THE 2001 CAPE TOWN CONVENTION
ON INTERNATIONAL INTERESTS IN MOBILE EQUIPMENT

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How can OECD export credit agencies (ECAs) further support Emerging Markets and Developing Economies?

The case for OECD ECAs to grant the Cape Town Discount on their premiums charged for underwriting railway rolling stock financing when the Luxembourg Rail Protocol applies

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Summary

- Emerging Markets and Developing Economies (EMDEs) urgently need to develop their rail networks. Public resources are heavily constrained, and even if private finance for railway equipment is available, it is often at a cost that is economically unsustainable.

- The Luxembourg Rail Protocol to the Cape Town Convention is an international treaty that makes it easier and cheaper for the private sector to finance railway rolling stock of all types[1]. It achieves this by:

  - Establishing a clear global framework stipulating creditor rights

  - Underwriting credit based on the collateral of financed equipment rather than on the credit-worthiness of the debtor

  - Establishing a common system that reduces the need for country-specific finance documentation and facilitates the cross-border operation of financed rolling stock

- The Luxembourg Rail Protocol has been in force since March 8, 2024. So far it has been adopted by six states together with the European Union in respect of its competences. More ratifications are coming, particularly in Africa, where it is fully supported by the African Union and the UN Economic Commission for Africa. The Protocol applies when the debtor/lessee is in a contracting state.

- Under the OECD Arrangement on Officially Supported Export Credits (the "Arrangement") and the Aircraft Sector Understanding thereunder, export credit agencies (ECAs) may discount their risk premiums by up to 10% (known as the "Cape Town Discount") when the Cape Town Convention and the Aircraft Protocol thereto apply, and certain declarations are made by the relevant contracting state.

- The Luxembourg Rail Protocol is very similar to the Aircraft Protocol, applying the Cape Town Convention to railway rolling stock rather than aircraft.

[1] From freight and passenger locomotives and wagons to trams, light rail train sets, rail infrastructure building and maintenance equipment (such as boring and tamping machines), cable cars and other vehicles running on tracks or above, on or under a guideway (Art. 1 (2) (e) of the Luxembourg Rail Protocol).

However, it introduces three key innovations that deal with specific problems that do not exist in relation to aircraft, namely:

- The first ever public registry at which a creditor's security interest may be registered

- A global, unique rail vehicle identification system (URVIS) applicable to all types of railway equipment

- Special UN Model Rules stipulating how rolling stock should be permanently marked with the URVIS number

- In addition, work is ongoing with the UN to introduce a mechanism for URVIS numbering to be incorporated into digital platforms, thereby making it possible for creditors to establish the location and status of financed railway equipment in real time. This enhances creditor security further by facilitating repossession on debtor insolvency or default (because the creditor knows precisely where the equipment is located). It also supports the creation of other security for creditors, including geo-fencing and maintenance monitoring.

- Accordingly, the incremental security given by the Luxembourg Rail Protocol to creditors, as well as to ECAs guaranteeing credits, should be reflected by lowering the total cost of credit. The Rail Working Group respectfully requests ECAs to amend the Arrangement to allow individual ECAs to implement a Cape Town Discount on the minimum premiums that can be charged in respect of the financing of railway rolling stock when the Luxembourg Rail Protocol applies. We believe that this should be at least 10% but probably higher, bearing in mind that:

  - Railways have a key role to play in the fight against climate change, offering the most environmentally efficient and safest way of moving goods and people in significant volumes, and

  - Railways are a significant factor in economic development and the regional integration of EMDEs.

In any event, given the clear environmental, social and economic benefits of rail compared to aviation, there can be no justification for ECAs offering a reduced premium when underwriting aircraft finance but not when underwriting rolling stock finance, when essentially the same conditions apply.

- We request that our proposal be adopted in principle by ECAs under the Arrangement at the earliest opportunity. The Rail Working Group stands ready to assist by participating in any committee or task force commissioned by ECAs to work out in detail how the Cape Town Discount should be applied to railway rolling stock.

Introduction

Railways are an essential part of any sustainable development strategy.

