- The jurisdiction in which the debtor has its principal place of business (or if the debtor is a natural person, the jurisdiction in which that person has its place of habitual residence), such opinion confirming also that the Luxembourg Rail Protocol is in force in such jurisdiction; and
- The jurisdiction whose laws govern the security agreement, noting that the Protocol does not need to be in force in such jurisdiction.

It may be argued that, since the Protocol will only be adopted progressively across Europe and Asia over a number of years, the creditor still takes the risk that its collateral may be in a state which is not a contracting state at the time it needs to enforce its rights. Certainly, if the Protocol is in force in all conceivable jurisdictions in which the rolling stock may potentially be located, this is the ideal position. However, even if this is not the case, the Protocol affords the creditor significant more security when the debtor has its principal place of business in a contracting state. Firstly, any judgement obtained against such debtor should be enforceable in relation to the asset in other jurisdictions either through local law, mutual enforcement agreements¹⁶ or, in the case of arbitral decisions, through the Convention on the Recognition and Enforcement of Foreign Arbitral Awards, also known as the New York Convention¹⁷. Secondly, the introduction of the international registry and the unique identifier for rolling stock will significantly enhance the enforceability of the security even in jurisdictions which are not contracting states.

Conclusion

We welcome the EBA's desire to improve the effectiveness of enforcing debt obligations and improving overall industry standards. We share these goals entirely. But the Proposals must take into account the inherent stability of the rail sector and the long-term value of rolling stock as an asset class. As currently stated, the draft guidelines will significantly constrain, or make more expensive, the provision of private credit at a time when more private sector investment in the rail sector is urgently needed. The requirement for legal opinions should be limited to a level which is reasonable in the context of how the rail industry and financing works in practice.

¹⁴ Article I, Section 2(d) Luxembourg Rail Protocol

¹⁵ Article 7 Cape Town Convention and Article V, Section 2 Luxembourg Rail Protocol

¹⁶ For example, the Brussels I Regulation in relation to EU member states and the Lugano Convention

¹⁷ <http://www.newyorkconvention.org/11165/web/files/original/1/5/15432.pdf>



Further, the Luxembourg Rail Protocol will provide significant incremental protection for creditors lending on, or leasing, rolling stock. It is expected that the Protocol will be in force by the time your guidelines come into force. We urge you to take this protection into account as you refine your guidelines.

We are at your disposal should you require further information or assistance in relation to this matter.

Yours truly,

A handwritten signature in blue ink that reads "Howard Rosen". The signature is written in a cursive, flowing style.

Howard Rosen
Chairman