

## Aviation - International

In search of a level playing field: the 2011 Aircraft Sector Understanding

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### Introduction

On February 25 2011 the rules governing the financing that export credit agencies can provide for the purchase of aircraft changed. The new rules apply to all forms of official state support for export credits and set out the most favourable terms allowed for aircraft financings supported by the export credit agencies of members of the Organisation for Economic Cooperation and Development (OECD), and Brazil.<sup>(1)</sup> The objective of the new rules is to:

*"encourage competition among exporters based on quality and price of goods and services exported rather than on the most favourable officially supported financial terms and conditions."*<sup>(2)</sup>

In addition, the rules are an attempt to level the playing field with respect to government support among manufacturers, airlines and governments. The new regime is also intended to narrow the pricing gap between export credit agency-supported transactions and commercially financed transactions.

The new rules are set forth in the 2011 Sector Understanding on Export Credits for Civil Aircraft (informally referred to as the 'Aircraft Sector Understanding'). The new rules were agreed to by the member states of the OECD and non-OECD member Brazil.<sup>(3)</sup> The new rules do not constitute a treaty, but are considered to be 'soft law' or a gentlemen's agreement. This update reviews the history of international efforts to standardise export credit agency support in the aviation sector and the main features of the new rules.

### Brief history

The 2011 Aircraft Sector Understanding, which took effect on February 1 2011, replaces the 2007 Aircraft Sector Understanding. The OECD arrangement that preceded the 2007 Aircraft Sector Understanding (the 1986 Large Aircraft Sector Understanding) did not cover regional aircraft, and therefore did not provide a set of export credit agency financing rules for Canada and Brazil. Until implementation of the 2007 Aircraft Sector Understanding, disputes between Canada and Brazil over government support of aircraft exports were heard by the World Trade Organisation. The export credit agency financing support provided by the governments of Brazil and Canada became subject to the updated version of the export credit agency rules embodied in the 2007 Aircraft Sector Understanding.

### Revisions required

As well as adding the Brazilian and Canadian export credit agencies, the 2007 Aircraft Sector Understanding divided subject aircraft into two categories – large aircraft and regional jets – with different rules for each category. However, when the Bombardier CSeries jet was launched in July 2008, Canada sought to classify it in Category 2 as a regional jet. The European Union and the United States cried foul because the 110 to 149-seat CSeries aircraft will compete more directly with the narrowbodies made by Airbus and Boeing than with traditional regional jets, and they that claimed the less restrictive rules for Category 2 aircraft would give the CSeries an unfair market advantage over the Airbus and Boeing products. A movement to revise the 2007 Aircraft Sector Understanding rules promptly ensued; the 2011 Aircraft Sector Understanding is

the result of that revision effort.

### Significant changes

The 2011 Aircraft Sector Understanding makes several significant changes from the its predecessor. The most important of these changes concern:

- the elimination of aircraft categories and the different rules for each category;
- the increase in the minimum premiums payable in connection with financings;
- the additional risk mitigants required of higher-risk borrowers;
- lower loan-to-value ratios; and
- more restrictive repayment terms.

#### **Elimination of aircraft categories**

With the abolition of the categories, all aircraft are now treated the same under the 2011 Aircraft Sector Understanding. This means that regional jets, which received more favourable financing than larger aircraft under the 2007 Aircraft Sector Understanding, will now be subject to the same financing terms as large aircraft. This change eliminates the differences of opinion between Canada on the one hand, and the European Union and the United States on the other, regarding the appropriate category for the C Series.

#### **Increase in minimum premium rate**

For the airlines and other borrowers which are the beneficiaries of export credit agency financing support, perhaps the most important change is the increase in the minimum premium rate to be paid by the borrower in a financing. The minimum premium rate will be adjusted periodically to reflect market conditions in accordance with the complex adjustment mechanism specified in the Aircraft Sector Understanding. Ultimately, according to the OECD, the intent is to "bring fees for financing transactions closer to market conditions and create new mechanisms to smooth very sharp market movements".<sup>(4)</sup> Depending on the borrower's risk classification (a rating assigned by all the participants acting jointly and discussed further below), the minimum premium rate applicable at the outset of the new rules will be more than double the previous rate for borrowers in some risk categories, and almost double the previous rates for all others. The table below shows the basic minimum premium rates in effect for former Category 1 aircraft as of February 1 2011, and the changes from the 2007 Aircraft Sector Understanding to the 2011 Aircraft Sector Understanding.<sup>(5)</sup> These rates do not include transaction or borrower-specific increases or decreases resulting from risk mitigant requirements, additional fees associated with grandfathered transactions (discussed below) or Cape Town discounts.<sup>(6)</sup>

