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## **Basel could affect us all**

The beautiful Swiss city of Basel is home to the Bank for International Settlements (BIS) where central bankers meet and try to find common positions on how to regulate the world's financial system. The financial crisis in 2007/2008 created enormous financial instability and many major banks had to be rescued at significant cost for various governments as many major financial institutions had to be recapitalised. As a result, governments and central banks across the world have been working hard to introduce new rules to require banks to carry additional capital against its financings and then to stress test banks to ensure that they can deal robustly with any future financial shock.

Under new capital adequacy rules, banks are reducing their leverage but, since capital is limited and a real cost for banks, this suppresses new investment because of more restrictions on, and a higher cost for, credit. So regulators have to find a sensible balance between ensuring adequate capitalisation of banks without forcing the banks to overcapitalise. Recent BIS recommendations showed that it in one key area, they have not got the balance right.

Secured asset finance, either through loans collateralised on assets or leasing is an essential back-bone for the Western economy. It provides credit to commercial operations without needing them to be heavily capitalised, opening the way to SMEs and entrepreneurs entering into markets with limited capital enabling them to compete against large public and private organisations.

When it came 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 the last five years, and in particular under the so called Basel II regulations, these internal models have become sophisticated, evaluating the risk of default and its cost industry by industry. 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.

The consultation issued by the BIS in December 2015, and its latest consultation of March 2016, proposes to abolish this 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

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simpler and less costly. 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 governments or treaties.
3. It will make finance in low risk industries more expensive.
4. 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.
5. 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. So it cannot make sense to treat secured financing or 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 members estimate that the additional capital costs of complying with the new system will increase their margins by at least 1.5% since they will 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 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. Significant increase in financing costs could tip private operators, running at low margins, into insolvency as they compete against parastatal operators.

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.