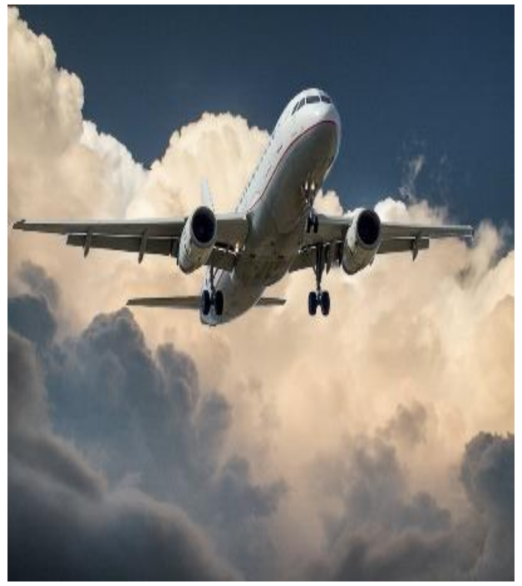   

The Cape Town Convention treaty system:

An international legal regime to increase certainty in high-value asset-based financing

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THE CAPE TOWN CONVENTION TREATY SYSTEM

Convention on International Interests in Mobile Equipment (2001)

- Protocol on Matters Specific to Aircraft Equipment (2001)
- Luxembourg Protocol on Matters Specific to Railway Rolling Stock (2007)
- Protocol on Matters Specific to Space Assets (2012)
- Protocol on Matters Specific to Mining, Agriculture and Construction Equipment (2019)

Uniform legal regime created by treaty, to increase certainty and reduce risk in asset-based financing and leasing of certain types of uniquely identifiable, mobile high value equipment used in key industry sectors:

Aviation (Aircraft Protocol); **Rail** (Luxembourg Rail Protocol); **Space** (Space Protocol); **Mining, agriculture and construction** (Pretoria MAC Protocol)

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The CTC as a tool to facilitate and improve international access to credit in key economic sectors

Starting point: growing global need for financing (including private capital) in the acquisition and use of high value mobile equipment

Particularly evident, initially, in the aviation sector:

Exponential growth of air traffic and aviation industry

Reduction of public financial support, need to attract private capital

Positive externalities of acquisition and use of new equipment (e.g., greater safety of air travel)

BUT:

