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on

Draft Guidelines on Credit Risk Mitigation for institutions applying the IRB Approach with own estimates of LGDs

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The **German Banking Industry Committee** is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks finance group, and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks. Collectively, they represent approximately 1,700 banks.

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General comments

The period between the expected communication of the final guidelines and their intended integration into the supervisory practices of the various competent authorities (from 1 January 2021) is too short, in our view. The final guidelines will reach institutions at a relatively advanced stage in their model development or calibration. As a result, it will either not be possible to incorporate, or fully incorporate, some of the new requirements or they will have to be implemented at great effort and expense in a short period of time. This also applies to requirements which are procedurally complex – take, in particular, the checks on the legal enforceability of collateral agreements (paragraphs 19 et seq.). The guidelines – as well as the other requirements of the "Future of the IRB Approach" programme – should therefore be applied from 2022 together with the final papers on Basel III (Basel IV).

Question 1: Do you agree with the proposed clarifications on eligibility requirements in accordance with Article 181 (1) (f) of the CRR?

As for the requirements on **legal certainty,** we see a lack of practicability.

Paragraph 16, first, requires institutions to ensure that the collateral arrangement is legally effective and legally enforceable in "*all relevant jurisdictions".* In this regard, please see our comments on Question 2.

Second, the collateral arrangement should give the institution the right to liquidate or repossess the collateral "*also in the event of the default, bankruptcy or insolvency of the obligor or custodian*". Legal opinions invariably include a qualification in this respect, saying that the rights of the financers under the relevant collateral agreement and the legal opinion itself are subject to insolvency, bankruptcy and other similar laws generally affecting the enforcement of creditors' rights. They do not opine on these issues because they can be very complex, include cross-border legal issues, and will turn on the facts of the particular case. It has therefore become common practice for legal opinions to carve out any effect that insolvency, etc. may have on the enforceability of the collateral agreement.

As for of the **collateral valuation** requirement, our view is that the requirements set out in paragraphs 17 (a) and (b) are achievable and reflect standard practice in the shipping finance market. These requirements are already set out in the internal policies of institutions and are reflected in loan and collateral agreements with customers.

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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?**

1. Comments on proposed clarifications under paragraphs 19 to 21

We agree with a number of the elements of the approach set out under paragraphs 19 to 21 of the draft guidelines. However, we have considerable concerns that the proposed approach to clarifying legal certainty may be too rigid by overstating the role and function legal opinions are able to assume in the process and failing to provide sufficient flexibility to take into account the legal and practical limits to what legal opinions can do.

We also see a need for some further clarifications of specific aspects to avoid uncertainties and misunderstandings:

- **General observations on function/role of legal opinions in a legal review process and their limitations:**

  - The concept of a legal opinion is, of course, now established and well known in the context of regulatory requirements. It is nevertheless useful to bear in mind that it is based on a common law concept with a very specific and rigid formal understanding, which was developed to address very specific common law problems such as the lack of statutory law and formal registers. It is therefore important to ensure that the term "legal opinion" is interpreted and applied more broadly than, and independently of, its common law origins and the formal common law framework when applied in an EU regulatory context. In particular, the understanding of "legal opinion" in the context of EU regulatory legal review requirements needs to be open and flexible enough to allow for a flexible, proportionate and risk-based implementation of these requirements. This means that the format and scope of these opinions can and should differ significantly depending on the risks involved and type of transactions they are required for. Moreover, in order to facilitate the transfer of the concept of legal opinion to all legal traditions, it would perhaps be better understood and described as a qualified/expert legal review or assessment.

  - As recognised by the proposed clarifications in the second subparagraph of paragraph 19, legal opinions/assessments can take the form of an assessment of a specific transaction and the related specific contractual documentation (transaction-specific opinion) or a generic assessment of a template or sample contractual arrangement for generic types of transaction (generic opinion).

