

THE 2001 CAPE TOWN CONVENTION  
ON INTERNATIONAL INTERESTS IN MOBILE EQUIPMENT



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## **Position of the Rail Working Group on the application of the OECD Sector Understanding on Export Credits for Rail Infrastructure (RSU)**

### **Written Submission**

Consultation between Civil Society Organisations and Members of the OECD's Working  
Party on Export Credits and Credit Guarantees (ECG) and the Participants to the  
Arrangement on Officially Supported Export Credits

OECD, 14 November 2017



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### **About the Rail Working Group**

The Rail Working Group (RWG) is a global non-for-profit rail industry association focusing on the introduction of the Luxembourg Rail Protocol to the Cape Town Convention on International Interests in Mobile Equipment. Based in Switzerland, it has about 70 direct members and hundreds of additional rail stakeholders represented indirectly by various industry organisations which belong to, and support, the objectives of the RWG. It currently has 22 national or regional contact groups across the world, tasked with working constructively with government officials and the local industry as the Protocol.

### **The Luxembourg Rail Protocol**

The Cape Town Convention on International Interests in Mobile Equipment (the Cape Town Convention) was adopted, together with the aircraft protocol thereto, at a diplomatic conference in Cape Town South Africa in 2001.<sup>1</sup> The Cape Town Convention creates a new international system to protect the rights of creditors financing high value mobile equipment, which rights are registrable and searchable at an international registry, accessible 24/7 through the internet. Both the Cape Town Convention and the aircraft protocol entered into operation in March 2006 and are now in force in close to 70 countries. The international registry for recording creditor interests in aircraft, based in Dublin, has accepted over 800,000 registrations since 2006. By making private sector finance more secure and reducing creditor risks, these instruments will reduce the cost of finance for operators. The Aviation Working Group estimates that the adoption of the Cape Town Convention and the aircraft protocol will save the industry billions of dollars in the coming years.

The Luxembourg Rail Protocol, extending the Cape Town Convention to the rail sector, was adopted in 2007 at a diplomatic conference in Luxembourg. The Protocol will make it much

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<sup>1</sup> The principal sponsor of the Convention is UNIDROIT, the International Institute for the Unification of Private law, an intergovernmental organisation, founded in 1926 and based in Rome.



easier for the private sector to finance railway rolling stock worldwide. Railway rolling stock is very broadly defined and includes any vehicle which runs on tracks or above, on or under a guide way. This means that not just conventional rolling stock but also light rail, metro trains and trams are covered by the Protocol.

The Protocol will provide a new system of international security rights for creditors (conditional sellers, secured lenders and lessors) whose interests will be registered, and searchable 24/7, at an international registry to be based in Luxembourg. It will enhance the creditor's rights in relation to its repossession of the collateral on default or insolvency of the debtor. Moreover, the introduction through the Protocol, of the first public registry of creditor security interests and a new global unique identification system for rolling stock will bring real practical benefits for creditors. It applies if the Protocol is generally in force and has been ratified by the state in which the debtor (and not the equipment) is located.

The Luxembourg Protocol will facilitate banks and other financiers providing finance to support much needed new rolling stock procurement without state guarantees. It will lower the barriers to entry for operators, encourage entrepreneurs and lead to a more competitive and dynamic rail industry worldwide – bringing important social, environmental, developmental and economic advantages to the world community.

The Luxembourg Rail Protocol is not yet in force. It has been ratified by the European Union, in respect of its competences, as well as by Gabon and Luxembourg. Italy, Germany, France, Mozambique, Sweden, Switzerland and the UK have all signed the Protocol and are moving towards ratification. Other EU and non-European states are now actively working on adopting the Protocol. At least four ratifications are required before the Protocol can enter into force and this is expected by mid-2019.

## **The Increasing Importance of Private Finance**

Historically the public sector has been the principal source of finance for procurement of rolling stock. However, this is changing. Government resources and budgets are restricted with the finance ministry is constantly juggling conflicting priorities. Generally, there remains a need for government engagement for the financing of rail infrastructure but there is a growing recognition that governments do not need to allocate precious resources to rolling stock where the private sector is perfectly able to provide those resources as long as its collateral for providing such finance is secure.

Reports commissioned by the Rail Working Group from consultants Roland Berger and published in 2016 and 2017<sup>2</sup> have highlighted two clear trends. Firstly, there is a direct correlation between liberalisation of the rail sector and the need for private finance. Secondly, as the market liberalises around the world, private finance is playing an increasingly important role in new procurement programmes for rolling stock<sup>3</sup> and this trend is expected to continue and accelerate, particularly in relation to the financing of freight rolling stock. On the other hand, non-conventional sources of finance are opening up for the rail sector. Private equity funds and institutional investors (for example pension funds) view rolling stock as an attractive long-term investment.

