HERBERT SMITH FREEHILLS

European Banking Authority

Herbert Smith Freehills LLP
Exchange House
Primrose Street
London EC2A 2EG
T +44 (0)20 7374 8000
F +44 (0)20 7374 0888
D +44 (0)20 7466 2586
DX28 London Chancery Lane
E Rex.Rosales@hsf.com
www.herbertsmithfreehills.com

Our ref

Your ref
EBA/CP/2019/01

Date
17 May 2019

Dear Madam, dear Sir

Consultation Paper dated 25 February 2019 (EBA/CP/2019/01) attaching Draft Guidelines on Credit Risk Mitigation for institutions applying the IRB Approach with own estimates of LGDs

Response to Question 2

I refer to the Consultation Paper described above (the "**Consultation Paper**").

I am writing on behalf of the Asset Finance team at Herbert Smith Freehills LLP 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?

By way of background, Herbert Smith Freehills LLP is an international law firm, with 27 offices worldwide. We are a recognised market leader in Asset Finance (including Aviation Finance), an area in which we have been practicing for over 35 years. Our team acts for a large variety of institutions (including airlines and other asset operators, leasing companies, banks and other financial institutions and Export Credit Agencies) in the European Union, and elsewhere.

A number of our clients would be particularly affected by the proposals in the Consultation Paper and we have discussed with some of them the potential consequences that would result from the implementation of the provisions set out in the Draft Guidelines attached to the Consultation Paper (the "**Guidelines**"). However, in providing our comments, we express only the views of Herbert Smith Freehills LLP, and do not purport to speak on behalf of any other institution.

We set out below our views in relation to specific aspects noted in relation to question 2 contained within the Guidelines:

1. Explanatory box for consultation purposes

1.1 In the first paragraph the following suggestion is made:

it is proposed to identify the set of relevant jurisdictions where the collateral could move during the lifetime of the loan according to the collateral agreement.

The first paragraph then concludes:

This may be perceived as a too strict approach because implicitly require the collateral arrangement to specify this set of jurisdictions.

We fully agree with the conclusion that this would be a too strict approach in relation to aircraft and other highly movable transportation assets. The nature of these assets is to move from jurisdiction to jurisdiction, depending on the commercial requirements at the time. 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.

This is not to say that the collateral arrangement would not contain any restrictions on the location and operation of the asset. The customary market practice in aviation finance, for example, is for the arrangements to specify where the assets may not be operated (for example, by reason of sanctions legislation) 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 obtain finance or leasing facilities from entities not subject to the Guidelines.

1.2 In the alternative, the second paragraph 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 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. 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 very likely unachievable logistically on a deal by deal basis. By way of illustration, the minimum cost of the simplest legal opinion in a lower cost 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 $500,000. Banks in the EU requiring these would be severely hindered in their ability to compete with other financial institutions.

2. **Paragraph 20**

The introductory paragraph states that ***in relation to physical collateral which are movable and not in the possession of the institution the collateral is legally effective and enforceable against the obligor at least in the following jurisdictions:***

Then follows a prescriptive list of jurisdictions where legal opinions will be required to be obtained.

EU banking institutions arrange and participate in a myriad of different structures in the Asset Finance sector and these structures will vary depending on the obligor involved (for example an operating lessor or an airline), the legal structure which is adopted (full recourse or limited recourse) and the jurisdictions which are involved.

Our view is that for each particular financing structure, the jurisdictions where an opinion will be required will depend on the nature of the risks arising from the particular structure.

So for example, where there is a direct financing to an airline, it will be necessary to obtain a legal opinion in the jurisdiction of registration of the aircraft regarding the enforceability of the security instrument. However, in the case of a financing of an operating lessor secured on a portfolio of leases to various airlines around the world, it is not usual to obtain a mortgage in the jurisdiction of registration; the reason being that if the airline defaults, the operating lessor is still required to service the debt and the operating lessor will have to manage the repossession of the aircraft and its re-lease to a new airline. In addition, the operating lessor grants a mortgage to the lenders under either English law, New York law or the law of its jurisdiction of incorporation and that mortgage will typically be registered on the International Registry established under the Cape Town Convention (as to which we refer you to discussion below). Finally, the parent company of the operating lessor grants a charge over the shares of the operating lessor and so the lenders can "take over" the asset owning company in case of default.

Therefore, our conclusion is that it would be overly prescriptive (and unnecessary) to list out a hard and fast list of jurisdictions where opinions need to be obtained. In some circumstances, the jurisdiction of registration is important and not so in others. 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, as to what legal opinions are required to best ensure the effectiveness and enforceability of their collateral arrangements in the different possible default and insolvency scenarios.

3. **Paragraph 20a**

If the final guidelines were to adopt a list of minimum jurisdictions where a legal opinion is required to be obtained, we therefore now comment on the relevance of the jurisdictions mentioned in paragraphs 20a to 20d.

Paragraph 20a recommends that an opinion be obtained from the jurisdiction in which the lending institution is incorporated. We do not consider that would ever be a relevant jurisdiction. For example, a German bank taking security from an Irish obligor with the asset registered in Denmark would not need to establish the enforceability of those arrangements in Germany. The fact that the beneficiary of the security is located in Germany is irrelevant for the purposes of determining the enforceability of the security where the asset will be located at the time of enforcement.

Similarly, we do not consider that an opinion should be required from the jurisdiction where the obligor (that is, usually, the borrower of the facility) is incorporated, unless that entity is 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 (as borrower), the bank should only be concerned with the laws relating to Party A to establish the effectiveness and enforceability of the security.

4. **Paragraph 20b**

Our view is that in all cases, a bank would obtain, as a matter of course, an opinion from the jurisdiction whose law governs the collateral agreement.

5. **Paragraph 20c**

As mentioned above in point 2, depending on the type of financing structure involved, it may not be necessary to obtain an opinion from the jurisdiction where the collateral is registered.

As to the jurisdiction in which the owner of the collateral is incorporated, a bank would, as a matter of course, obtain an opinion from such jurisdiction.

6. **Paragraph 20d**

As mentioned in point 1.2 above, our view is that a requirement to obtain legal opinions from every jurisdiction where an asset may be located during the term of the collateralised obligation would be disproportionately expensive and very likely unachievable logistically on a deal by deal basis.

We would make two additional comments:

From a practical perspective, the jurisdiction where the creditor decides to pursue repossession or enforcement proceedings may be completely fortuitous and will be very much dependant on the operations of the asset at the time of default. 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, because they will have chosen that jurisdiction specifically because of the favourable legal regime in that jurisdiction.

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 recognised 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.

Thank you for giving us the opportunity to comment on the Consultation Paper. Please contact the undersigned if you have any questions.

Yours faithfully

Rex Rosales