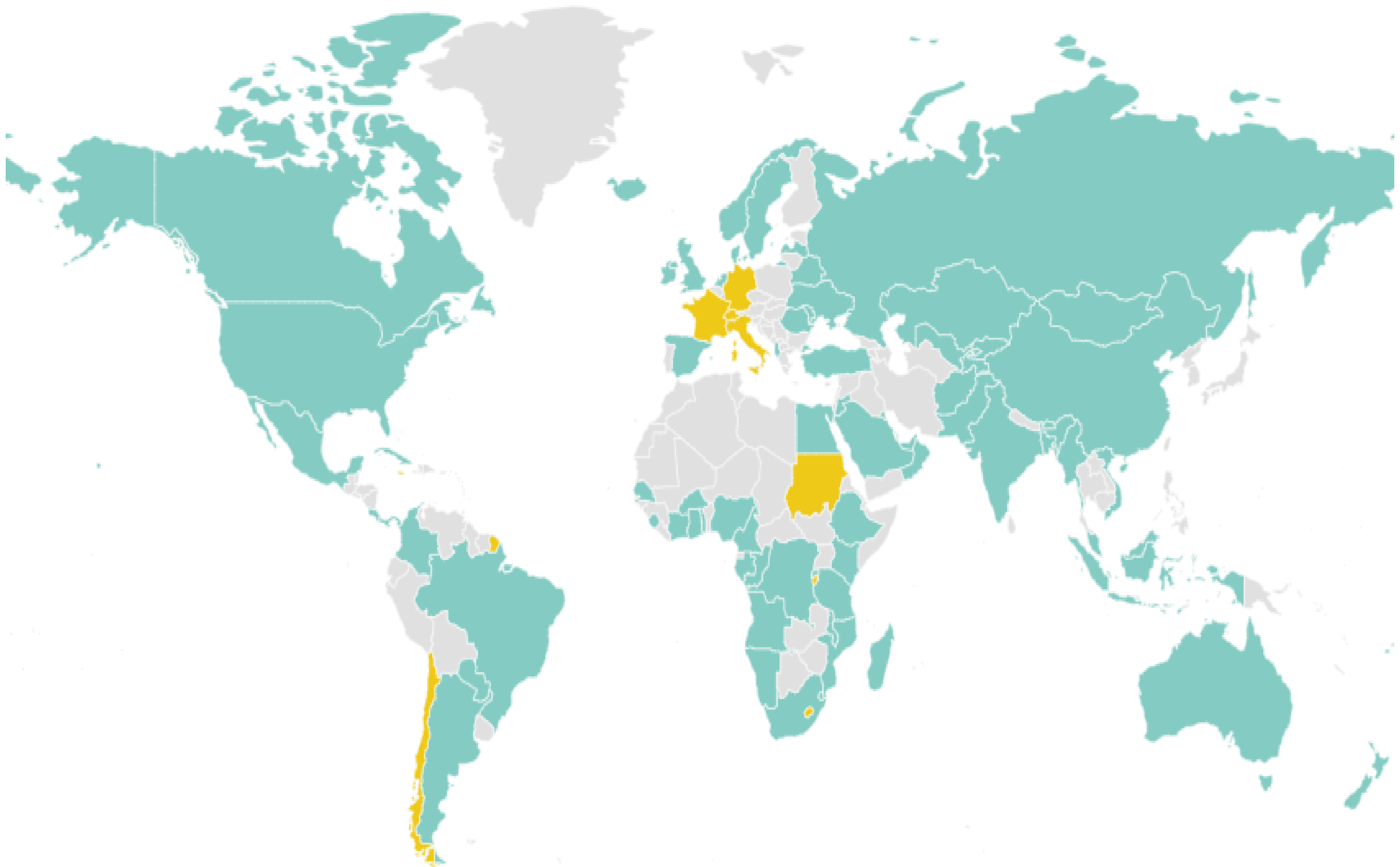
LEGAL OBSTACLES in using asset-based financing and leasing, particularly in cross-border transactions, without uniform law:

- Traditional conflict-of-laws approach not suited to assets moving across frontiers

- Legal systems vary in their approach to recognition of security interests, the process for enforcement, and the remedies available: domestic laws on secured transactions often not suited to the needs of modern financing

International success of the Cape Town Convention: the example of the Aircraft Protocol

STATUS MAP OF THE PROTOCOL TO THE UNIDROIT CONVENTION ON INTERNATIONAL INTERESTS IN MOBILE EQUIPMENT ON MATTERS SPECIFIC TO AIRCRAFT EQUIPMENT - SIGNATURES, ENTRY INTO FORCE



Political acceptance

- CTC: 85 contracting States + European Union
- AP: 82 contracting States + 1 European Union

Volume of transactions

- More than 1.5 Million registrations in the AP Registry since 2006, over 1 trillion USD in value of collateral

Proven economic benefits

- "Cape Town Discount" for Export Credit Agencies under OECD sector understanding (10% discount applicable when debtor is located in a CTC contracting State)
- Improved rating in recourse to capital market debt financing (leasing agreements)

CTC & Aircraft Protocol cover more than half of global financing in the aviation sector

What are the factors that concur in the success of this treaty?