They enable the mass movement of freight and passengers in the most economically and environmentally efficient way, while being key to the regional and sometimes even intra-continental integration of economies. Moreover, where the alternative is transport by road, WHO figures[2] show that road traffic accidents result in almost 1.2 million deaths and 20 to 50 million people suffering non-fatal injuries worldwide, at a global cost of some 3% of GDP. By contrast, the number of injuries and deaths on the railways each year is minimal.[3] Moving the transport of freight and goods in cities from road to rail also results in significantly reduced congestion and pollution. As such, railways fulfil no less than nine of the 17 United Nations Sustainable Development Goals.[4]

In any major new rail project, the cost of the rolling stock generally represents between 20% and 30% of the total project costs; the balance is allocated to infrastructure. However, this ratio is beginning to change as:

- More technology is built into locomotives, removing the need for trackside signalling

- New propulsion systems using hydrogen, fuel cells, and battery technology potentially remove the need for expensive catenary

- Artificial intelligence opens the way to more intense and efficient utilisation of infrastructure.

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[2] World Health Organisation study 13 December 2023

[3] 92% of the world's fatalities on the roads occur in low- and middle-income countries, even though these countries have around 60% of the world's vehicles

[4] For more than this, see https://www.railworkinggroup.org/wp-content/uploads/docs/R0870.pdf

Taking into account the ongoing need to re-equip existing infrastructure with new rolling stock, financing options for rolling stock are becoming even more significant.

About 60% of the world's rail network is standard gauge track. Aside from supplies of rolling stock from China, the vast bulk of standard gauge rolling stock is manufactured in OECD states. However, in almost all developing economies governments are extremely short of resources. A recent article noted that 23 out of 40 African nations assessed by the World Bank are at a high risk of debt distress, or are already in distress.[5] As a consequence, if private credit is provided at all, it is made available at a high cost, which reflects the poor credit rating of the country where the debtor is based. This creates a debt trap: the high cost of credit makes actions needed to improve the economic structure of the state financially unsustainable.[6] One solution to this problem is to bring in private capital secured on the assets being financed rather than on the credit rating of the debtor (or the country where the debtor is located). But this must be done in a way that is as secure and cost-effective as possible for the debtor.

ECAs supporting the financing of railway equipment worldwide

ECAs have a critical role to play in supporting private financing of new railway rolling stock. Under the latest iteration of the OECD Arrangement on Officially Supported Export Credits (the "Arrangement"), introduced in July 2023[7], moving most railway rolling stock into the Climate Change Sector Understanding, the financial terms available when underwritten by export credit agencies have undoubtedly improved. But the cost of credit for developing states looking to finance new rolling stock is still too high. Critical opportunities are being missed to fight climate change and to support economic development and regional integration through investment in the railways.

The answer is to facilitate more and cheaper private credit to equip rail networks with modern rolling stock, where the debt provided by creditors is collateralised in a legally effective way by the equipment being financed.

A new tool for ECAs

The Luxembourg Rail Protocol to the Cape Town Convention on International Interests in Mobile Equipment creates a new worldwide legal framework for the recognition, enforcement and prioritisation of security interests held by creditors lending on, or leasing, all types of railway equipment. These security interests (each known as an

[5] *South Africa's G20 presidency: a chance to tackle the debt crisis* - Vera Songwe and David McNair, African Business December 16, 2024
[6] For example, 61% of African states currently have an OECD country risk classification of 7 (the worst) and another 25% a risk classification of 6.
[7] Updated in September 2024 at https://one.oecd.org/document/TAD/PG(2024)6/en/pdf

"international interest") are registered in a new International Registry, based in Luxembourg, and searchable by the public 24/7 online.

The Protocol introduces the Unique Rail Vehicle Identification System (URVIS), a new global 16-digit numbering system for permanently and uniquely identifying rolling stock. This number is issued on demand by the international registry. It cannot be recycled or duplicated. The international interest registered at the international registry must be by reference to the URVIS number.

The United Nations has now adopted global Model Rules on the Permanent Identification of Railway Rolling Stock (the Model Rules) setting out minimum standards for the permanent marking of railway rolling stock with URVIS numbers. Compliance with the Model Rules is a precondition for registering an international interest. Work is now ongoing with the UN Economic Commission for Europe to enhance the Model Rules further by creating a framework for integrating the URVIS numbers into digital platforms. This will allow creditors to know, for the first time, the precise location and status of the rolling stock they are financing in real time, in turn facilitating contract compliance as well as repossession of the financed equipment on debtor default or insolvency.

As a result, not only does the Protocol create enhanced security for financiers of railway rolling stock, and their guarantors, on a domestic level, by creating a commonly accepted set of legal rights for creditors, it also makes it significantly easier (and more secure) for financed equipment to move across national boundaries when a common treaty-based legal system applies.