  - Both types of legal opinion or assessment will always take an ex-ante perspective and cover abstract legal risks which can be anticipated from this perspective. Ether form will therefore necessarily be subject to assumptions and qualifications, including limitations of the scope of the review. In particular, any legal opinion/assessment will have to be made on the basis of a set of predetermined/assumed facts and circumstances. The

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legal opinion/assessment will also necessarily have to concentrate on the central legal questions it is required for, namely the validity and enforceability of the contractual documentation. It is not intended or able to address all other potential legal issues in connection with the transactions made on the basis of this documentation. The scope of the opinion has to exclude potential legal issues which are specific to each individual case/transaction/obligor and factual circumstances, such as the individual capacity of the specific counterparties to enter into the transaction or similar factual issues.

- As it would be virtually impossible (and clearly disproportionate) to undertake an advance legal assessment in respect of the documentation for an individual transaction (other than in exceptional cases such as a highly complex and high-volume transaction), the legal review will also necessarily – and as the rule rather than the exception – be based on predetermined/standard collateral documentation (in some areas in the form of industry opinions on industry standard documentation).

- To make the legal review process manageable, the scope of jurisdictions to be included has to be narrowed down to key jurisdictions which have direct relevance to the validity and enforceability. The central jurisdiction will always be that of the governing law of the contractual arrangement. Other jurisdictions, such as the place of the registration of the collateral arrangement (where applicable) or the jurisdiction in which the institution and the obligor are incorporated, can also be of particular relevance, but this depends very much on the type of arrangement and collateral. However, in order to avoid placing a disproportionate/unreasonable burden on institutions, the requirements regarding the scope of jurisdictions to be covered should not be too rigid or formal (for more details, see specific comments below on paragraphs 20 and 21).

- A legal opinion (in whatever form) cannot ensure or provide “certainty” over the effectiveness and enforceability of a contractual agreement as it cannot address every possible legal risk. It can – at best – provide a high degree of confidence with regard to the key legal risks. Legal opinions are not, and should not be seen as, an end in themselves: they are a highly useful tool for assessing/establishing the legal situation. They also provide a valuable basis for assessing and identifying legal risks. However, a legal assessment of the validity/enforceability of contractual agreements is only one element of a broader legal review and (legal) risk management process.[1] Too much focus on the formal legal opinion/assessment as such may actually create a false sense of certainty and encourage a box-ticking mentality.

- In view of the above observations, we strongly believe that the legal review processes to be implemented by institutions must allow for a risk-based approach. The depth of the legal review should not have to be identical across all types of transaction and agreement. Rather, it has to be appropriate to, and commensurate with, the risks involved. Complex transactions or complex collateral arrangements may require a more thorough and formal approach. Simpler types of credit risk mitigation instruments with

[1] The German Banking Industry actively supports institutions with legal review requirements by providing “industry opinions” on standard contractual arrangements, including collateral arrangements. One example is the legal opinion programme covering the German master agreements for financial transactions (including the collateral addenda), which covers a range of jurisdictions (currently 25 jurisdictions for the netting agreement and 12 jurisdictions for the collateral addendum).

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a long track record should only require minimal/simplified legal review measures. Without such risk-based flexibility, the legal certainty requirements could effectively force institutions to withdraw from certain types of transaction, especially medium or small ticket trade finance transactions even if the actual legal risks are minimal, simply because the burdens associated with formal legal certainty requirements are becoming too high. The same applies to transactions involving moveable collateral (airplane/ship finance transactions/transactions involving rolling stock) if the scope of jurisdictions to be covered is not clearly limited (see below). Furthermore, a risk-based approach would allow for a simplified approach to collateral arrangements within the EU and thus governed by a largely harmonised legal framework which already provides a very high degree of legal certainty.

- Finally, it should also be taken into consideration that the legal risk of collateral arrangement documentation not being valid and enforceable is actually comparatively low. Market participants have considerable experience with most types of collateral arrangements and the legal framework for these arrangements is generally well established in most jurisdictions. When it comes to some forms of credit risk mitigation instruments, for example bank guarantees, the contractual arrangements may in fact be extremely simple because they are based on long-established practices and do not require formal/complex documentation.

- **Specific issues**

  - Paragraph 19, second subparagraph (generic/transaction-specific opinion):

    As mentioned above, transaction-specific opinions will be the exception rather than the rule. While the clarifications certainly recognise the possibility of a generic opinion (single opinions for multiple collateral arrangements), they may give the impression that transaction- and obligor-specific opinions are the more regular or even preferred approach. It would therefore be helpful to clarify that this is not the case and spell out that institutions will normally rely on generic opinions for sample or template agreements.

