

AWG

Aviation Working Group



International Air Transport Association

30 May 2001

Airbus Industrie
Co-Chair

The Boeing Company
Co-Chair

Bombardier

Boullouin Aviation
Services

Citigroup (Citibank
and Salomon
Smith Barney)

Crédit Agricole
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Deutsche
VerkehrsBank

Embraer

GE Capital Aviation
Services

General Electric
Aircraft Engines

International Lease
Finance Corporation

Morgan Stanley

J. P. Morgan

Pratt & Whitney

Rolls-Royce

Singapore Aircraft
Leasing Enterprise

SNECMA

Kreditanstalt für
Wiederaufbau
Consultative Member

Via Facsimile Message, Email and Courier

Basel Committee on Banking Supervision
Attn: Basel Committee Secretariat
Bank for International Settlements
CH-40002 Basel, Switzerland

**Re: New Basel Capital Accord/Consultative Document/Aviation-Specific
Comments**

Basel Committee Secretariat:

This comment letter on the above-referenced consultative document (New Capital Accord Document) is submitted to the Basel Committee on Banking Supervision (Committee) jointly by the Aviation Working Group (AWG) and the International Air Transport Association (IATA). AWG is an international grouping of major aviation manufacturers and financial institutions, whose members are listed in the left margin. The purpose of AWG is to consider and develop policies designed to facilitate advanced international aviation financing and leasing. IATA is the principal international organisation representing the world's airlines.

Introduction

1 The New Capital Accord Document is predicated on greater risk sensitivity. The use of financial collateral in the credit risk mitigation (CRM) parts of the standardised approach and the foundation IRB approach is an element of such risk sensitivity. Yet the blanket nonrecognition of *physical collateral* (save in respect of claims secured by residential property and commercial real estate) runs counter to that fundamental objective. Consequently, the New Capital Accord Document is insufficiently risk-sensitive.

2 In particular, the nonrecognition of *modern aircraft* in the CRM parts of these approaches disregards certain distinctive aspects of this type of collateral.¹ It is also likely to have a material adverse effect on the availability and cost of credit to the air transport industry,² a sector dependent on external debt financing for its capital requirements.³ These effects on extensions of aviation-related credit would have materially adverse spillover macroeconomic effects.⁴ The foregoing may differentiate modern aircraft from certain other types of physical collateral.

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3 In submitting these comments, we are mindful of the principal objections to the use of physical collateral in risk mitigation: *valuation difficulties*, including those related to cyclicity and volatility, and *realisation of security issues*. We address these items in principle below, and offer our assistance in examining them in greater detail.

Case for Preferred Risk Weighting for Claims Secured by Modern Aircraft

4 The case for preferred risk weighting for claims secured by modern aircraft is based on their comparatively low rates of loss-given-default (LGD),⁵ assessed historically and considered prospectively.

5 In this context, low LGD rates as a justification for preferred risk weighting have two essential elements. First, physical collateral must retain its reasonably anticipated cash flow-producing and resale values, measured objectively and over a reliable time period, taking into account industry cyclicity, and thus presumed asset volatility. Secondly, legal features and transactional practices must provide assurances that such values will be available to reduce loss.

6 Our experience, as leading actors in the sector, has been that modern aircraft have, in fact, retained their reasonably anticipated cash-flow producing and resale values over a reliable time period. To put the matter conservatively, we believe that an appropriate model⁶ and set of assumptions⁷ would identify a valuation tranche that could safely be taken into account in the standardised and foundation IRB approaches.

7 The exceptionally strong case for recognition of modern aircraft collateral in CRM reflects an assessment of the relevant legal features and industry practices, namely the:

7.1 relatively advanced⁸ security realisation laws around the world relating to aircraft collateral;

7.2 role of advanced security structures, developed and documented by international legal advisers, designed to reduce residual realisation-of-security risk⁹;

7.3 existing international treaty¹⁰ and private law¹¹ based legal framework, which recognises nationally created security rights in aircraft collateral;

7.4 extreme mobility of aviation assets, which presents opportunities for repossession and realisation, thus providing incentives for voluntary surrender of assets and alternative arrangements; and

7.5 global market for redeployment and resale of aircraft used as collateral, resulting from (i) largely internationalised standards for aircraft (*e.g.*, technical, safety, operational, maintenance¹² and appraisal¹³ standards), which enhance asset values and effectively limit transfer costs, and (ii) consistent growth in demand for passenger and cargo air transport services.

8 Culminating a decade of developmental and consensus-building activity, a Diplomatic Conference will be held later this year for adoption of an international treaty designed to make asset-based financing and leasing of aircraft equipment even more efficient (Treaty).

