

AVIATION BULLETIN



CAPE TOWN CONVENTION – IMPACT ON FINANCING THE BIG BIRD

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INTRODUCTION

Buying, maintaining, and flying an aircraft is an expensive proposition. It involves huge investments, numerous regulatory permissions are to be secured, security clearances, and legal issues to be considered and addressed. Due to increase in the numbers of air travelers and new entrants entering airline operations market, demand for aircrafts has increased. As the quantum of investments involved are huge, financing agencies play a huge role in procuring the aircrafts. An airline operator has to repay the loans along with interest levied thereon and a small percentage interest reduction on the loan amount makes huge differences on the balance sheet. Keeping these aspects in mind Indian government proposes to ratify the Cape Town Convention on International Interest in Mobile Equipment, 2001 (**‘Convention’**) and Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Aircraft Equipment, 2001 (**‘Protocol’**). The purpose of this bulletin is to briefly discuss how Indian airline operators finance an aircraft purchase and evaluate the impact that the Convention would have on financing of aircrafts, if India ratifies the Convention.

1. Financing- Present position

Announcement of procurement of aircrafts by Indian companies and potential of the Indian market directed the interest of aircraft manufacturing giants to Indian aviation industry. In order to support aircraft sales and to ensure that the purchasers stand by their orders of procuring aircrafts, aircraft manufacturers not only ensure quality of delivery (both in terms of superiority of product and time) but also help finance the procurement price. Two major manufacturers in the aircraft industry today are Boeing in the USA and Airbus in Europe. Both provide assistance to the purchasing airlines in obtaining finances from commercial banks and financial institutions.

The availability of finance largely depends on the credibility of airline in the market. Payments made for aircraft entail payment of an advance in order to secure delivery of the order. Remaining payments are to be made progressively over a span of 2-3 years, that is, the time from placing the order till the date of actual delivery of aircraft, in accordance with the “Aircraft Purchase Agreement”. Funding of payments is done by the airlines either through External Commercial Borrowings (**‘ECB’**)¹, or through a company’s own cash reserves, which depends on capital invested by the promoter².

Export Credit Agencies (**‘ECAs’**), such as, US EXIM Bank, for aircraft manufacturer by Boeing or Compagnie Francaise d’Assurance pour le Commerce Exterieur (**COFACE**) in Europe, for Airbus aircraft, are the principal agencies for aircraft financing. ECA guarantees are provided to airlines outside US and

¹ Eligible lenders as notified by Reserve Bank of India vide A.P. (DIR Series) Circular No. 60 of January 31, 2004 from whom ECB can be raised include international banks, international capital markets, multilateral financial institutions, export credit agencies, suppliers of equipment, foreign collaborators and foreign equity holders.

² As per the ‘Domestic Air Transport Policy’ issued by Ministry of Civil Aviation, Government of India on March 1, 1994 the capital norms for scheduled airlines are: (i) INR 500 Million subscribed equity capital in respect of operators having aircraft or all-up-weight exceeding 40,000 kilograms and for every 5 aircrafts added there is an added equity requirement of INR 200 Million, (this category includes passenger aircrafts manufactured by Boeing and Airbus) and (ii) INR 200 Million for operators having aircraft of all-up-weight not exceeding 40,000 kilograms and for every 5 aircrafts added there is an added equity requirement of INR 100 Million (these include passenger aircrafts manufactured by Bombardier and Embraers). However, no further enhancement of the capital is required if the equity capital of the company is INR 1000 Million.

Europe to facilitate aircraft “exports”³. ECAs provide guarantees to the extent of 85%⁴ of the actual cost of the aircraft against which international commercial banks are able to provide financing. EXIM Bank can offer maximum repayment term of twelve years and EXIM Bank supported financing is required to amortize to zero over the repayment term⁵. The ECA guarantees are backed by the counter guarantee of Government of India given on behalf of the Indian airline procuring the aircraft. The airline has to pay Indian Government a fee of 0.5⁶ per cent of the amount guaranteed, while ECA charges a one-time exposure fee of 3 per cent⁷.

