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the authoritative voice
of the EMEA market

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Sent via online submission

Dear Sirs

Consultation Paper – Draft Guidelines on Credit Risk Mitigation for institutions applying the IRB Approach with own estimates of LGDs (the "Consultation")

We write to you further to publication of the Consultation and your request for feedback in respect of the proposals contained therein (the "**Proposals**").

The use of credit risk mitigation ("**CRM**") as a technique to reduce credit risk in respect of underlying exposures is of fundamental importance to those institutions that are bound by the Capital Requirements Regulation ("**CRR Firms**"). It is on behalf of these firms, being members of the Loan Market Association[1] ("**LMA**"), as well as other affected parties, that we submit this response.

Summary

Whilst we strongly support the underlying objectives of the Consultation and very much welcome the desire of the European Banking Authority ("**EBA**") to provide additional guidance for market participants on the subject of CRM, there is a particular aspect of the proposed guidance that we believe would benefit from greater clarification/amendment in the context of asset finance. We consider this to be necessary in order to ensure that the use of CRM continues to operate effectively and in the spirit envisaged by the CRR.

Above all, we are concerned that, if this matter is not addressed, the availability of asset finance will be negatively impacted, causing unnecessary disruption to a very well-functioning and stable market: something that we believe the EBA cannot have intended.

[1] The LMA is the trade body for the EMEA syndicated loan market and was founded in December 1996 by banks operating in that market. Its aim is to encourage liquidity in both the primary and secondary loan markets by promoting efficiency and transparency, as well as by developing standards of documentation and codes of market practice, which are widely used and adopted. Membership of the LMA currently stands at over 700 across over 60 nationalities and consists of banks, non-bank investors, law firms, rating agencies and service providers. The LMA has gained substantial recognition in the market and has expanded its activities to include all aspects of the primary and secondary syndicated loan markets. It sees its overall mission as acting as the authoritative voice of the EMEA loan market vis à vis lenders, borrowers, regulators and other interested parties.

Response

We would like to answer the following question posed by the Consultation:

2. **Do you agree with the proposed clarifications on the assessment of legal certainty of movable physical collateral? How do you perform the assessment of legal effectiveness and enforceability for movable physical collateral?**

Under paragraph 20(d) of the Consultation, the EBA proposes that legal opinions which are required to be obtained in the context of collateral agreements relating to "other physical collateral" (i.e. collateral which is movable and not in the possession of the institution) should confirm the legal effectiveness and enforceability of the collateral against the obligor in "the set of jurisdictions where the collateral could move during the lifetime of the loan according to the collateral agreement". A similar requirement is set out in paragraph 21(b) for collateralised leasing exposures.

We are concerned that this requirement is simply unworkable. Furthermore, we do not consider that it addresses the risk of enforcing security over movable assets, nor the likelihood of recovery. Rather, given that these sectors are specialist by their nature and dominated by bank finance, we believe it will simply result in reduced access to finance for sectors such as aviation, shipping, automotive, transportation (as well as associated leasing businesses), and trade and commodities since they would become unviable for A-IRB institutions to provide.

Further background

By its intrinsic nature, "during the lifetime of the loan", movable collateral "could" move to any number of jurisdictions and, despite ownership in the case of leasing, is not in the control of the collateral takers. Furthermore, it should be noted that it is extremely rare for asset leasing and financing arrangements to prescribe a location or series of locations where the moveable asset must be located or operated. Such an approach would be too restrictive for the obligor who, as a commercial matter, may need to change operational routes and locations for business flexibility/continuity or to move the asset swiftly for maintenance or regulatory reasons. Whilst it is common for the user to be restricted from moving the asset to a list of prohibited countries (e.g. by reference to applicable sanctions or excluded countries for insurance purposes) these would typically be relatively few in number. As a consequence, in theory, a moveable asset could pass through/be located in almost any jurisdiction in the world, thus requiring legal opinions in relation to every such jurisdiction. The situation may be further complicated by the fact that some assets are routinely leased/sub-leased to third parties and that market practice allows a degree of flexibility to most obligors to lease out the asset within certain parameters without lender consent (e.g. in shipping, short term leases are generally permitted without consent; in aviation, there is typically a lengthy "white list" of permitted lessees/jurisdictions). As a result, an analysis of where the financed asset could go during the financing term would in many cases need to include not only the primary obligor's, but also any lessee's/sub-lessee's potential operational routes. Consequently, any assessment of the collateral arrangement's legal effectiveness and enforceability as required by Paragraphs 19 and 20 would be hugely challenging, time consuming, costly to undertake and,

given the undeveloped state of some jurisdictions' personal property laws, probably conceptually impossible.