The Luxembourg Rail Protocol provides an important opportunity for the export credit community to utilise a new tool to provide valuable, and cheaper, support to developing economies, when it comes to underwriting commercial financing of rolling stock, without compromising the risk profile of the ECAs.

The Protocol has been in force in contracting states since March 8, 2024. Gabon, Luxembourg, Paraguay, South Africa, Spain, Sweden, and the European Union in respect of its competences, have all ratified the Protocol (as well as the Convention). France, Germany, Switzerland, Mozambique, Italy, and the UK have already signed the Protocol and are moving at various speeds towards ratification. Many African states, including the Democratic Republic of Congo, Kenya, Namibia, Eswatini, Senegal, Ethiopia, Zimbabwe and Mauritius, are actively looking at adoption of the Protocol.

The Cape Town Discount

The Rail Working Group presented a detailed paper to ECAs, entitled "Effective and Fair ECA support for the Railways in Africa" in November 2023[8]. As its title suggests, the principal focus of the paper was on Africa, but many of the comments have general application to other EMDEs. The arguments set out there, which we do not intend to repeat, remain valid. At that stage, the Protocol had not entered into force, the regulations for the operation of the international registry had not been finalised and the international registry had not started operations, and the UN Model Rules had not been adopted. This has now changed.

The Cape Town Convention and the Aircraft Protocol thereto, applying the Convention to aircraft, were adopted in 2001, and are now in force in 84 countries. Under the Arrangement and the Aircraft Sector Understanding therein, ECAs may discount their risk premiums by up to 10% when the Aircraft Protocol applies. This is known in the industry as the "Cape Town Discount".

As we argued in 2023, it is neither reasonable nor equitable that ECAs are permitted to apply the Cape Town Discount to aircraft financings when the Aircraft Protocol to the Cape Town Convention applies, but not to the financing of rolling stock when the Luxembourg Rail Protocol to the same Convention applies, particularly taking into account ECAs' welcome concern to provide further assistance to EMDEs. Moreover, there is a strong argument that the Cape Town Discount should be higher than 10% in light of the clear policy of the OECD ECAs to favour financing of more environmentally friendly assets, as well as the clear social and economic benefits of supporting development of the railways. In addition, as EMDEs will often be designated as high risk under the OECD country risk classification, the benefit of the Cape Town Discount in monetary terms is proportionately higher – and makes a significant difference to the present value cost of procurements in these states.

And to be clear, this is not charity. As already elaborated in our 2023 paper, the Protocol delivers enhanced security to creditors and guarantors:

(i) It introduces into the local law of contracting states a clear legal framework guaranteeing the rights of creditors that are collateralised by railway rolling stock, either through leases or secured loans, and specifically making it easier, cheaper, and faster for such creditors to enforce their rights on debtor default or insolvency.

[8] https://www.railworkinggroup.org/wp-content/uploads/docs/R1034.pdf

(ii) This framework is effectively guaranteed by virtue of the Protocol having the status of an international treaty[9].

(iii) It will be a common framework operating in neighbouring countries, thereby providing more security when rolling stock crosses jurisdictional boundaries.

(iv) A common set of rules leads to more standardised, and cheaper, local country due diligence and documentation.

(v) The international registry created under the Protocol for the first time provides a public registry where parties providing secured credit for rolling stock can register their security in a public registry searchable 24/7 through the internet, thereby creating an active defence against fraud, as well as governing the priority of competing security interests.

(vi) The unique rail vehicle identification system (URVIS) introduced by the Protocol establishes the first ever common global system for uniquely identifying rolling stock, thus supporting finance collateralised by the asset, irrespective of country or debtor risk.

(vii) The UN Model Rules create a global minimum standard for physically marking railway rolling stock with the URVIS number, and the planned extension of these rules to create a system for integrating this number into digital platforms will enhance creditor security further by making it easier for creditors to track in real time, and if necessary repossess, financed railway equipment.

(viii) The Protocol, by underwriting operating leases and reducing rentals when the residual values are higher, opens the way for a more extensive secondary market in railway rolling stock. It creates an incentive for more standardised and interoperable rail equipment[10], as well as facilitating a more dynamic rail market by removing the financial barriers to entry for competitors[11].

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[9] Article 27 of the Vienna Convention on the Law of Treaties states that "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 of the Vienna Convention states that "[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."

[10] With the additional benefit of manufacturing economies of scale being reflected in lower unit costs for rail equipment.