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<sup>2</sup> Available at <http://www.railworkinggroup.org/documentation/articlesreports/>

<sup>3</sup> In Europe this will be over 20% now



With the increasing interest of investors and enhanced security, the costs of financing railway equipment should decrease where the Luxembourg Protocol applies. For banks and other financial institutions, the decreased risk will permit them to reduce their capital provisions and therefore lead to lower bank margins. The Protocol will also reduce legal, documentation and transaction structure costs. In addition, by providing a new and effective mechanism to secure operating lessors, it will increase the availability of operating leases leading, in turn, to a more competitive rail sector as new, less heavily capitalised, operators enter the market. By creating a cost benefit, in terms of residual value assumptions, for standardised rolling stock, the operating lease will also facilitate economies of scale at the manufacturer level.

## **The Aircraft Sector Understanding (ASU)**

Following the adoption of the Cape Town Convention and the aircraft protocol, Export Credit Agencies agreed, under the auspices of the OECD, to a sector understanding on export credits for civil aircraft<sup>4</sup>. Often referred to as the Aircraft Sector Understanding or ASU, the initial agreement in 2007 has been revised and the most recent iteration entered into force in 2014<sup>5</sup>. A key provision of the ASU is that, subject to certain declarations being made by contracting states when adopting the Cape Town Convention and the aircraft protocol, ECAs will be permitted to reduce their risk premiums by 10% where the Cape Town Convention and the aircraft protocol apply to a specific credit. This is sometimes referred to as the "Cape Town Discount". Currently<sup>6</sup> 27 countries fulfil these conditions.

## **The Rail Sector Understanding (RSU)**

The Rail Sector Understanding agreed under the auspices of the OECD,<sup>7</sup> came into operation in 2014. Despite its name, it applies both to rail infrastructure and rolling stock and sets out agreed criteria for ECA support. In many respects, it is a more conventional document than the ASU, applying the standard criteria for ECA credit support to the rail sector. Within certain parameters stipulating maximum tenor of supported credits, interest rates and amortisation periods, ECAs have considerable discretion as to how they price support for rolling stock exports. The original Understanding was due to expire at the end of 2017. We are pleased to note that it has now been extended for a further three years.

Some industry stakeholders, particularly the manufacturer community, have questioned the restrictions on ECA support for exports of rolling stock. It can be argued that eventually ECAs should have more liberty to offer or support credits with a longer tenor and at a lower interest

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<sup>4</sup> Sector Understanding on Export Credits for Civil Aircraft agreed by the Participants to the Arrangement on Officially Supported Export Credits

<sup>5</sup> 1 September 2011

[http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=tad/asu\(2011\)1&doclanguage=en](http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=tad/asu(2011)1&doclanguage=en)

<sup>6</sup> As at March 2017

<sup>7</sup> Sector Understanding on Export Credits for Rail Infrastructure agreed by the Participants to the Arrangement on Officially Supported Export Credits of 20<sup>th</sup> December 2013,

[http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=tad/pg\(2013\)14/Final&doclanguage=en](http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=tad/pg(2013)14/Final&doclanguage=en)



cost compared to the current understanding. The purpose of this paper however is to deal with a different aspect of the Understanding.

Our suggestion to ECAs is that whatever the level of support under current or future iterations of the RSU, ECAs should abide by three principles, which should be applied concurrently and successively, i.e. one after the other.

### **Commercial Criteria**

Firstly, ECAs need to differentiate and improve their offered conditions depending on whether the debt is collateralised with the financed equipment and Luxembourg Rail Protocol is applicable to the credit concerned, taking into account the enhanced security which will then be available. We would call these the “Preferential Factors”. Moreover, it is important to recognise that the Protocol will be creating a *common* system across many jurisdictions for securing creditors. That in itself has a real value in terms of attracting investment as well as when repossession is required. We recognise that ECAs need to take into their risk assessment the comparable analysis of private sector funders. But we would respectfully suggest that therefore since private sector funders will undoubtedly reflect in their rates the benefit of the Preferential Factors, particularly where the debtor creditworthiness is limited, ECAs should do the same. So this should be, we would submit, the first guiding principle of ECAs when setting the applicable rates.

### **Buyer and Country Risk**

We believe that in certain circumstances private sector borrowers, financing railway rolling stock, can be a more secure debt, assuming that the Preferential Factors apply – that the finance is collateralised by the rolling stock and the Luxembourg Protocol applies, than an uncollateralised state credit. We understand that the consensus amongst ECAs is that, whilst the individual debtor risk (sometimes known as “buyer risk”) can be discounted, possibly down to zero, the country risk classification<sup>8</sup> is a fixed benchmark from which deviation is not possible. So if the country risk classification is 7, ECAs cannot offer terms based on a better country risk than that of the state in which the debtor is located or, put another way, funding rates cannot be less than the government borrowing rate in the state where the debtor is located.

We submit that this approach is flawed in relation to financed rolling stock because it

- does not differentiate between static collateral – for example infrastructure – and equipment which by its very nature moves across national boundaries, so the location of the debtor may not be a critical factor in repossessing equipment in another jurisdiction
- does not take into account the fact that in certain circumstances the buyer risk can be better than the country risk where the Preferential Factors apply<sup>9</sup>
- can be “gamed” by a debtor being set up in a state with a better country risk rating,<sup>10</sup> especially where the financed equipment is moving across national or jurisdictional boundaries.