- **Expected benefits: CTC improves access to credit in key economic sectors, overcoming the legal obstacles to asset-based financing and leasing which exist in the absence of uniform law:**
  - One harmonized system: increased legal certainty
  - One global on-line registry: efficiency and transparency
  - Clear system of priorities
  - Efficient enforcement
  - Protection in insolvency
- **Innovative approach to treaty making: The Cape Town Convention treaty system introduced innovations in treaty making, that helped enhance the effectiveness of the legal regime and the political acceptance of the treaty**
  - Great flexibility
  - Non-invasive: coexists with national systems of secured transactions
- **Resilience of the instrument and response to new demands at international level: The Cape Town Convention has proven to stand the test of time faced to supervening circumstances, and responds to the challenges posed by sustainable growth international goals**

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The CTC as a tool to facilitate and improve international access to credit in key economic sectors

KEY LEGAL FEATURES OF THE CTC AS APPLIED TO ALL PROTOCOLS:

- **INTERNATIONAL INTEREST:** Parties can create an autonomous "international interest" over the equipment, deriving from a security agreement, a conditional sale or a lease agreement; this interest does not displace existing domestic law but offers parties an additional option
- **INTERNATIONAL REGISTRY:** A dedicated international asset-based and wholly electronic registry ensures transparency and predictability as well as effectiveness as against competing creditors and in insolvency – need for an internationally binding instrument to achieve this objective
- **CLEAR PRIORITY RULES:** The registry provides a clear rule for determining priorities, including as against competing interests in domestic law, with limited and well-defined exceptions
- **EFFECTIVE ENFORCEMENT MEASURES FOR CREDITORS:** CTC provides effective and swift enforcement measures, including out-of-court remedies, if Contracting States so agree, and including advance relief pending final determination during court proceedings
- **EFFECTIVENESS IN INSOLVENCY:** Creditors can exercise their remedies in the insolvency of the debtor
- **ENHANCED CREDITORS' PROTECTION THROUGH ASSET-SPECIFIC PROTOCOLS:** Protocols allow States to make declarations which strengthen creditor's rights in enforcement and insolvency, in order to maximise the Convention's economic benefits

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KEY ELEMENTS

- **CTC provides Legal Clarity:** it is **one system for all financing transactions on certain assets**, one everyone can understand, based on a **few basic ideas** which are now identified with **international best practice**, and with **flexibility** thru system of declarations
  - ✓ one type of security interest (international interest)
  - ✓ regulated in one general convention and a protocol
  - ✓ with clear rules in case of stress for the transaction (when it matters)
- **CTC provides Legal Certainty:** in its most relevant facets, namely
  - ✓ **Macrolevel**: legal protection ***from ex post state action*** by domestic law and relative isolation from political action
  - ✓ **Microlevel:** legal certainty concerning the ***rights of the parties to a legal transaction***
- **CTC offers operational efficiency:**
  - ✓ **One international registry,** on line, state of the art technology, user friendly, accessible world wide
  - ✓ Very **low cost of use,** especially in relative terms

CLEAR, CERTAIN, EFFICIENT, NEUTRAL = RELIABILITY

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BENEFITS OF CTC SYSTEM TO PARTIES

- Advantages for **financing institutions**:
  - Reduction of due diligence costs (debtor & country risk)
  - Reduction of risk of damage derived from default: see the OECD discount for the
  - Possibility to increase business (more credit, both for export and imports)
- Advantages for the **industry:**
  - More financing available, cheaper: relevant even for countries where already financing is available
  - Increase in scope of export countries: more legal certainty, less debtor risk
  - Increase in business activity
- Advantages for **suppliers**
  - Cheaper financing, increased business (derived from increase in exports/industry activity)
- Advantages for the **State**
  - Growth, higher tax collection, international influence, etc.