The Treaty, jointly sponsored by two intergovernmental organisations,¹⁴ further minimises realisation of security risk. Among other things, it permits States to provide *specific timetables* relating to the realisation of aircraft collateral, including in the context of insolvency proceedings.¹⁵

In sum, the Treaty provides an unprecedented degree of legal certainty regarding creditors' security rights in aircraft collateral.¹⁶ It reinforces reliance on aircraft collateral values in CRM. It addresses the key factors

noted in paragraphs 68-71 of the New Capital Accord Document and argues further for the recognition of aircraft collateral in the CRM provisions.

Substantiating Data and Analytic Materials

9 We are compiling, and, at the Committee's request, are willing to submit substantiating data with established modeling in support of the statements made in point 6. For efficiency purposes, it would be necessary to have advance contact with the Committee to establish agreed terms-of-reference, including methodological parameters and basic assumptions.

10 We are also preparing, and, at the Committee's request, are willing to submit a document containing analytic materials for use in assessing the complex realisation-of-security topic addressed in points 7-8, together with an illustration of the relevance of the Treaty to these matters. Advance discussion of this document between the Committee and AWG/IATA would enhance its utility to the Committee.

Final Notes

11 The important work of the Committee, sharpening the focus on risk sensitivities in connection with capital requirements, is to be applauded. It proposes to align prudent banking practices and bank capital regulation. Our comments on the potential role of aircraft collateral for purposes of preferred risk weighting do no more than encourage the extension and refinement of this approach to a specific, well-established banking sector.

12 It is our understanding that comments similar to those contained in this letter are being made to certain national supervisory authorities, and, through these channels, will come to the attention of the Committee. Accordingly, our offer of assistance in points 9-10 extends to work for consideration by such authorities.

13 In closing, AWG and IATA support, in principle, the selective use of physical, as well as financial, collateral in CRM. Since our comments are primarily an aviation industry-specific assessment of the New Capital Accord Document, focusing on the use of modern aircraft collateral, this letter is being submitted *without prejudice to the positions of financial institutions in the AWG submitting or associated with broader or more general comments on the New Capital Accord Document.*

Sincerely yours,

Aviation Working Group

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(pp/po Françoise Briló)
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ENDNOTES

¹ The vast majority of aviation financing transactions rely for their security on the cash-flow producing and resale values associated with the aircraft. Many are structured through special purpose vehicles. Moreover, corporate credit ratings are not common in the aviation sector. In particular, and based on data provided by one major rating agency, (i) only 21 passenger airlines currently have public corporate credit ratings from that agency, 13 of which are U.S. airlines, and (ii) of the publicly rated airlines, only three carry ratings of BBB or higher. (Source: unpublished data provided by Standard & Poors, used and cited herein with their consent.)

² In light of the limited number of ratings in the aviation sector, absent the recognition of modern aircraft in CRM, financial institutions unable to utilise the advanced IRB will be at a disadvantage to those institutions that can. This disadvantage is likely to act as a disincentive to the continued participation of banks using the standardised or foundation IRB approach in aircraft financing. The point takes enhanced significance in view of the robust syndication market involving many smaller lending institutions. That syndication market is a key source of funds to the aviation sector.

³ It has been estimated that such external capital funding requirements (the difference between capital spending and internal cash flows) for the ten-year period 2001–2010 is US\$ 234 billion, or an average annual amount of approximately US\$ 23.5 billion. See *Moody's Global Aerospace and Defence Industry Outlook*, 31 January 2001 (New York) (citing *The Airline Monitor*, November 2000).

⁴ A study, prepared by leading applied economists, was undertaken under the auspices of the Institut Européen d'Administration des Affaires (INSEAD) and the Salomon Center of New York University. While the study focused on financing benefits associated with the Treaty (discussed in point 8), aspects of it are relevant here.

Part 6 of that study discusses the linkages between microeconomic benefits in the field of aviation finance and macroeconomic gains in the areas of (i) aggregate output and income, (ii) trade, investment and multiplier-effects, (iii) employment effects, (iv) public-sector revenues, fiscal balance and privatisations, (v) external debt and sovereign borrowing capacities, and (vi) potential growth effects. See generally A. Saunders & Ingo Walter, "Proposed Unidroit Convention on International Interests in Mobile Equipment as applicable to Aircraft Equipment through the Aircraft Equipment Protocol: Economic Impact Assessment," 23 *AIR & SPACE LAW* 339 (1998).

