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**The Relevance of the Luxembourg
Protocol for Central and South America**

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I. – FOREWORD

The fact that 20 countries have already ratified or acceded to the 2001 *Cape Town Convention on International Interests in Mobile Equipment*¹ is a clear indication that the regulation of international interests has profound relevance when it comes to stimulating the flow of capital worldwide for the benefit, in particular, of emerging markets where the legal status of security interests is not well developed.

It is important to recall that, while the Cape Town Convention indicates, in its Preamble, that its leitmotif is

“the need to acquire and use mobile equipment of high value or particular economic significance and to facilitate the financing of the acquisition and use of such equipment in an efficient manner,”

the body of the text

“provides for the constitution and effects of an international interest in certain categories of mobile equipment and associated rights. (...)The categories referred to in the preceding paragraphs are: (a) airframes, aircraft engines and helicopters; (b) railway rolling stock; and (c) space assets.”

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¹ *Convention on International Interests in Mobile Equipment* (hereinafter: “the Cape Town Convention”), signed in Cape Town (South Africa) on 16 November 2001 at a diplomatic Conference to adopt a Mobile Equipment Convention and an Aircraft Protocol held, under the joint auspices of the International Institute for the Unification of Private Law (UNIDROIT) and the International Civil Aviation Organization (ICAO), at the invitation of the Government of South Africa, in Cape Town from 29 October to 16 November 2001; Convention entered into force: 1 April 2004; Aircraft Protocol entered into force 1 March 2006; texts at: <www.unidroit.org/english/conventions/mobile-equipment/mobile-equipment.pdf>.

The Explanatory Report to the Cape Town Convention ² is not explicit as to why these particular assets were selected as being of “particular economic significance”, but it does state clearly that

“(…) the Convention system is designed to bring significant economic benefits to countries at all stages of economic development, and in particular to developing countries by bringing within their reach commercial finance for mobile equipment that has previously been unavailable or available only at relatively high cost. A sound, internationally adopted legal regime for security, title retention and leasing interests will encourage the provision of finance and reduce its cost.”

Clearly, railway rolling stock belongs to a category of assets with economic significance for developing countries. While railway rolling stock financing has not exactly headed the investment portfolios of banks, financial institutions, lenders and lessors operating in Latin America, there is no doubt that one of the effects of the Cape Town Convention and its Luxembourg Protocol relating to railway rolling stock ³ must be greater availability of financing for all projects designed to improve the transport infrastructure of such economies.

This article reviews the current business, legal and economic environment of railway rolling stock financing in Latin America, its potential and the possible effects of the adoption of the Luxembourg Protocol.

II. – RAILWAYS AND ROLLING STOCK IN LATIN AMERICA

The history of the railways in Latin America is not a happy one. It is a compilation of dreams that never came true. It is true that by the mid-nineteenth century, some important railways had been built with British, U.S. and French capital in Argentina, Chile, Bolivia, Peru, Brazil, Ecuador, Colombia and Venezuela. An example is the Transandino Railway connecting Buenos Aires in Argentina on the Atlantic seaboard with Valparaiso in Chile on the Pacific. At the same time, there were plans for a Pan-American railway

² R. GOODE, *Convention on International Interests in Mobile Equipment and Protocol Thereto on Matters Specific to Aircraft Equipment – Official Commentary*, UNIDROIT, Rome (September 2002), ISBN 88-86499-08-9.

³ *Luxembourg Protocol to the Convention on International Interests in Mobile Equipment on Matters specific to Railway Rolling Stock* (hereinafter: “the Luxembourg Protocol”), signed on 23 February 2007 at a diplomatic Conference to adopt a Rail Protocol to the Convention on International Interests in Mobile Equipment held, under the joint auspices of the International Institute for the Unification of Private Law (UNIDROIT) and the Intergovernmental Organisation for International Carriage by Rail (OTIF), at the invitation of the Government of the Grand-Duchy of Luxembourg, from 12 to 23 February 2007. See elsewhere in this issue for the text of the Protocol in English, French and German.

linking New York in the United States with Buenos Aires in Argentina, using infrastructure that was to be built in Central America, Colombia, Ecuador, Peru, Bolivia and Chile.⁴