    It would also be helpful to recognise that institutions should take a risk-based approach to implementing the legal review process (no need for a uniform/identical depth of review across all types of transaction and agreement – see general observations above). In this connection it could further be clarified that such a risk-based approach can take account of the significantly reduced legal risks in the EU owing to the largely harmonised legal frameworks, in particular those governing financial collateral and insolvency proceedings.

  - Paragraphs 20/21, item a. (legal review of jurisdiction of debt provider)

    The key jurisdiction for assessing validity and enforceability is always the jurisdiction of the governing law of the collateral provider or situs/place of registration of the collateral (subject to our comments below on moveable collateral). The jurisdiction of the debtor is generally irrelevant. It should only be part of the legal review process in exceptional cases, e.g. where a claim serving as collateral is directly contingent upon the claim

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against the original debtor (accessory rights) – which again underlines the need for a risk-based approach regarding the scope and depth of the legal review process in order to prevent disproportionate/unreasonable results. However, in such a case it should be considered that the debtor (i.e. the undertaking) may act through a branch in a country that differs from the country of incorporation (i.e. the head office).

- Paragraph 20 (geographical scope for moveable collateral/risk-based approach)

  We understand from the explanations in the background and rationale (items 3.3.1, paragraphs 16 et seq. and item 3.3.2, paragraphs 18 to 20) as well as in the explanatory box for paragraphs 20 and 21 that there is no intention to compel institutions to cover all jurisdictions where the collateral may potentially be moved throughout the term of the arrangement since this would be virtually impossible and thus clearly disproportionate – and not commensurate with the risks involved.

  The approach reflected in the current version of paragraphs 20 lit d) and 21 lit b) would, however, effectively result in such a broad and ultimately disproportionate scope of possible jurisdictions to be covered in the legal review process. Limiting the scope to jurisdictions (expressly?) specified in the arrangement would not necessarily help in this context: in the case of moveable collateral such as motor vehicles, trucks, ships, rolling stock or airplanes, it would simply not be possible to specify the jurisdictions to which the collateral could potentially move. Contractual restrictions could also very well be legally ineffective or cause unintended legal consequences. In any event, such restrictions would defeat the very purpose of the objects in question and therefore invalidate their value as collateral.

  Take ship financing as an example: the guidelines would require institutions to obtain a large number of legal opinions (probably more than 100) for each transaction. This would be a very expensive and burdensome exercise. Even requiring legal opinions for all jurisdictions where the ship will presumably be *usually* located would be excessive and fraught with legal and practical problems:

  - A ship will travel to several places and call at several different ports during the life of the loan – which, in the case of ships, is usually between five and seven years. Its trading pattern will change several times and the chartering arrangements will also change – an average charter is 12 months long and ships also frequently trade on the spot.

  - It would therefore be impractical to attempt to agree and list in advance all the relevant locations in a collateral agreement. Furthermore, any attempt by a financial institution to insist on such a list would doubtless be seen by the shipowner as interference in its business planning and would be met with strong resistance. With this in mind, we believe that the necessary contractual restriction on the use of the collateral would be very difficult to enforce in the market.

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It would also be burdensome from an administrative point of view. Changing the list of jurisdictions would require constant notifications to/consents by the financial institution and amendments to the collateral agreement, not to mention the registration requirements for such agreements or the need for new legal opinions.

Finally, a financial institution which took such an active view of which locations a ship may or may not visit might risk being seen as a "shadow" director of the shipowning company with all the legal consequences that this entails under English law and that of similar jurisdictions.

As a result, it would no longer be possible to use such collateral to mitigate regulatory capital requirements. This, in turn, would mean that such transactions would migrate to unregulated areas. Indirect incentives would be created to enter into riskier unsecured transactions.