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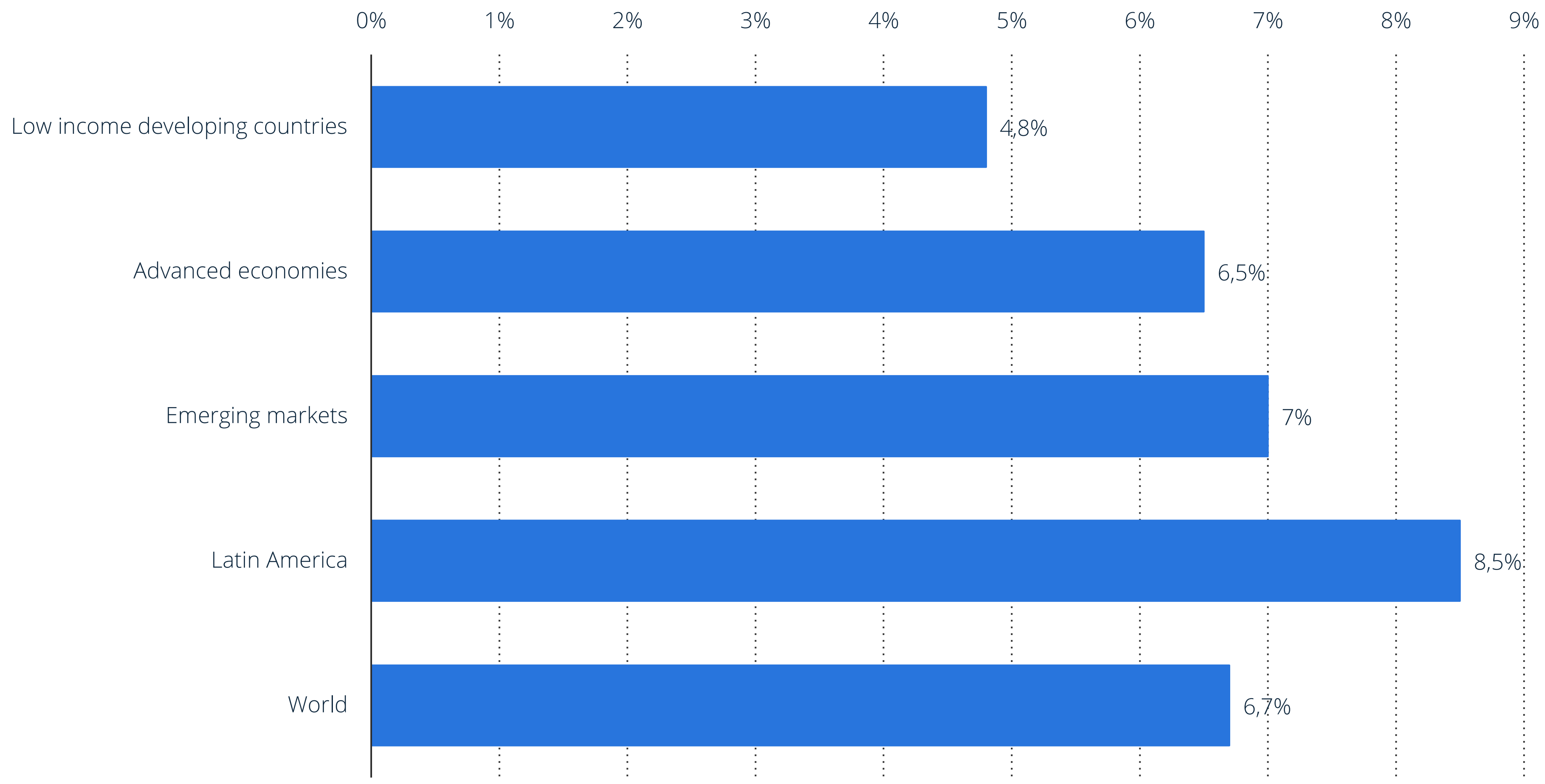
AN INNOVATIVE APPROACH TO TREATY MAKING

- **FLEXIBILITY IN THE ARCHITECTURE OF THE TREATY SYSTEM: The treaty system consists in the main Convention, that provides a common core of uniform rules, and separate Protocols that while maintaining a basic common approach, adapt it to the needs of the particular equipment/market. The Convention only applies in connection with one Protocol, and the Protocols prevail over the Convention.**
- **FLEXIBILITY THROUGH DECLARATIONS: Contracting States cannot introduce reservations, but have the possibility to make declarations to the Convention and to the Protocols, to achieve different purposes:**
  - **E.g., States can adapt the international legal regime to achieve internal policies (e.g., to protect certain domestic non-consensual interests, such as those securing the rights of employees to unpaid wages or social security contributions, for policy reasons)**
  - **E.g., and more interestingly, States can enhance the economic effectiveness of the legal regime by opting into rules strengthening the position of creditors in enforcement and in insolvency**
- **INCLUSIVE TREATY NEGOTIATIONS: Negotiations of the Convention and its Protocols allowed for participation not only of international experts, governmental experts, and intergovernmental or international organisations, but also to representatives of the stakeholders in the relevant industries.**