The burdensome nature of the requirement appears to be recognised by the EBA in paragraphs 16 and 17 of Section 3 of the Consultation ("Background and Rationale"). In addition, the fact that the EBA has articulated that "softer alternatives" had been considered suggests that it would be amenable to considering alternatives methods by which this requirement could be more appropriately dealt with, whilst maintaining compliance with the CRR.

Suggested solutions

We firstly note that Article 194 of the CRR requires institutions to obtain assurances that collateral (funded credit risk mitigation) arrangements are effective and enforceable in "all relevant jurisdictions" and that Article 181 requires that a that "generally consistent" approach is taken. We believe that this implies that a more purposive, rather than literal interpretation, of "all relevant jurisdictions" could be taken by the EBA in its guidance. This is particularly important given the range of assets that are caught by the category of "other physical collateral", bearing in mind that what might work for one asset or group of assets, may not work for others.

Therefore, in terms of which jurisdiction could be considered "relevant" for the purpose of the guidance, some potential "relevant jurisdictions" for a moveable collateral asset could include:

a) **The jurisdiction where the asset is registered**, if the institution considers appropriate given the overall structure of the financing (we would highlight, however, that this remains asset/sector dependent since the law of the flag (for shipping finance) may be more appropriate in some instances);
b) **The jurisdiction of the governing law of the asset mortgage/other security** – this is relevant to the enforcement of the mortgage and will generally be the same as the jurisdiction where the asset is registered, although that is not always the case;[2]
c) **The jurisdiction of the governing law of the facility agreement** - this will most commonly be English, New York law or sometimes the lender's domestic jurisdiction law (mainly in relation to loans to relationship customers);[3]
d) **The jurisdiction of incorporation of the grantor of the asset mortgage / other security.**

However, we would emphasise that, whilst these and other jurisdictions might be considered "relevant" for certain assets/transactions, above all, the guidance has to facilitate a case-by-

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2 For example, assets registered in jurisdictions whose laws are not deemed to be user-friendly or reliable, or where local law security attracts significant stamp duty or similar costs, may be subject to English or New York law security instead.

3 This may be relevant because a judgment on the merits of the secured claim may be required by the courts of jurisdiction of where the asset is located on enforcement (or less commonly the jurisdiction where the asset is registered).

case analysis of each individual transaction, since what is appropriate for a particular asset and range of circumstances, may not be relevant for another. Given the range of assets and sectors covered by paragraphs 20(d) and 21(b), we believe it is extremely important that flexibility is maintained. It is also our understanding that numerous institutions and industry bodies with expertise in respect of particular assets/sectors are submitting responses to the Consultation and we would ask the EBA to take their representations into account before publishing final guidance, since not to do so could result in a particular asset class being treated unfavourably over another, for reasons that have very little to do with legal effectiveness or enforcement of the underlying collateral.

Finally, we would also highlight the existence of the Cape Town Convention on International Interests in Mobile Equipment ("**CTC**") as something of potential relevance. Whilst the CTC is currently only relevant (given ratifications to date) to aircraft and is not of universal application (it only applies where a transaction has the relevant nexus which is, in simple terms, by way of either (a) the aircraft being registered in a jurisdiction which has ratified the CTC or (b) the relevant obligor being situated in a jurisdiction which has ratified the CTC), given that nearly 80 countries have ratified the convention, and given that aircraft are often owned by SPVs which are incorporated in a jurisdiction that has ratified it, the application of the CTC in the context of aircraft is widespread. The applicability of the CTC means that an "international interest" over the aircraft is created, which is perfected by online registration with the International Registry, maintained in Dublin. The CTC therefore offers material additional enforcement protections in the context of aircraft security used as CRM.

We would be happy to discuss any aspect of this response with you in more detail and to meet with you as required. If we can be of any further assistance, please do not hesitate to contact my colleague Amelia Slocombe via email at amelia.slocombe@lma.eu.com or by telephone on 020 7006 4114.

Yours faithfully

Amelia Slocombe
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Loan Market Association