Another example is rolling stock (trains etc.), motor vehicles and trucks. It is impossible to predict which countries these will be moved to. If the countries in which the vehicle is allowed to be moved to had to be indicated, this would mean that it would be illegal to use the vehicle in any other country. This would be unacceptable because it would, for instance, prevent private customers from taking a holiday trip in a country not indicated in the collateral agreement. What is more, it would be impossible to monitor compliance with such a restriction. All in all, therefore, the requirement proposed under lit d) would be impossible to comply with.

Instead of trying to limit or define the jurisdictions to be considered, it would make better sense to take a risk-based approach. This risk-based approach should normally focus on the jurisdiction of the law governing the collateral arrangement and perhaps also the law of the jurisdiction where the collateral is (if at all) being registered. In addition, the legal review process could provide for steps and measures to react to indications from, incidents in, and practical experience with, other jurisdictions where the relevant type of collateral arrangement or its enforcement has been successfully challenged (see below for common practice in this regard).

As mentioned above, it should also be remembered that the legal risk of a collateral arrangement being invalid or unenforceable is not particularly high compared to other risks and that excessively rigid requirements will effectively force institutions to withdraw from certain types of transaction simply because the burdens associated with formal legal certainty requirements is becoming too high.

Against this background we strongly believe that paragraphs 20 d) and 21 b) should be deleted.

2. Current practice regarding movable physical collateral

Legal opinions on the effectiveness and enforceability of collateral arrangements are currently an important element of the legal review processes of institutions. They are, however, integrated into a general legal risk management process. This process includes processes and

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guidelines regarding the contractual documentation to be used (i.e. identifying standard documents or provisions and/or requiring involvement of the legal department) and legal opinions or legal assessments to be made.

In certain areas where standard documentation is industry practice (especially regarding derivative and securities financing transactions) many institutions make use of the industry opinion programmes offered.

As regards collateral arrangements for moveable collateral, institutions apply a risk-based approach (see above) taking into account past experience with jurisdictions and collateral arrangements. Again, take the example of ship financing: the common approach is to obtain a legal opinion on the enforceability of the collateral agreement in the jurisdiction whose law governs that collateral agreement. Occasionally, that same legal opinion may confirm that the collateral agreement will also be enforceable in the jurisdiction whose law governs the underlying finance document creating the debt obligation (e.g. the loan agreement).

In the special case of ship financing, only in situations where the vessel is an offshore vessel that is permanently situated in a particular location or in cases of cabotage is it common practice to obtain a legal opinion on the jurisdiction where the ship is located or is moving to.

Also in the case of ship financing, institutions obtain separate legal opinions on the capacity of the obligor to enter into the relevant collateral agreement. These opinions focus on the jurisdiction where that obligor is incorporated, but do not usually opine on enforceability.

The usual approach when an institution wants to arrest a vessel is to follow the trading pattern of the vessel and arrest it when it is in a “friendly” jurisdiction with an established legal system. Prior to the arrest, institutions will obtain legal advice and legal opinions as to which of these possible “stopovers” will be more favourable in this respect.

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Question 8: Do you agree with the proposed rules for the application of the substitution approach? Do you see any operational limitations in excluding the guaranteed part of exposure to which substitution approach is applied from the scope of application of the LGD model for unguaranteed exposures?

Within the framework of the substitution approach for unfunded credit protection (UFCP), institutions are to be able to split the exposures in two separate parts if they are only partially hedged by an UFCP (page 38). In our opinion, it should be clarified whether this splitting of the exposures should only be presented and tracked in the mathematical derivations, e.g. in model documentation or also by corresponding data sets in data processing systems. The same applies to the risk weight floor.

Furthermore, the substitution approach has shortcomings in the handling of certain types of guarantee. The methods described for UFCP essentially only assume forms of guarantee that take effect prior to the realisation of material collateral. Thus, forms of UFCP such as residual value insurances, which are applied from an economic point of view after considering the realisation of funded credit protection (FCP), are not sufficiently taken into account. The partial exposure for such guarantees cannot be modelled appropriately. The same applies to the risk weight floor.

The separate risk weight function for the substitution approach indicated in the explanatory box for consultation purposes (page 36, third bullet point) shows different treatment compared to the modelling approach and the adjustment of grades, pools or LGD estimates. In this case, a recomposition of the exposure and corresponding key figures might be a more suitable method.