In case of default in payment, the local bank of the customer financing the aircraft encashes the ECA guarantee and ECA on its part encashes the counter guarantee of the Indian government. Alternatively, ECA has the possibility to repossess the aircraft and realize its debts through sale of the aircraft. ECA retains the ownership right over the aircraft by structuring the finance in a way that the airliner (borrower) and the ECA (lender) set up a SPV in a foreign country which leases the aircraft to airliner. SPV is launched in a country where leasing aircrafts to Indian companies are exempted from withholding tax⁸, for example, Cayman Islands. The shares of such a SPV are held jointly by the airliner and the lending banks. Control over SPV is retained by the lenders and in case of default, the borrower repossess the assets of the SPV in order to realize its dues.

To enable airline companies to lease and purchase aircraft at a cheaper rate, the government of India is likely to ratify the Convention and Protocol. The philosophy of the Convention and the advantages to the Indian airlines are discussed hereunder.

2. Cape Town Convention, 2001

The Convention primarily facilitates asset-based financing and leasing of high value mobile equipment and is designed as a ‘multi equipment treaty’ covering aircraft equipment, railway rolling stock and space assets. The Convention applies to leasing and financing of airframes⁹ and helicopters.

The Convention is backed by two agencies namely, International Institute for the Unification of Private Law (‘**UNIDROIT**’), an United Nations agency dealing with private law conventions and International Civil Aviation Organization (‘**ICAO**’) and was concluded at a diplomatic conference in Cape Town in November 2001. To the present day, 38 countries have ratified the treaty till date including US, UK and France.

³ See Financial Express; ‘Building a profitable airline is not easy’ dated July 2, 2005.

⁴ <http://www.exim.gov/products/transportation/aircraft.cfm> visited on April 16, 2007.

⁵ Supra.

⁶ See Economic Times; “Cape Town pact ratification set to lower cost of aircraft deals” as published in Economic Times dated January 23, 2007.

⁷ <http://www.exim.gov/pressrelease.cfm/A45E77EE-DF56-CE48-084A25574AAEA175/> visited on April 16, 2007.

⁸ Is a tax imposed by the government on the borrowings raised by domestic corporates from foreign banks.

⁹ Article 2(e) of the Protocol defines “airframes” to mean airframes (other than those used in military, customs or police services) that, when appropriate aircrafts engines are installed thereon, are type certified by the competent aviation authority to transport: (i) at least 8 persons including crew, (ii) goods in excess of 2,750 kilograms, together with all the installed, incorporated or attached accessories, parts and equipment (other than aircraft engines), and all data, manuals and records relating thereto.

2.1 Defined objective

Repossession of the financed aircraft on account of default in payments has been a cumbersome task for financing companies. As the aircrafts are registered in various countries across the world, namely the country of the operator of the aircraft, and lack of uniformity in local legal systems with respect to security and title reservation rights makes it difficult to repossess aircraft and sell or lease them to third party for realizing out- standing dues, the Convention aims to reduce creditors' uncertainty by providing secure and readily enforceable rights in an aircraft which may be uniformly applicable to all the countries. On the other hand creditors will be able to reduce the interest rate charges on the loan amount due to reduced risk on the repossession of the asset. For example, EXIM Bank US has reduced its exposure fee from three percent to two percent on the asset backed financing of the new large commercial aircrafts and spare engines for the buyers located in countries who have ratified the Convention¹⁰.

