



www.railworkinggroup.org

c/o Howard Rosen Solicitors, Baarerstrasse 98, PO Box 2258, 6302 Zug, Switzerland
Tel: +41 (0)41 760 28 88; Fax: +41 (0)41 760 29 09; email: howard.rosen@railworkinggroup.org

The Secretariat
Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

24th June 2016

Dear Sirs,

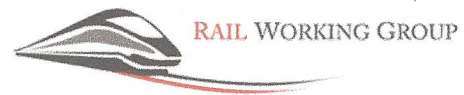
Re: Consultation on reducing variation in credit risk-weighted assets – constraints on the use of internal model approaches (**the Consultation**)

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 Protocol to the Cape Town Convention on International Interests in Mobile Equipment (generally known as the Luxembourg Rail Protocol). Our group's worldwide membership comprises, directly, about 60, and indirectly, through member organisations which are part of the RWG, many hundreds, of stakeholders in the rail sector. 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 ultimately financed by the banking community.

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

The Luxembourg Rail Protocol will make it much easier and cheaper for the private sector to finance railway rolling stock. It sets up a new system for recognition, priorities and enforcement of creditor and lessor rights, which will be registered in an international registry based in Luxembourg, accessible to everyone over the internet 24/7. It applies 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.¹

¹ For more on the Luxembourg Rail Protocol and the Rail Working Group, please see www.railworkinggroup.org



The Protocol is not yet in force but Luxembourg has ratified it as has the European Union. Germany, Italy, the United Kingdom and Switzerland have all signed the Protocol and they, and many other countries around the world, are actively working on adopting the Protocol. It is expected to come into force in 2017 or 2018. The Cape Town Convention as well as the equivalent aircraft protocol, applying these principles to financing of aircraft, was adopted in 2001 and is now in force in over 60 countries.

A report prepared for the Rail Working Group by consultants Roland Berger and published in January 2016² showed that currently in Europe about 88% of all rolling stock procurement is either financed or underwritten by the state. Globally, outside of North America, the position is similar. But governments are under increasing budgetary pressures leading to underinvestment in an area which is a vital part of a sustainable development agenda. Within Europe there is a common long term commitment, now embodied in the EU 4th Railway Package³, to a liberalisation of the rail sector. The Berger report also made it clear that there is a direct correlation between liberalisation and the need for private capital. So there will be a growing need for private capital for the rail sector in Europe in the future. The same will be the case in other parts of the world.

Currently, 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. Indeed 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.

Once it comes into force, the Luxembourg Rail Protocol will facilitate banks and other financiers providing finance to support much needed new rolling stock procurement at rates reflecting the greater value of the collateral 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.

It is against this context that we comment on the Consultation and specifically its proposals on risk weighting for object based lending.

We fully support the Committee's objective, in setting risk weighting rules, of striking a balance between simplicity and risk sensitivity. We acknowledge that the claims by special interest groups have to be examined critically but, we would argue, should be viewed sympathetically if they present a coherent case for differentiation based on security considerations.

The proposals set out in the Consultation insofar as they relate to secured finance of tangible assets cause our members great concern. When it comes to secured finance, historically, banks have created reserves of capital to cover potential defaults taking into account the likelihood of defaults and the value of the security. In recent years banks have created sophisticated advanced internal ratings based models (A-IRB), evaluating the risk of default and its cost industry by

² http://railworkinggroup.org/wp-content/uploads/docs/160122_Private%20financing%20of%20rolling%20stock_Europe.pdf
³ <http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:52013DC0025&from=EN>



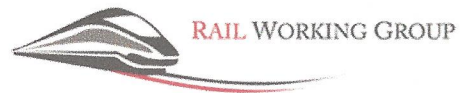
industry and market by market. As a result, lenders have been able to create optimal risk modelling providing secured credit priced to accurately reflect the risks the banks and lessors take.

In relation to all object based lending, the Consultation proposes to abolish the A-IRB system and instead move the financial institutions back to a standardised approach in providing capital for its secured lending. Although there will be some flexibility taking into account the credit conditions, essentially lenders will have to make the same capital allocation on secured finance regardless of the asset, default history, industry sector and customer profile. The Consultation suggests that the new system will be simpler and less costly. In our view, this approach is misconceived and will have serious unintended consequences.