But if our submission is, at least for the time being, not acceptable to ECAs, we would argue strongly that where the Preferential Factors apply, ECAs should use their discretion to discount buyer risk to zero or close to zero, since the state is effectively guaranteeing that the legal

<sup>8</sup> See <http://www.oecd.org/trade/xcred/cre-crc-current-english.pdf>

<sup>9</sup> Where for example the debtor in Mozambique is RTZ is rated A- by S&P or Vale BBB compared to Mozambique which has a sub-junk status.

<sup>10</sup> say South Africa (4) rather than Mozambique (7)



system will respect and enforce the creditor collateral *even where* the state does not explicitly or implicitly guarantee the debt itself.

### **Applying the Cape Town Discount**

The third principle is this. We consider that, since the railways offer more societal benefits compared to aviation, particularly environmental, it would be perverse if Export Credit Agencies, either owned or supported in most cases by OECD member states, would offer worse terms on financing of railway rolling stock, when the Cape Town Convention is applied by the Luxembourg protocol to railway equipment, than would be applicable to aircraft than the respective aircraft protocol applies. We fully understand that there is no direct analogy between the ASU and the RSU but we would still argue that *at the very least*, the 10% Cape Town Discount now available to a large number of states in relation to aircraft finance should also be available, for rolling stock finance. We would argue that in fact the discount should be higher.

We fully appreciate that it is not possible simply to transpose the formula used in the ASU into the RSU since the methodology concerning credits is different. It is accepted that there is no automatic base figure to which the discount can be applied. But we stand ready to work with ECAs, on an individual or on a collective basis, to work through the detail of how such a principle can be implemented in a fair, consistent and reasonable way.

### **Publicity**

We do not advocate developing the RSU into a new highly complex document to compare with the ASU. But it is very important that any application of the principles we advocate is, in one way or another, communicated to both manufacturers and their customers as well as to commercial banks providing initial credit for procurements of rolling stock across the world. This will assist manufacturers and make their offerings potentially more competitive against fierce global competition. It will also encourage states where the borrowers are located to move forward expeditiously with the adoption of the Luxembourg Rail Protocol, in turn creating the more favourable conditions for exporters from OECD states. We know that the potential availability of cheaper funding through ECA support in relation to aircraft purchases once the aircraft protocol to the Cape Town Convention applied, was a key factor in the speedy take up of the protocol by many states. In time, we would suggest that the principles are incorporated into a future iteration of the RSU, but this could be potentially a lengthy process and manufacturers need support now. Preferably we would request that a statement or memorandum issued collectively by the ECAs, confirming that ECAs will take into account the three principles enunciated above when setting the levels of credit support. If this is not immediately possible we would ask that individual ECAs are permitted to make such statements.

### **Conclusion**

More investment is urgently needed in railway rolling stock, both urban (trams, metros etc) and inter-urban, in the passenger and freight sectors. There is a growing trend for railway rolling stock to be financed from the private sector. The Luxembourg Rail Protocol to the Cape Town Convention will create a new system of rights and priorities for creditors in the rail industry worldwide and for the first time, a global public registry of security interests in rail equipment. In so doing, it will significantly reduce risks for lessors of railway rolling stock, as well as for creditors lending secured on railway rolling stock, where the debtor is in a state



which has ratified the Protocol and the Protocol has generally entered into force - expected mid 2019.

The sister protocol, for the aircraft sector has been in force for over 10 years and is saving debtors many billions of dollars each year. In addition, under the Aircraft Sector Understanding, agreed by ECAs which are members of the OECD, ECAs are reducing risk premiums by 10% when the protocol is applicable and certain declarations have been made.

The Rail Sector Understanding, which is not directly comparable to the agreement for aircraft, gives ECAs considerable latitude, within certain parameters, as to how they price credit support for exports of rolling stock. We welcome the extension of the Rail Sector Understanding through to the end of 2020. The Rail Working Group argues that when the credit is secured against the rolling stock being financed and the Luxembourg Protocol applies to the debtor, the rates offered by the ECAs should

- be reduced to the maximum extent possible, within the parameters set by the RSU, to reflect the decreased risk in line with the position which will be taken by private sector lenders
- exclude any material “buyer risk”; and
- at least match the additional benefits given to the aircraft sector under the Aircraft Sector Understanding (credit charges reduced by 10%)

We also ask that either collectively or individually, ECAs should communicate such policy to manufacturers, operators and commercial financiers which in turn will encourage the adoption of the Protocol across the world.

We fully understand that ECAs will be pressured to improve their financial terms in order to assist the competitive position of rail manufacturers. Certainly, we would support a softening of the current parameters under the RSU. But we are not advocating here a “race to the bottom”; only that the rates for ECA support are a legitimate reflection of the genuine reduction in risk profile on secured rolling stock finance when the Luxembourg Rail Protocol applies. The Luxembourg Rail Protocol provides an opportunity for ECAs to provide additional support for their exporters, operating in a tough global market, in a fair and commercial way.

**For further questions, please contact**

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