2.2 Basic provision

Once the Convention is ratified by a country it recognizes 'international interest'¹¹ of foreign organization over the asset located within their jurisdiction and is liable to maintain an electronic international register for registering such an interest. This system will ensure that the international financing organization has the priority of interest over any other lending agency, in case any second charge is created by the operator of the aircraft. In addition the Convention provides creditors with right to (i) deregister the aircraft and procure its export¹², (ii) take possession or control of the aircraft¹³, (iii) sell or grant a lease in the aircraft and (iv) collect or receive income or profits arising from the management or use of the aircraft with respect to any aircraft financed in a country that has ratified the Convention and Protocol.

2.3 International Registry

The Convention created an international registry for the registration, amendment, extension, or discharge of international interests. Either party to an international interest may register an interest with the consent in writing of the other party of the Convention¹⁴. The registration of an international interest remains effective until discharged or until expiry of the period specified in the registration.¹⁵ An international interest will rank for priority as from the time of registration over a subsequently registered interest and over

¹⁰ <http://www.exim.gov/pressrelease.cfm/A45E77EE-DF56-CE48-084A25574AAEA175/> visited on April 16, 2007.

¹¹ As defined in Article 2 of the Convention – International Interest 1. This Convention provides for the constitution and effects of an international interest in certain categories of mobile equipment and associated rights. 2. For the purposes of this Convention, an international interest in mobile equipment is an interest, constituted under Article 7, in a uniquely identifiable object of a category of such objects listed in paragraph 3 and designated in the Protocol: (a) granted by the charger under a security agreement; (b) vested in a person who is the conditional seller under a title reservation agreement; or (c) vested in a person who is the lessor under a leasing agreement. An interest falling within sub-paragraph (a) does not also fall within sub-paragraph (b) or (c). 3. The categories referred to in the preceding paragraphs are: (a) airframes, aircraft engines and helicopters; (b) railway rolling stock; and (c) space assets. 4. The applicable law determines whether an interest to which paragraph 2 applies falls within subparagraph (a), (b) or (c) of that paragraph. 5. An international interest in an object extends to proceeds of that object.

¹² Article 13 of the Protocol.

¹³ Article 9 of the Protocol.

¹⁴ Article 20 of the Convention.

¹⁵ Article 21 of the Convention.

an unregistered interest.¹⁶ Under the Convention, the registered international interest will have priority over the unregistered interest and will not be affected by insolvency proceedings.¹⁷

2.4 Commercial impact

The plain reading of the Convention gives an impression that it has been drafted to protect the interest of the creditors. One may argue as to what benefit will countries like India get, being primarily debtors. Some of the benefits of ratifying the treaty in the Indian context can be: (i) aircraft manufacturers and suppliers will be able to get access to expanded markets, higher output and sales levels as because of reduced rate of interest many more airline operators/individuals will opt for procurement of aircrafts. This will propel the demand for new aircrafts. (ii) airlines will be benefited by reducing financing costs and providing greater access to finance (iii) governments will gain by reducing debt levels where government is lending the money to purchase the aircraft through guarantees and reducing risk, and eliminating providing counter guarantees to international financial institutions in the long run (iv) investors will be able to get higher returns on investments as banks have assurance of secured debt (v) passengers will be able to get cheaper air tickets as interest amount payable has to be factored in the ticket prices, reduction in interest payment amount will be passed down to the passengers and there will be increased frequency of flight services with more aircrafts being inducted¹⁸.

CONCLUSION

Aviation sector is booming and in countries like India where the air traveler is increasing by the day, it has become important that the government facilitate the financing options of aircrafts to public and private operators. If government of India ratifies the Convention and Protocol it will not only help the financial companies from the hassle of recovering money from defaulting debtors but will benefit the domestic aviation companies who are incurring losses across the board as of date, to get loans on concessional rates. These loan discounts will trickle down to air travelers in form of cheaper tickets. Further, the government would not have to provide counter guarantees to ECAs. Airline companies would be able to revamp their fleet as state operators are in desperate need of the same due to ageing aircrafts.

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¹⁶ Article 29 of the Convention.

¹⁷ Article 30 (1) and (2) of the Convention.

¹⁸ Supra footnote 6.