⁵ While we have used IRB approach terminology, since it helps crystallise the point, the reasoning extends to use of modern aircraft as collateral in the standardised approach as well.

⁶ Precedent may be found in the methods employed by rating agencies in their assessments of Enhanced Equipment Trust Certificate (EETC) transactions, the most significant form of financing for US airlines. EETCs are now well established in the United States, having provided over U.S.\$26.8 billion in financing in recent years (over U.S.\$9 billion in 2000 alone). In such transactions, the rating differential between an airline's unsecured credit rating and the secured EETC notes is material (the average unsecured rating for the airlines was Ba2/BB- (weighted by debt amount at issuance), while the average EETC rating was A1/AA- (same weighting), an average upgrade in rating of 7 grades (Moody's)/ 9 grades (Standard & Poor's)). The principal justification for this rating upgrade in EETC transactions is the value of the aircraft collateral. (Source: unpublished data provided by Morgan Stanley, used and cited herein with their consent.)

⁷ In addition to standard assumptions, such as inflation rates, economic lives of aircraft collateral and its effect on redeployment scenarios, and timing-related factors relating to repossession and conversion to proceeds, threshold assumptions are needed to distinguish modern aircraft from other aircraft.

⁸ Many States have specific security laws applicable to rights in aircraft. Often, particularly in civil law jurisdictions otherwise hostile to the grant of nonpossessory security interests in collateral (i.e., in collateral that remains in the physical possession or under the control of the borrower), aircraft are either treated as having a State's nationality or are deemed to be immovable property. These legal constructs facilitate the use of aircraft as collateral in financing transactions. They do so by applying well-developed laws, often derived from historical shipping laws (*re* nationality) or real property laws (*re* deemed immobility), to aircraft financing transactions. See generally P. Wood, *Comparative Law of Security and Guarantees* at 202-21 (Sweet & Maxwell 1995).

⁹ In addition to the use of special purpose vehicles, which isolates credit risk, many aircraft financing transactions are documented under the laws of commercially oriented jurisdictions, thus minimising extant legal risks. As indicated in notes 10-11 below, international treaties and accepted private law rules call on States to recognise the basic security laws of the State in which an aircraft is registered. Well-established choice of law rules also require States to recognise the contractually selected law, as concerns matters between parties to an aircraft financing transaction. See, e.g., Convention on the Law Applicable to Contractual Obligations, opened for signature 19 June 1980, O.J. (L266) 1, art.3.

¹⁰ A treaty for cross-border recognition of rights in aircraft is adhered to by 85 States. See Convention on International Recognition of Rights in Aircraft (1948), opened for signature 19 June 1948, 310 UNTS 151 (Geneva Convention).

¹¹ Many States that are not parties to the Geneva Convention would nonetheless reach the same general result, namely, recognition of security rights validly created in the State where the aircraft is registered. This rule, *lex registri*, is (in the context of personal property) generally limited to collateral with "nationality," most notably aircraft and ships. Application of the Geneva Convention, and, absent that treaty, the *lex registri* rule, avoids a basic problem in cross-border security. That problem, short-handed the *lex situs* rule, arises when a court is called upon to assess the validity of security rights under the laws of the jurisdiction where an item happens to be located from time to time.

¹² Most aviation finance transactions require aircraft maintenance programs, which bear directly on asset values, to comply with the stringent maintenance standards of the European Joint Aviation Authority and/or the US Federal Aviation Administration, regardless of the legal location or operational base of the airline.

¹³ An international body, the International Society of Transport Aircraft Trading, certifies appraisers and sets professional standards.

¹⁴ The Treaty is co-sponsored by the International Institute for the Unification of Private International Law (Unidroit) and the International Civil Aviation Organization (ICAO). Unidroit is an intergovernmental body charged with examining ways of harmonising and coordinating the private laws of States. ICAO is the United Nations body with exclusive competence in the field of air law. For the text of the Treaty, see *Report of the 31st session of the Legal Committee* (Doc. 9765-LC/191), Attachment D, Part I and Attachment E, Part I. AWG/IATA have been actively involved in the development of the Treaty with a view toward ensuring its prompt entry into force.

¹⁵ These provisions are elective, but once so elected by a State are binding. They provide a framework for calculating repossession delay risk.

¹⁶ The Treaty *inter alia* (i) sets out specific criteria for the creation of an international security interest in aircraft collateral, (ii) provides basic enforcement remedies available to a creditor in the case of nonperformance by its counterparty, and (iii) establishes an electronic international registry, which, on a first-in-time basis, will determine the priority of competing claims over aircraft collateral.