However, the Pan-American railway never took off, and the Transandino Railway suspended its passenger operations in 1978 and its freight services in 1982.⁵ In Mexico, railway construction began in the mid-1830s, but it was not until 1878 that the railways became significant in Mexico (under President Porfirio Diaz).⁶ Recent privatisations under the government led by Ernesto Zedillo have led to ongoing changes in the business.⁷

Notwithstanding this sad history, rail projects are currently drawing the attention of hundreds of investors and governments. While rail transport started out as the only efficient way of carrying passengers and cargo overland, cars and road vehicles eventually displaced the railways as the preferred means of transport. Nowadays, and looking into the future, rail transport stands for “clean” transport from an environmental standpoint, and this is likely to produce positive economic fall-out both for its users and for the economy as a whole.

Currently, the rail projects underway in Latin America can be broken down into three main categories:

- Urban Massive Transportation Systems using railways
- Commodities rail transportation projects
- Tourism and passenger rail transportation projects

Samples of such rail projects are:

Argentina

- ◇ Buenos Aires
- ◇ Light-Rail: Tren de la Costa
- ◇ Tram: Premetro
- ◇ Historic Heritage Tram: Caballito (tourist operation on weekends)

⁴ For a detailed and fascinating history of the railways in Latin America, cf. Frederick M. HALSEY, *Railway Expansion in Latin America*, The Moody Magazine and Book Company, New York (1916).

⁵ *Revisiting the Transandine Railway*, available at <http://www.geocities.com/Baja/Mountain/4163/99_01.html> (accessed 4 Nov. 2007).

⁶ *Historia del Ferrocarril en México*, available at: <<http://www.estaciontorreon.galeon.com/productos627821.html>> (1 of 9) (accessed 4 Nov. 2007).

⁷ The Ferrocarriles Nacionales de México (N de M) were nationalised in 1938 and privatized 60 years later. N de M operated most railway trackage through the central and northeastern regions of the Republic. Cf. <http://en.wikipedia.org/wiki/Ferrocarriles_Nacionales_de_Mexico> (last accessed 4 Nov. 2007).

- ◇ Tranvía del Este (Puerto Madero Tramway)
- ◇ Proposed extension of Puerto Madero Tramway to major rail terminals; Retiro and Constitución
- ◇ Proposed Heritage Tram: San Telmo
- ◇ Mendoza – Urban Ferro Tram (Ferro Tranvía Urbano) (planning stages)

Brazil

- ◇ Rio de Janeiro – The Santa Teresa Historic Tramway
- ◇ Santos – Santos Historic Tramway
- ◇ Belém – Heritage Tram (under construction)
- ◇ Paraguay-Brazil railway (under study)

Colombia

- ◇ Ferrocarril del Atlántico (formerly managed by FENOCO, transferred to Drummond and other major coal operators);
- ◇ Ferrocarril del Pacífico;
- ◇ Ferrocarril del Cerrejón
- ◇ Massive Urban Transport rail project for Cali

Peru

- ◇ Lima – Heritage Tram
- ◇ Perurail (Tourist train including the route Cusco-Machupicchu), controlled by Orient Express

Puerto Rico

- ◇ San Juan to Caguas – Light interurban rail (planning stages)

Venezuela

- ◇ Maracaibo – Light Rail (under construction)
- ◇ Valencia – Light Rail (under construction)

Mexico

- ◇ Suburban
 - » Ferrocarril Suburbano de la Zona Metropolitana de México (under construction)
- ◇ Class I railroads
 - » Ferrocarril Mexicano (FXE)
 - » Ferrosur (FSRR)
 - » Kansas City Southern de México (KCSM)
- ◇ Short line railroads
 - » Ferrocarril Chiapas-Mayab (FCCM)
 - » Línea Ferrocarril Coahuila-Durango (LFCD)
 - » Carrizo Gorge de Mexico (Carrizo Gorge Railway subsidiary)
 - » Ferrocarril y Terminal del Valle de México (Ferrovalle)
 - » Ferrocarril Transimitico
 - » Ferrocarriles Peninsulares del Noroeste

These are only some examples; there are many others. However, unless new financial resources become available, the history of unattained dreams is likely to be repeated. This is where the Cape Town Convention and its Luxembourg Protocol may make a difference. Why and how?