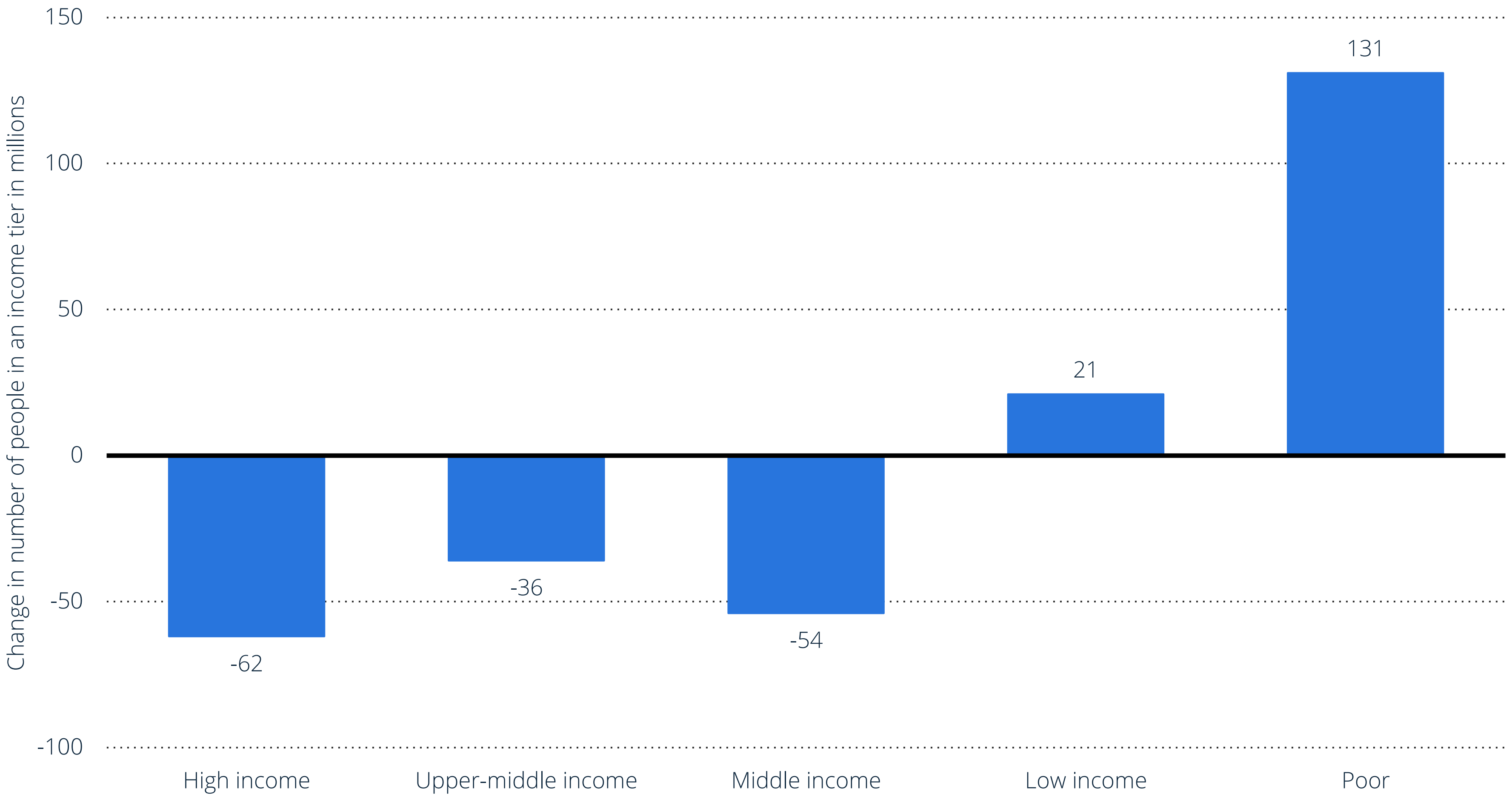
CTC IN TIMES OF DISTRESS (I) COVID PANDEMIC AND ITS CONSEQUENCES

- **COVID generated crisis is one of its kind:**
  - ✓ Almost **simultaneous, global, affecting directly or indirectly the vast majority of economic** sectors
  - ✓ Millions of **contracts** and economic exchanges suffered **interference**
  - ✓ **Transport sectors** (goods and persons) most directly affected: aircraft, rail; primary sector (MAC) also indirectly

Share of GDP lost as result of COVID-19) in 2020, by economy



Change number of people in selected income tiers due to COVID-19 pandemic worldwide in 2020 (in millions)



CTC IN TIMES OF DISTRESS (II)

- **And things are likely to worsen due to additional harzards:**
  - ✓ **Softer effects** on *developing economies* only **apparent**: effects take longer due to structure of value chain; numbers also less clear, more limited availability
  - ✓ Crisis happens in **historic moment from a monetary policy** standpoint:
    - ❖ Unprecedented amount of liquidity in the system, extremely low interest rates
    - ❖ Liquidity substantially enhanced as instrument to contain COVID-generated crisis

Remember the situation cannot last or global debt will become incontrollable (if not already)

Inflation to be added to the picture, CBs moving towards liquidity crush

Eventually **shortage of credit** may become **increasingly evident** (already happening in some sectors/countries)**:**

- ✓ **Crisis hitting banking sector already: <u>regulatory response</u> may make things worse**
- ✓ **Shortage of domestic credit**
- ✓ **Shortage of international credit/investment**

Project-based lending under threat

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HOW CAN CTC HELP?

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LEGAL CERTAINTY

- For the reasons explained, **CTC** offers **unparalleled legal certainty,** which is exactly what **lenders, financiers and investors need** in a situation of **volatility** and **drainage of credit for business projects, both nationally and internationally:**