Risk Category	Risk Classification	2007 Aircraft Sector Understanding	2011 Aircraft Sector Understanding	Increase
1	AAA TO BBB-	4.00	7.72	93%
2	BB+ TO BB	4.75	10.44	120%
3	BB-	5.50	11.03	101%
4	B+	5.50	11.85	115%
5	B	6.25	13.38	114%
6	B-	6.25	13.50	116%
7	CCC	7.50	14.45	93%
8	CC TO C	7.50	14.74	97%
			Average increase	106%

#### **Risk classifications**

The export credit agencies will together determine the risk classification of each borrower. The assigned risk classification will be based on the borrower's senior unsecured credit rating as determined by an outside rating agency. The risk classifications are binding on all participant export credit agencies and will be revised at least annually. As was the case under the 2007 Aircraft Sector Understanding, borrowers with risk classifications lower than BB will be required to provide risk mitigants.

#### **Risk mitigants**

Under the 2011 Aircraft Sector Understanding, the risk mitigants have been divided into two categories, A and B, with borrowers in risk categories lower than Category 1 being required to provide a proscribed number from each category, depending on that

borrower's risk classification. The risk mitigants include:

- a 10-year repayment term instead of the generally applicable 12-year term;
- straight-line amortisation, instead of the generally applicable mortgage-style amortisation;
- reductions of 5% from the permitted advance rate of 85% of net price;(7)
- a security deposit equal to three months of principal and interest payments;
- three months of lease payments paid in advance; and
- maintenance reserves structured to reflect market practice.(8)

#### **Maximum repayment term**

The new maximum repayment term is 12 years, although this may be extended to 15 years with prior notice and the payment of a surcharge of 35% of the minimum premium rate.

#### **Security package**

To obtain the minimum premium rates, supported transactions must include:

- a first-priority security interest in or in connection with the aircraft and engines;
- if the transaction is a lease structure, assignment or a first-priority security interest in the lease payments; and
- cross-default and cross-collateralisation of all aircraft and engines owned by the same parties under the financing, whenever possible under law.(9)

#### **Maximum advance rates**

Under the 2011 Aircraft Sector Understanding, the maximum advance rate for risk classification Category 1 borrowers is 80% of the aircraft's net price; for borrowers in other risk classifications, it is 85%.

#### **Grandfathered transactions**

To facilitate a smooth transition from the former rules, the 2011 Aircraft Sector Understanding allows for the grandfathering in of certain transactions such that the former rules, and not the 2011 Aircraft Sector Understanding rules, will still apply. The 1986 Large Aircraft Sector Understanding will govern great-grandfathered transactions for an unlimited number of aircraft scheduled for delivery by December 31 2010 under contracts concluded by April 30 2007. A commitment fee of 35 basis points a year accruing from the earlier of either the final commitment date or March 31 2011 will be charged. For this subset of great-grandfathered aircraft, there is no limitation on delivery date.

The 2007 Aircraft Sector Understanding will cover grandfathered transactions for former Category 1 aircraft delivered by December 31 2012 and former Category 2 and 3 aircraft delivered by December 31 2013, the firm contracts for which were concluded by December 31 2010. These transactions will incur a 20 basis points a year commitment fee, which is in addition to the minimum premium rate, accruing from the earlier of either the date of the final commitment or January 31 2011 for former Category 1 aircraft, or June 30 2011 for former Category 2 and 3 aircraft, until the actual delivery date and payable on delivery. In addition, each participant may provide support for 69 former Category 1 aircraft and 92 former Category 2 aircraft which are subject to a firm contract concluded by December 31 2010 pursuant to the 2007 Aircraft Sector Understanding rules. These additional aircraft transactions will also be subject to commitment fees, in addition to the applicable minimum premium rates.