III. –THE CAPE TOWN CONVENTION AND THE FUNDAMENTALS OF ASSET-BASED FINANCING

In the world of financing, the phenomenon of asset-based financing has brought additional security to lenders and providers of financing. While all lenders and financing providers face the credit risk, *i.e.* the risk that the debtor may not meet its payment obligations as contracted, that risk is always linked to the debtor's ability to generate enough cash to meet its obligations, and having the moral integrity to allocate the resources to doing so. Sometimes, the ability of the debtor to generate sufficient cash flow is highly uncertain. In such cases, the debtor is either unable to obtain financing, or must be able to pledge certain assets as a source of value in the event of the debtor's failing to generate the necessary cash flow through its business project. This is particularly relevant when providing financing for small and medium-sized enterprises, as well as in project financing. Most large and development-impacting infrastructure projects fall into that category.

Asset-based financing would be an illusion if there was no legal system in place to enable the lender or financing provider to recover value by repossessing, seizing and disposing of the asset placed as security. That is the case in most emerging markets. Asset-based financing contracts do not give lenders and financing providers the ability to recover value from the secured asset unless they are able to: (i) prevail *vis-à-vis* the debtor and all subsequent third parties (including good faith purchasers); (ii) seek efficient enforcement granted by the legal system, either with court intervention or under a legal system that permits alternative settlement of rights and dispute resolution (including "self help"), and (iii) access a secondary market or any other source of value for the asset.

National or domestic laws have addressed these issues in different ways. In some countries, the legal system has evolved to provide secure, reliable and efficient means of asset recovery. In others, the legal system is not sufficiently clear or transparent to allow an asset-based financier to recover value from the asset as described.

It was in this setting that the International Institute for the Unification of Private Law (UNIDROIT) started work in 1988 on "(...) uniform rules governing security interests in cross-border transactions,"⁸ culminating in the adoption, on 16 November 2001, of the *Cape Town Convention on International Interests in Mobile Equipment* and its accompanying *Protocol on Matters*

⁸ GOODE, *supra* note 1, 3.

specific to Aircraft Equipment. The Convention covers the following three principal forms of financing: (a) loans secured by a security interest in the object; (b) sales under an agreement in which the seller reserves ownership until payment is made in full (title reservation agreement), and (c) leases, which may be either finance leases or operating leases and may or may not include an option to purchase.

The Convention sets forth the rules for the creation and perfection of international security interests on certain assets. *Prima facie*, these were narrowed down to (i) airframes, aircraft engines or helicopters; (ii) railway rolling stock and (iii) space assets. Such international security interests may either be purely international security interests in countries that have no national regulation for security interests, or a combination of both national and international security interests, or the co-existence of national and international security interests. The latter is of special importance in countries such as the United States of America where the perfection of security interests is regulated under Article 9 of the Uniform Commercial Code, while the principles and forms of perfection and registry differ from the system laid down by the Cape Town Convention.

At the core of the Cape Town Convention system lie its default remedies provisions. The secured creditor (also called the “chargee”) should be legally empowered to (a) take possession or control of any secured asset; (b) sell or grant a lease of such asset, and/or (c) collect or receive any income or profits arising from the management of the asset. The Convention provides such empowerment for such secured creditors provided the debtors agree to these remedies; failing such agreement a court order is needed. These remedies apply whether or not there is a registration system in place. This core aspect of the Convention is its principal merit: it addresses the fundamental concern of any asset-based financing provider, and in general the fundamental concerns of secured lenders, sellers under conditional sales agreements and lessors under both finance and operating leases. The remedies provided by the Cape Town Convention encompass the three driving forces of repossession, *i.e.* the ability to: gain physical control of the asset,⁹ sell or dispose of the asset in the secondary markets¹⁰ and funnel the inherent productivity of the asset for the benefit of the asset-based financing provider.¹¹ These forces reflect the two basic faces of repossession: (a) the negative face, where the debtor is deprived

⁹ Art. 8(1)(a) of the Cape Town Convention.

¹⁰ Art. 8(1)(b) *ibidem*.

¹¹ Art. 8(1)(c) *ibidem*.

of the use of the asset, a risk that ought to operate as an incentive to the debtor to keep its obligations current, and (b) the positive face, which involves the secured creditor's ability to recover value from two potential sources: (i) the re-sale of the asset, and/or (ii) the productivity of the asset.