  - ✓ **Increasing asset-based financing** (also as **complement to project-finance** structures) would substantially **reduce the ensuing regulatory problem and overcome bad local systems**
  - ✓ **CTC system** has proven **enormously resilient** to date even under the **most complex circumstances:** widespread financial distress of strong, politically well-connected debtors
  - ✓ **CTC** is an **international convention/treaty** and hence must be **complied with** by CTC jurisdictions to avoid breach of international duties under the **Vienna Convention on the Law of Treaties**:

Article 27

Internal law and observance of treaties

A party may not invoke the provisions of its internal law as justification for its failure to perform a treaty. This rule is without prejudice to article 46.

Article 46

1.A State may not invoke the fact that its consent to be bound by a treaty has been expressed in violation of a provision of its internal law regarding competence to conclude treaties as invalidating its consent unless that violation was manifest and concerned a rule of its internal law of fundamental importance.

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REDUCING THE COST OF FINANCING

- **Cheaper financing is the key to sustainable recovery**

  - ✓ It will allow **cheaper credit** to flow from the **private sector**
  - ✓ It could also be **used by public sector** to finance **strategic sectors** limiting its own country-risk (sovereign insolvency is no longer something in history books)
  - ✓ It could prove **key in new business projects**: ie, ITA
  - ✓ It should be essential in **less capital-intensive, more volatile sectors:** the **MAC Protocol** should make a difference in accessing cheaper credit in weakest markets whose economies are based on MAC sectors (start of value chain)

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HYPOTHETICAL EXAMPLE OF CTC SAVINGS (EXPORT CREDIT)

One Widebody Aircraft	CTC Savings
Estimated Cost **$140 million**	Cape Town Discount 10% **1.114%**
Financing amount 85% **$119 million**	Discount **$1.33 million**
Risk Category 6 **11.14%**	