#### **Home country rule**

Possibly the most contentious aspect of the 2011 Aircraft Sector Understanding is the unwritten home country rule, which is considered to be part of the rules. The home country rule, observed under the earlier aircraft sector understandings and unchanged under the 2011 Aircraft Sector Understanding, is an agreement between the US and European export credit agencies that EX-IM and EU export credit agency financing support will not be made available to airlines based in the United States, the United Kingdom, France, Germany and Spain. Airlines in these countries have long complained that their ineligibility for export credit agency-supported financing has distorted the market by forcing them to obtain more expensive, non-export credit agency supported commercial financing, while financially sound airlines from other countries have reaped the benefits of lower-cost export credit agency supported financing. Historically, Canada and Brazil have not observed the home country rule and are not expected to do so.

#### **Future of export credit agency financing support**

The new rules represent substantial efforts to close the gap between export credit agency financing and commercial financing, and to provide for the uniform treatment of all aircraft and thus all participants. Their success is largely in the eye of the beholder. Commercial lenders have generally looked unfavourably on export credit agency

financing support, because the export credit agencies could offer financing terms the commercial lenders could not match. The new rules and the more onerous minimum terms mandated appear to close the gap between the terms offered by the commercial lenders and the terms of export credit agency-supported financing. Airlines that benefited from export credit agency support favoured keeping the old arrangements in place, while the airlines that were barred from taking advantage of such financing support would be only too happy to see export credit agency support eliminated. The participants, with exports and jobs at stake, have an interest in ensuring the survival of export credit agency financing support and in monitoring each other. At least as written, the new rules seem to reduce the points of contention among the participants and the airlines, and between the export credit agencies and the commercial finance market. It remains to be seen how level the playing field becomes, and remains, for the various players as a result of the new rules.

## Endnotes

- (1) The new agreement also includes rules for export credit agency support for the purchase of used aircraft, spare engines, cargo conversion and major modification contracts, maintenance and service contracts and engine kits.
- (2) *Arrangement on Officially Supported Export Credits*, published by the Trade and Agriculture Directorate of the OECD, Document TAD/PG(2100)4, March 2011, Part I, Article 1.
- (3) The current participants are Australia, Brazil, Canada, the European Union, Japan, Korea, New Zealand, Norway, Switzerland and the United States. Representatives of the governments of China and Russia attended the negotiations regarding the 2011 Aircraft Sector Understanding as observers and participated in the related debates. The OECD has officially invited China and Russia to implement the new rules and to agree to follow the rules themselves. Each has chosen to retain observer status for the time being, but the OECD continues to urge them to sign up to the new regime.
- (4) OECD Press Release, February 25, 2011.
- (5) Rates under the 2007 Aircraft Sector Understanding are from OECD Publication TAD/PG (2007)4/FINAL, July 27 2007, *Sector Understanding on Export Credits for Civil Aircraft*, Table 1a "Category 1 Aircraft Minimum Premium Rates for 12-Year Repayment Term Asset-Backed Transaction" at page 33. Rates under the 2011 Aircraft Sector Understanding are from OECD Publication TAD/PG (2011)4, March 3 2011, *Arrangement on Officially Supported Export Credits, March 2011*, Table 5 "Minimum Premium Rates (12-year repayment term, asset-backed transactions)" at page 73.
- (6) Discounts of 10% off the minimum premium rate are available when the borrower (or operator or lessor, depending on the transaction structure) is in a Cape Town Convention country. Under the 2007 Aircraft Sector Understanding, the amount of this discount varied from 5% to 20%, depending on the borrower's risk rating.
- (7) A transaction may utilise more than one 5% reduction, with each such reduction constituting one risk mitigant.
- (8) In addition to the minimum premium rate, there are other mandatory fees which depend on the structure of the transaction, including premium holding fees on the undrawn portion of official support, arrangement and commitment fees and administrative fees.
- (9) The cross-default and cross-collateralisation requirements were not mandatory under the 2007 Aircraft Sector Understanding.

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