[11] i.e. the need to be heavily capitalised.

The Luxembourg Rail Protocol clearly reduces creditor, and therefore guarantor, risk. Indeed, ECAs' extension of the Cape Town Discount to railway rolling stock would not only create an incentive for states to adopt the Protocol but also enhance the security of the lender/lessor in relation to *past* financings already guaranteed by ECAs[12].

Arguments against the Cape Town Discount for railway rolling stock

Sceptics make a number of arguments as to why the Cape Town Discount should not apply to railway rolling stock. We address a number of these arguments below:

(i) *Aircraft are a different type of asset and therefore easier to remarket than rolling stock.*

It depends entirely on the asset. Flatbed container wagons are ubiquitous and are relatively easily re-marketable. But rail equipment is procured to fulfil a specific requirement, and that requirement does not necessarily disappear even if the debtor has failed. Moreover, in underwriting operating leasing, the Luxembourg Rail Protocol creates an economic dynamic towards standardisation of rolling stock, since its residual value will be higher if it is standardised equipment, thereby reducing rentals and indirectly helping to reshape the market. Lastly, ECAs can encourage more standardisation through applying different levels of discount to financings of different types of railway equipment, not by denying the discount to the premium on all financings of railway rolling stock.

(ii) *It is easier to repossess and fly out aircraft than to repossess and move out rolling stock.*

This is partially true if repossession results in physically moving the rolling stock from one jurisdiction to another. However, if there is a regional common gauge system this does not preclude moving rolling stock within that regional system. And certainly, it is economically viable to transport the more expensive equipment to other non-contiguous same-gauge locations outside the jurisdiction. Moreover, banks often report that in the event of debtor default or insolvency, they look for ways to redeploy equipment, not repossess it. The Protocol directly facilitates this creditor remedy, making it easier to repossess and redeploy the rolling stock within a national or regional rail system.

[12] This is a complex issue, but although the Protocol can only apply to financings closed after the Protocol enters into force in the state in which the debtor is located, there are specific provisions relating to the preservation, and registration at the international registry, of creditor priorities on pre-existing interests (Article 60 of the Cape Town Convention as amended by Article XXVI of the Luxembourg Rail Protocol).

Furthermore, the Protocol obliges the local government to assist (assuming the Protocol is in force in the state concerned).

The Protocol also gives creditors more rights to enforce their claim against the collateral, and makes it easier to remarket equipment where, as in many cases, the rolling stock is fulfilling a public service and therefore, while the debtor may be replaced, there is still a clear need for the rolling stock. Lastly, the ease with which aircraft can be moved around also represents an incremental *risk* for creditors.

(iii) *The Aircraft Sector Understanding (ASU) is a highly complex document so it's too simplistic to transpose the same conditions to rolling stock.*

It is indeed complex (and that's not the fault of the rail industry) but that should not obscure the fact that the incremental security given by the additional provisions in an international treaty, particularly the privileged rights of recovery on debtor default or insolvency, has real value to a creditor. This should be taken into account by the ECAs when pricing – which is precisely why the Cape Town Discount is given under the ASU as long as the Aircraft Protocol to the Cape Town Convention applies (and not otherwise).

In fact, the additional security given to financiers of rolling stock under the Luxembourg Rail Protocol is *greater* than the comparable incremental security for aircraft finance:

- Aircraft have a global common unique identification system. However, this is not the position with rolling stock without the Luxembourg Rail Protocol.

- Creditors financing aircraft have the benefit of national aircraft registries at which their interests are registered and the 1948 Geneva Convention on the International Recognition of Rights in Aircraft. These benefits do not exist in the rail sector without the Luxembourg Rail Protocol.

- The international registry created under the Luxembourg Rail Protocol creates, for the first time, a public system for the registration of security interests in rolling stock. The URVIS numbering system is a game changer.

- The UN Model Rules create a global mechanism for permanently identifying and marking railway rolling stock with the URVIS number.

(iv) *The ASU requires an independent audit of a contracting state to ensure that all the necessary declarations are made and that they are binding on parties as a matter of domestic law.*

We find this process somewhat bureaucratic, but if this is what it takes, the rail industry will accept this as long as contracting state adoption of either Alternative A or Alternative C under art. IX (repossession on debtor insolvency) is accepted as compliance with the list of declarations required (there is no Alternative C under the analogous art. XI of the Aircraft Protocol). We stand ready to work with ECAs to find a fair and practical solution. This is not a reason for inaction.