The registration system is perhaps the most interesting practical tool provided by the Cape Town Convention. Registration is intended to give public notice of the existence of an international interest or a prospective international interest and provides the secured creditor with the following benefits: (a) it contributes to breaking the presumption of good faith ("*en fait des meubles, possession vaut titre*"), i.e. the presumption that whoever acquires personal property is the legal owner of the asset. The registration system requires that a good faith purchaser of an asset potentially subject to the Cape Town registration system must first undertake a search of the International Registry in order to be protected by that presumption; (b) it enables the secured creditor to preserve its priority on the asset, and (c) it underpins the effectiveness of the international interest in insolvency proceedings against the debtor. However, it should be noted that registration is simply a public notice system and that it neither substitutes nor validates the lack of legal validity of the security interest.

The registration system is asset-based, hence it requires the asset to be identifiable and to meet all the identification criteria. For the purposes of railway rolling stock, the Luxembourg Protocol provides that railway rolling stock shall be identifiable by type and by item. The Registrar must allocate serial numbers to such items regarding manufacturers, and national and/or regional identification numbers. Such identification must be affixed to the corresponding railway rolling stock.

There are other important derivative consequences of the main regulations of the Cape Town Convention, such as the provisions about priorities, the effect of a debtor's insolvency and all other related issues.

IV. –THE LUXEMBOURG PROTOCOL: THE MAIN PROVISIONS AND ITS MOST NOTEWORTHY EFFECTS

It is not the purpose of this paper to address all the important provisions of the Luxembourg Protocol; instead, the author has selected what, in his view, are the most important ones: (a) the provisions defining what is meant by "railway rolling stock", (b) the provisions governing default remedies for this kind of equipment, (c) the provisions regulating priorities and insolvency procedures, (d) the provisions regulating the potential re-exportation of repossessed

railway rolling stock, and (e) the provisions addressing the application of remedies in the event of governmental intervention in the case of public utilities services.

Article I(2)(e) of the Protocol defines “railway rolling stock” (as...)

“vehicles movable on a fixed railway track or directly on, above or below a guideway, together with traction systems, engines, brakes, axles, bogies, pantographs, accessories and other components, equipment and parts, in each case installed on or incorporated in the vehicles, and together with all data, manuals and records relating thereto”.

This definition includes some highly interesting elements that are of great importance for Latin American projects.

The first relevant aspect of the definition is that it covers rolling stock movable not only on fixed railway tracks but also above or below a “guideway”. This definition opens the door for rolling stock that not only circulates over or below (hanging on) rails, but also operates over roads, subject to the guideway limitation. Thus, the equipment subject to and protected by the Luxembourg Protocol will not only include equipment using new technologies such as “magnetic levitation” (or “mag-lev”) trains, but also trams and similar mass transportation solutions with rubber tires, such as the Automated Guideway Transit (AGT) operating in France (Lille), Japan (Osaka and Kobe) and more recently, in several Latin American cities where they are enjoying great success, namely Curitiba (Brazil), Bogota (Colombia) and, shortly, Lima (Peru). These AGT systems have turned out to be highly successful and useful for the respective economies. However, prior to the Luxembourg Protocol, these means would not have been considered subject to the provisions of the Cape Town Convention. Now, for example in the case of the guideways system that operates in Bogotá (Colombia) under Transmilenio management, the rolling stock (mainly Mercedes-Benz buses and other equipment) could qualify for protection under the Luxembourg Protocol.

The inclusion of traction systems as part of the definition paves the way for the financing of items such as pantographs that are, in essence, devices that collect electric current from overhead lines for electric trains or trams, thus relieving the burden on governments and concessionaires. It also makes it possible to cover assets such as bogies (wheeled wagons or trolleys – *i.e.* chassis or framework carrying wheels – attached to a vehicle).

Another important factor in the Protocol’s definition of railway rolling stock is the inclusion of certain items that would otherwise be considered as “soft costs” and therefore as a rule excluded from financing, namely data,

manuals, and records related to such equipment. Again, this helps to relieve the burden on project owners by providing full financing for all acquisition costs of such equipment.