Savings under the ASU "Cape Town Discount" **more than $1 million per aircraft**

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HYPOTHETICAL EXAMPLE OF CTC SAVINGS (CAPITAL MARKET)

One Widebody Aircraft

- Estimated Cost
  $140 million
- Financing amount 85%
  $119 million
- B+ Credit Airline
  Best offer - Bank Debt
  Libor + 255bp

CTC Savings

- Cape Town enabled EETC
  Resulting Financing Cost
  Libor + 173bp
- Savings achieved by using
  CTC enabled EETC
  More than $6.5 million per aircraft over life of the loan*

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UNBURDENING OF COURTS AND EFFECTIVE ENFORCEMENT

- **Strict compliance with CTC agreement** should **limit litigation considerably:** CTC contracts unaffected by force majeure/hardship open renegotiation schemes
- **Strict, efficient enforcement mechanisms** should prove especially relevant in the aftermath of the crisis:
  - ✓ no involuntary grace periods, etc.
  - ✓ Deregistration (where applicable), CTC self-help remedies should allow creditors to steer clear of courts when they will likely be under stress
- **CTC should help unburden Courts, and the court system** (bailiffs, officers of the court, etc). This ought to alleviate ordinary functioning of legal system and ultimately bring about savings for CTC States
- **Also CTC as substitute for dysfunctional domestic secured transactions systems (MAC)**
- **AWG's CTC compliance index**: transparency and technical assessment

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PROTECTION IN INSOLVENCY AND COMPLEMENTING DOMESTIC SYSTEMS

- **CTC protects against cram down in insolvency situations**
- **CTC** and the **theory of "rational selection"** in insolvency situations:
  - ✓ CTC **allocates rights**, offering legal certainty: it **does not impose enforcement** or any other behaviour, merely places creditor in strong negotiating position
  - ✓ Often, **creditors will negotiate if in their interest**. Not infrequently, **interest aligned** with that of debtor:
    - ❖ If debtor **viable business**, **continuation of business** (esp in oligopolistic markets)
    - ❖ Avoiding **repossession** when **too burdensome** (additional costs) or in **inadequate time** (no alternative use)
    - ❖ Other enforcement mechanisms (**sale) may not work when general crisis** (low credit, low activity, low demand low price in sale)
  - ✓ To some extent, **CTC creditor** (like other sophisticated creditors) become **key in valuation of viability of business**. This can prove positive, at least in less developed markets where alternative decision-makers are not in a position to make rational decision or conflicted
    - ❖ Paradoxically, asset-based financiers end up as ultimate business model (project) appraisers

ACADEMIC EVIDENCE ON CTC EFFICIENCY. SOME EXAMPLES

Evidence on pre-CTC scenario:

- Aircraft sold by airlines that file for bankruptcy are under-maintained and have lower quality than aircraft owned by non distressed US airlines
- Adjusting for quality reduces the fire sale discounts to about 8-10%
- Buyers of distressed aircraft are more productive than the distressed sellers

Post-CTC Scenario

- Author used CTC ratification to estimate impact of stronger creditor protection on aggregate productivity through reallocation of aircraft and credit
- Productivity increases: estimates monthly flying hours/aircraft increase by 12% following adoption of CTC
- More efficient airlines with higher aircraft utilization rates expand, buy younger/ more modern aircraft, at expense of less efficient users. Post reform 25% of firms experience contraction. Least productive airlines downsize and exit
- Channel for reallocation:
  - ✓ Faster redeployment of aircraft from less productive airlines to new users: reduction from 10 months to 4
  - ✓ Foreign lenders increase their lending by 10% on average
  - ✓ More innovation in the industry
- Countries with weaker creditor rights gain the most from the Convention, e.g. India
- Increase in competition: drives emergence of low cost airlines
- Other benefits: greater safety and increase in consumer satisfaction

- Evidence on fire sales, productivity and misallocation: Franks, Seth, Sussman and Vig (2021)
- "Globally consistent creditor protections, reallocation and productivity", Bian 2021

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