(v) *It is easier to check the location and status of aircraft compared to rolling stock.*

This was the case in the past, but this is changing. The UN Model Rules now empower creditors to unequivocally identify items of rolling stock and they will soon be able to track the utilisation and location of the rolling stock in real time. Repossession rights have limited benefit if the creditor cannot clearly identify its collateral and has no idea where the rolling stock is located. This is a major improvement of the practical rights of the creditor providing secured financing of rolling stock when it applies.

The way forward

The rail industry accepts that the extension of the Cape Town Discount to railway rolling stock requires careful consideration. Implementation will need to take into account the structure of the Arrangement and have specific rules to ensure that the extension is not abused.

We propose a three-stage process:

(i) *Policy announcement*
At the outset, ECAs should agree a clear policy statement accepting the principle of extending the Cape Town Discount to railway rolling stock when the Luxembourg Rail Protocol applies to the debtor, and an international interest created by the credit is registered at the international registry.

This in itself will create a clear incentive for states around the world to move forward quickly with the adoption of the Luxembourg Rail Protocol, taking into account that international treaties take time to be ratified and then domesticated into national law.

(ii) *Detailed consultation and review*

We suggest that a task force or committee be established by the OECD Working Party on Export Credits and Credit Guarantees (the Working Party), mandated to establish:

- A detailed set of conditions on the application of the Cape Town Discount to ECA financings, or underwriting of financings, of new railway rolling stock exported by manufacturers in OECD states.

- If considered appropriate, the conditions under local law for access to the Cape Town Discount (in particular which declarations must be made by contracting states to make the benefits of this discount available).

- An audit system to ensure that the liberty given to ECAs to reduce their risk premiums is only exercised when the conditions are complied with.

The task force or committee should also consider whether a flat 10% reduction is the appropriate figure for the Cape Town Discount for railway rolling stock and make recommendations.

We propose that such a task force or committee would be open to participation by industry experts and representatives. The Rail Working Group stands ready to participate. We would hope that the OECD Secretariat can provide some support. The task force or committee would need to issue interim reports and consult with ECAs before coming to final conclusions.

(iii) *Formulation of detailed conditions*

Detailed conditions will need to be drafted, circulated for comment, and then presented to a future meeting of the Working Party for approval and for subsequent publication.

Conclusion

The building and operation of railway networks is fundamental to sustainable economic development in EMDEs. But governments in these markets are often very short of credit, and to make this work, private sector financing is essential. The easiest way to achieve this is to encourage the private sector to finance railway rolling stock at competitive rates. This supports developing economies as well as rolling stock manufacturers and their suppliers in OECD states looking to expand their markets, also helping them to compete effectively against suppliers in non-OECD states offering highly attractive finance packages.

The Luxembourg Rail Protocol provides significant incremental security to creditors. The risks will be reduced when it applies, and it is both logical and fair that this is reflected in the premium rates that ECAs offer. It will also allow ECAs to play a pivotal role in promoting the expansion and modernization of global rail networks and helping EMDEs develop in a practical and sustainable way.

The case for ECAs extending the Cape Town Discount on premiums for underwriting the financing new railway rolling stock under the Luxembourg Rail Protocol is overwhelming. It complements the strategic objectives of the Working Party to support environmentally sustainable projects and to provide important practical assistance, by facilitating cheaper finance for the export of railway rolling stock to EMDEs.

It cannot be right that the exports of aircraft is supported by the Cape Town Discount when the aircraft protocol to the Cape Town Convention applies, but the exports of rolling stock is not eligible for the discount, of at least 10%, when the rail protocol to the Cape Town Convention applies. Indeed, the level of the discount should be higher for railway rolling stock, taking into account the greater environmental, social, and economic benefits of the railways compared to aviation.

The extension of the Cape Town Discount to the financing of new railway rolling stock will require detailed consideration, with careful definition of the conditions to be complied with before the discount may be offered by ECAs, and the level of the discount. We propose a three-stage process in order to properly implement this extension. The Rail Working Group stands ready to assist where needed.

About the Rail Working Group

The Rail Working Group is a Swiss-based not-for-profit association focused on the adoption and implementation of the Luxembourg Rail Protocol. It has about 90 direct members, plus thousands of rail stakeholders represented indirectly by industry organisations that belong to, and support, the objectives of the RWG.

Contact us

For more on the Luxembourg Rail Protocol and the Rail Working Group

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