In terms of default remedies, the good news is that the Protocol preserves the default remedies provided under Article 8 of the Cape Town Convention as described above, namely, the right of the secured lender or chargee to take possession of the asset, sell it in the secondary market and/or collect revenues arising from the management or use of such asset. In addition, the Protocol expands the first and second remedy by including the right to “procure the export and physical transfer of railway rolling stock from the territory in which it is situated.”¹² This expansion implies that no intervention by a government authority need perforce be requested for the repossession and recovery of railway rolling stock for transfer to such markets where the equipment is more saleable (more liquid).

The bad news is that the Luxembourg Protocol breaks the presumption as to whether the application of repossession remedies is commercially reasonable, and places the burden of the proof as to whether or not its recourse to such remedies was in fact “commercially reasonable” on the creditor. This is a problem for secured creditors because of the risk of becoming involved in lengthy litigation that may prevent the expeditious use of the default remedies. In civil law countries (*i.e.* all Latin American countries, the concept of “commercially reasonable” is not particularly well-developed and is liable to give rise to a host of contradictory constructions that might neutralise the remedies’ effectiveness. It would be useful to see how this problem is dealt with both in Statute and case law. Although an in-depth examination is beyond the scope of this paper, the author would suggest that Section 355.9-627¹³ of the Kentucky Statute brings a definitional approach to the subject

¹² Art. VII(1) of the Luxembourg Protocol.

¹³ Section 355.9-627: Determination of whether conduct was commercially reasonable.

(1) The fact that a greater amount could have been obtained by a collection, enforcement, disposition, or acceptance at a different time or in a different method from that selected by the secured party is not of itself sufficient to preclude the secured party from establishing that the collection, enforcement, disposition, or acceptance was made in a commercially reasonable manner.

(2) A disposition of collateral is made in a commercially reasonable manner if the disposition is made:

(a) In the usual manner on any recognized market;
(b) At the price current in any recognized market at the time of the disposition; or
(c) Otherwise in conformity with reasonable commercial practices among dealers in the type of property that was the subject of the disposition.

(3) A collection, enforcement, disposition, or acceptance is commercially reasonable if it has been approved:

matter. In the case law, some criteria have been adopted for the concept “commercially reasonable manner”, such as: “The standard of commercial reasonability is predicated on two concepts prevalent throughout the UCC. All commercial transactions are required to be conducted in “good faith”. “ ‘Good faith’ means honesty in fact in the conduct or transaction concerned.” (12A O.S. 1971 § 1-201 (19). Commercial matters should be, if at all possible, resolved by means normally employed for handling such matters in the business involved, so long as the means deals fairly with all parties. Generally, the secured party acts in a commercially reasonable manner when in the process of disposing of repossessed security he acts in good faith and in accordance with commonly accepted commercial practices which afford all parties fair treatment.”¹⁴ The Aircraft Protocol to the Cape Town Convention has the same provision, and its absence in the Luxembourg Protocol would seem to be an unfortunate oversight on the part of the drafters that may prevent capital from flowing into Latin American and other emerging markets to finance rolling stock. However, the key question is: Can lessors, secured lenders and conditional sellers live with that? Of course they can, but there is a risk that premium costs will rise to cover the risk.

Attention must be paid to the important new provision of the Protocol that grants secured creditors the right to export and/or physically transfer the railway rolling stock out of the territory where it is located. This is an aspect that was never previously addressed by any international treaty until it was mentioned in the Aircraft Protocol. The case for rolling stock is more critical, in particular if such rolling stock only operates over rails: unless there is enough infrastructure in place in the country and there are financially sound operators as potential buyers or lessees of such equipment, the secured creditor of such rolling stock really only has one option and that is to re-export the equipment. The Convention certainly takes into consideration the fact that in many emerging markets, the lack of clear re-exportation rules may render useless repossession remedies. Clearly, therefore, the Protocol’s provision in this regards is of prime importance. It only requires the secured creditor to give timely notice, thereby giving any third party claiming to have rights on such equipment the opportunity to exercise them. The Luxembourg Protocol

- (a) In a judicial proceeding;
- (b) By a bona fide creditors’ committee;
- (c) By a representative of creditors; or
- (d) By an assignee for the benefit of creditors.

