What the Luxembourg Rail Protocol means for the Finance Industry

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- Regulated by Basle Committee on Banking Supervision
  - developing a more robust banking system
  - developing resilient banking institutions

- Determinants of Capital held on a portfolio requires an estimation of:
  - PD (Probability of Default) – average percentage of obligors that may default in a rating grade in any one year.
  - EAD (Exposure at Default) – estimate of the outstanding amounts at the point of default
  - LGD (Loss Given Default) – percentage exposure a bank/financier may lose if the obligor defaults

- Interaction between ratings of a client and the LGD impacts differently on the pricing of a client
  - investment grade versus non investment grade
  - very few investment grade rail operators
  - impact on pricing from an LGD perspective is far more beneficial
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• FOCUS ON LGDS
  • secured interest in assets will help reduce this factor
  • reduced capital to be held against the obligor by the Bank
  • positive impact on the pricing

• CERTAIN REQUIREMENTS
  • Legal enforceability
    – in all jurisdictions, reflect a perfected lien over the asset, should also be realisable within a reasonable time
  • Objective Market Value
    – reflect the value of a willing seller – willing buyer within a reasonable market
  • Frequent Valuation
    – valuation to be monitored frequently (at least annually)
    – significant changes in value should be verified by an expert or professional valuator.
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• CERTAIN REQUIREMENTS (cont’d)

  • Insurance
    – against deterioration or damage of the asset.

  • Environmental
    – liability against the asset for environmental liability

  • Maintenance
    – asset should be maintained in good condition
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• Security over movable assets is challenging; more so when the assets cross jurisdictional borders

• The Aircraft Protocol to the Cape Town Convention created a central registry; provided protection of international interests which is recognised by all ratifying states/jurisdictions

• When the Luxembourg Rail Protocol was adopted,
  – it created a legal framework;
  – recognised and regulated the security interests of financiers as well as lessors and other interested parties;
  – are secured by rolling stock.

• Protocol provides a central registry
  – all parties register their interests;
  – creditors can check rival claims to related rail equipment

• Enables creditors to enforce security in default and insolvency situations
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• Unique new identification numbering system for rolling stock
  – rolling stock is defined very broadly;
  – includes both above and beneath the ground systems, light rail to high speed, freight and passenger rail, trams and subways, gantries and cranes an even airport shuttles

• When ratified by a country, state or jurisdiction;
  – protocol will govern that country, state or jurisdiction and all debtors therein;
  – does not differentiate on the type of financing structures.

• Protocol should secure cheaper financing;
  – by securing the financier/creditor;
  – cheaper financing from the private sector;
  – result in more competitive rail sector and industry
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• Sector previously funded by Governments;
  – strain an available funding resources;
  – networks and fleets deteriorated
  – shift to more private sector appetite with more access to funding;
  – improvement in networks and the state of the rolling stock;
  – apparent in SA a few years back when Transnet’s average fleet age was over 30 years;
  – governments can start focussing on funding, repairing and maintaining the infrastructure.

• Foster cross border trade corridors;
  – improve access
  – improve trade flows
  – where there are traversing rights / access rights to networks, even greater benefits
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• All parties will benefit;
  – whether funding originates from the banking sector or capital markets;
  – whether parties are financiers, lessors, lessees, or users
  – from the secured interest in the underlying rolling stock

• In certain circumstances funders may rely more on underlying secured interest in asset as opposed to the underlying obligor/credit counterpart

• ECA institutions
  – monitoring the position with regard to ratifying countries
  – make premium concessions, as they do in aircraft finance transactions, to countries that ratify the protocol.
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• Domestic transactions
  – Benefits for transactions where all parties and rolling stock are in the same jurisdiction
  – What might be initiated as a Domestic transaction, may change during the term;
    • the Lessor or Lessee’s domicile may change
    • financiers to the transaction may change
    • subleases to other counterparts whose principle place of business is in another jurisdiction
    • rolling stock may be manufactured in another jurisdiction and have a security interest created before it is imported to the jurisdiction of use
    • rolling stock may be transported to another jurisdiction (during or after primary transaction) during its lifetime

• Common registry
  • facilitate Local recording, international interests and universal numbering system
  • provide for real time monitoring of rolling stock for tracking, maintenance and insurance
  • provides for clear creditor rights on termination, defaults, insolvency and other
  • registry clearly publishes priorities between interested parties
  • prevents unnecessary restructures in security interests as transactions change
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• BENEFITS
  – Reduce financing costs to operators
  – Facilitate lending to customers with poor credit ratings or infrastructure
  – Attract more private sector funding into this industry
  – Facilitate the leasing industry

• FINANCIAL (over five years)
  – Investment Grade approx 45 bps
  – Sub Investment Grade approx 90 bps
  – Weak Credit approx 190 bps