1. By delinking capital allocation with estimated risk, the banks' use of capital will be much less efficient.
2. Banks will have minimal flexibility to take into account external enforcement conditions provided by local legislation, governments or treaties.
3. There is no recognition of industry sector differences which directly impact the actual level of security offered by the collateral.
4. It will make finance in low risk industries more expensive.
5. Auditors will insist on a commercial risk analysis and provision by banks anyway, so not only will the proposals not save money but they will force a two track approach leading to additional cost.
6. Perversely, it will incentivise banks to take higher risks with the same capital allocation, as the rewards will be greater - precisely the opposite of what bank regulators should be aiming for.

This is particularly problematic for the rail sector - a long-term and highly stable industry. It is not consumer led and, unlike many other industries, it is only affected in a limited way by any economic downturn. In Europe, banks report that the incidence of credit defaults from secured lending on rolling stock is virtually zero. Admittedly with such a high level of state guarantee or underwriting of liabilities, this is not surprising, but this should not necessarily change even where there is no state support, especially in the passenger rail sector where governments will often reserve their rights to step in and assume debtor obligations should the (private sector) debtor fail. So it cannot possibly make sense to treat secured financing of railway equipment in the same way as other more risky secured consumer or business lending.

Further, in common with the aviation industry, through the Cape Town Convention, the rail sector has, or is about to have, a new international regime providing additional security for creditors and yet this is not taken into account in assessing the bank's allocation of capital (by contrast the OECD, through the Aircraft Sector Understanding, accepts that ECAs can reduce their credit support premium when risks go down through the Convention and we expect the same logic to apply to railway rolling stock as the Luxembourg Protocol to the Convention comes into force).



For the rail sector these proposals will lead to significantly higher costs as the banks increase their margins to cover their costs of capital and some banks withdraw from the market. Our research shows that the new system will force banks to double or perhaps even triple the amount of capital they have to have allocated to specific transactions even though there is no corresponding increase of risk. Higher lending and leasing rates will lead to higher fares and higher usage charges precisely at the time when policy makers are trying to encourage passenger and freight traffic to move from the roads to the rails and when, ironically, many central banks are working hard to encourage more infrastructure investment as an essential factor to stimulate economic growth. In both cases the policy objectives will succeed when more non-state actors are attracted into the rail sector and this, in turn is dependent on creating a level playing field between public and private sector participants. The proposals in the Consultation will frustrate these objectives and make the playing field even less level, thereby discouraging new competitive entrants into the rail industry. Further, significant increases in financing costs could tip current private operators, running at low margins, into insolvency as they compete against para-statal operators. This cannot make sense and is causing our members, particularly manufacturers and private operators, great alarm.

The proposals in the Consultation are in our view, as far as they relate to the rail industry, misconceived because there is no consideration given to:

1. the exceptional low default rates on rolling stock financings or for the robustness of the collateral, even in economic downturns;
2. the regulatory frameworks in various countries providing support for the stability of cash flow throughout the financing term;
3. the new creditor rights, the registration of creditor security interests in rolling stock and the increased ease of repossession when the Luxembourg Rail Protocol comes into force (why should the industry press governments to introduce the Protocol if it makes no difference to the way the banks provide capital against the secured receivables, and therefore their financing margin, even though the actual risks have declined?); and
4. the public policy need to encourage investment through private capital in the rail sector.

We would respectfully submit that, in its commendable quest for simplicity, the Committee has moved too far away from allowing banks to make reasoned risk assessments in relation to specific long term assets such as railway rolling stock and to calibrate the risk weighting of their loan books based on such assessments.

In conclusion, the current proposals in the Consultation, as far as they relate to the secured financing of railway rolling stock, will create serious damage to the rail sector across the world, restricting new procurement of railway equipment and undermining the competitiveness of the industry. They will make private sector finance of rolling stock more difficult in the future, and sometimes impossible. This at a time when policy makers worldwide recognise that private sector banks, lessors and other financiers have a critical role going forward in underwriting the expansion of the railways, in turn delivering important social, environmental, developmental and economic advantages as well as new business opportunities, new investment, new jobs and a new affordable vision for sustainable transportation in the 21st Century.



We strongly urge the Committee to revise its approach in relation to railway rolling stock, to allow lenders to match sensibly the risk weighting to actual risks and to adopt a system which encourages them, and governments, to minimise those risks. Railways are a major driver globally of sustainable development. With anaemic economic growth at the moment in many parts of the world, and public resources stretched, this is the wrong time for regulators to restrict much needed new investment in rolling stock and to make it more difficult and more expensive for rail operators to obtain private credit.

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

Yours truly,

Howard Rosen
Chairman