¹⁴ Oklahoma Supreme Court, *Wilkerson Motor Co., Inc. v. Johnson*, No. 49450. 580 P.2d 505, 1978 OK 12.

requires such notice whenever there has not been a repossession and an order to re-export handed down by the courts. Such notice must be given within a reasonable timeframe to allow third parties to oppose the notice or to ensure that their rights are preserved even in the event of re-export. What constitutes “reasonable” prior notice is left either to the discretion of the domestic or national law or to the courts, and also depends on the interested person, which under Article 1(m) of the Cape Town Convention may be:

“(i) the debtor; (...) (ii) any person who, for the purpose of assuring performance of any of the obligations in favour of the creditor, gives or issues a suretyship or demand guarantee or a standby letter of credit or any other form of credit insurance; and (iii) any other person having rights in or over the object (...).”

Since the debtor will be aware of the repossession, the time required to give prior notice to the debtor should be shorter than that required for guarantors or third parties claiming a right (such as labour liens or mechanical liens, where applicable). In summary, this is one of the good things about the Luxembourg Protocol: it gives the secured creditor a clear right to enforce cooperation by governments and customs authorities in regard of the export of repossessed rolling stock, thus shortening the cash-to-cash cycle associated with such deals.

Article XXV of the Luxembourg Protocol introduces a very interesting rule that has extremely important connotations from the point of view of international law. To begin with, it recognises the reality that sovereign States may impose restrictions on the remedies available to secured creditors for reasons of public interest, namely for “public service railway rolling stock”. This silences the discussion about whether or not in international law the respect of rights and remedies may be limited or restricted in the public interest or under “State of Necessity” circumstances.¹⁵ The Luxembourg Protocol makes it abundantly clear that such sovereign right can indeed be exercised. However, and most importantly, Article XXV(3) provides that a person exercising authority on behalf of the government

“shall also make or procure payment to the creditor of an amount equal to the greater of: (...) (a) such amount as that person shall be required to pay under the

¹⁵ The State of Necessity doctrine in international law has been a recent subject of debate: International arbitral tribunals have of late mischaracterized and mistaken the concept of whether or not a State *can* adopt measures limiting rights under State of Necessity, compared to whether, when such sovereign attribution is exercised, the State should or should not compensate or indemnify the affected private parties. (See ICSID Decision, *LG&E v. Argentine Republic*. In contrast, *CMS Energy v. Argentine Republic*).

rules of law of the Contracting State making the declaration; and (b) the market lease rental in respect of such railway rolling stock.”

The preclusion, suspension or modification of the regular creditors’ remedies under Article XXV is certainly grounds for obtaining commercial and political risk insurance. At the end of the day, it provides the remedy of applying to the relevant national courts or international arbitration to seek from the government or such other person or agency that exercises those rights compensation in either of the forms provided for in sub-paragraph 3 which would appear to amount in most cases to full recovery.

V. – CONCLUSIONS

While the geopolitical and geo-economic realities show that America’s power is waning, while Europe and China are gaining ground, the dream of maintaining economic and political leadership has been overridden by other priorities. In fact, shortly after the Maastricht Treaty of 1992 marked the start to the successful integration of Europe, America launched the Free Trade Area of the Americas (FTAA) initiative to integrate (in the word of former President George H.W. Bush Senior) the “territories between Alaska and Tierra del Fuego”. It is no exaggeration to assert that one of the key components of the success of integration in Europe has been the strength and high degree of development of its railroads. America would do well to bear in mind this factor which transcends politics and is rooted instead in economic reality.

The 21st century demands more efficient and environmentally clean transportation of persons and goods. Railways, guideways and rolling stock are poised to meet that demand.

It is in this sense that the social, geopolitical and geo-economic importance of the Luxembourg Protocol is enormous. The adoption and ratification of the Luxembourg Protocol will attract investment and financing, risk capital and credit, for the expansion of railway systems both to respond to the increasing demographic pressure in urban centers and as a means to bring about the much-needed economic integration that reluctant leaders are still denying the Americas and indeed the whole Western Hemisphere.

The Luxembourg Protocol provides clear rules for safer and sounder capital investment in railway rolling stock financing, favouring asset-based financing structures that can and will make all the difference to many people when it comes to eradicating poverty and fuelling economic development.

