

**THE CAPE TOWN CONVENTION ON INTERNATIONAL INTERESTS IN MOBILE EQUIPMENT
AN OVERVIEW OF THE DRAFT RAIL PROTOCOL:**

A SIGNIFICANT STEP FORWARD FOR THE RAIL INDUSTRY

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1. INTRODUCTION

After eight years of preparation, the Cape Town Convention on International Interests in Mobile Equipment was signed at a Diplomatic Conference on 16th November 2001. The Convention provides a mechanism for recognising and recording international security interests created in high-value moveable equipment, usually overriding local title interests or claims. At a time when business and its financing is increasingly international, this Convention is opening the door to more sophisticated cross-border and domestic financing of moveable assets in situations where otherwise banks, lessors and other financiers funding assets not in their possession would risk losing their security position, especially if it moves across a jurisdictional border. By providing more security to the private sector, the Convention is reducing the cost of borrowing and in certain cases, facilitate such borrowing where otherwise it would not be possible in the absence of a strong Government guarantee.

The Convention provides a basic framework that is applied to various industry sectors through the adoption of a protocol designed specifically for such sector. An Aviation Protocol to the Convention was signed at Cape Town in 2001 applying the Convention to aircraft equipment and came into force on 1 March 2006. The Final Act signed at the Diplomatic Conference contained a specific resolution mandating the speedy development and adoption of a parallel Railway Rolling Stock Protocol for the rail industry.

A Rail Working Group had been established in 1996 at the invitation of UNIDROIT (the International Institute for the Unification of Private Law), one of the Convention's sponsoring organisations. The Group has been responsible for drafting and then commenting on a working draft of the Rail Protocol, involving various parts of the rail industry wherever possible. A draft Rail Protocol has already been considered in detail by Government Experts at three separate meetings and UNIDROIT, OTIF and the Rail Working Group have organised a number of seminars about the Protocol.

2. CREATING INTERNATIONAL SECURITY INTERESTS AND A GLOBAL REGISTRY

The Convention recognises as International Security Interests the property rights of:

- a secured lender

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- a vendor selling with reservation of title
- a lessor under a lease

in relation to high-value moveable equipment covered by a Protocol to the Convention. The interest will be assignable and it will be possible also to register a prospective interest to protect the secured party in advance of completion of a financing. The possibility of extending the Convention to recognition of transfers of title is being actively considered in the run up to the Rail Protocol Diplomatic Conference. This option has already been taken in the Aircraft Protocol.

The Convention provides for a world-wide asset registry for each type of asset to which it applies, accessible via the Internet 24 hours a day, 7 days a week, through which any funder can check if any other party claims a right in the equipment to be financed. The funder will be able to register its interest which will then, in almost all cases, take precedence over any other unregistered security interest and over any subsequently registered interest. It will also take priority over any third party rights asserted in a bankruptcy of the possessor. The Registry will be operated by an independent organisation and will be overseen by a Supervisor, an international (possibly inter-governmental) body, appointed under the individual Protocols.

3. IMPROVED ACCESS TO PRIVATE CAPITAL MATTERS FOR THE RAIL INDUSTRY

The rail sector is deceptively large. It covers not only passenger and freight wagons, locomotives and specialist rail equipment, but also light rail and city underground rail and tram transportation systems. Although it is estimated that some US\$ 25 billion is already spent annually on railway rolling stock worldwide, the rail industry urgently needs more capital investment. In Europe, for example, the *average* life of freight rolling stock in circulation is close to its recommended useful life. In general the rail sector is unable to offer consistently modern rolling stock to customers despite a commercial need to do so and in many countries there is a critical lack of capacity. At the same time, manufacturing plants are being closed for lack of orders, losing valuable expertise, as more traffic shifts to the roads. Another competitor, operators in the aircraft sector, have traditionally had a much more flexible financing model, enhanced by the coming into force of the above mentioned Aviation Protocol. In many cases, operators are state-owned (national or local government), and as a result, resources are often limited and privatisation is not always a politically acceptable option.

The answer is for operators to access the private capital markets, with lenders providing funds without recourse to government guarantees or support. For both state-owned and private railways, this is often only practicable if lenders have security in the assets being financed, namely an unequivocal recognition of their property rights and a clear mechanism for repossession on default. In the aircraft sector, a competitor, leasing and other financing techniques have led to solid growth of investment in the last 25 years due to the lender/lessor being secured through registration of title or mortgage interests. By contrast, capital investment in the rail sector has been stagnant and worldwide there is no national public registry where lenders or lessors can register their interests in assets financed or treaty system recognising certain property rights. The Convention, when implemented for the rail sector by the rail protocol will provide a new, highly effective mechanism for both private and public sector rail operators to utilise the private capital markets cost-effectively and on similar terms to the aircraft sector, facilitating, in turn, a better service for the customer and a vital means of recovering market share from the road and air sectors in freight and passenger transportation.

4. CREATING NEW SECURITY SYSTEM FOR THE RAILWAYS

The rail sector was chosen as one of the first sectors to be covered by the Convention due to the additional risk that international financiers have in relation to assets which by their nature can cross borders. In addition, even in relation to rolling stock which does not cross borders, because most states have no domestic system to register liens on rolling stock, the Convention will create additional security for lenders financing rolling stock, even if just financed as a part of a domestic transaction. This should make domestic as well as international financing of rolling stock considerably simpler. Moreover once the Cape Town Convention applies to various categories of assets, it opens the way for sophisticated high volume and lower cost multi-asset securitisation and other financings with equivalent security for each asset type. This should also work directly to the benefit of the rail industry.

5. BENEFITS FOR RAILWAY OPERATORS

Even for state-owned railways, the Convention will bring considerable benefits by increasing the sources of capital available for investment in new rolling stock without the need for direct state support (financed by borrowing or taxation), indirect support (e.g. Eurofima), or guarantees. This will occur due to the reduction of risk that a funder will be required to take, and will also open up possibilities for non-recourse securitisation and other financings. It will give both publicly and privately owned railways more independence as to how they develop their equipment requirements, and facilitate future capital investment – as well as secure funding for state-owned operators as governments gradually withdraw from the sector, either through partial or full privatisation, or through by refusing to guarantee future debt incurred by the railways. Investment will be driven by requirements and economics and not limited by political considerations. For the private operator, access to the capital markets, directly or through banks and leasing companies, will be essential to their entry into the rail sector, and this in turn will be a key element in the renaissance of the rail industry in the new century. In each case, the more private sector capital there is available and the lower the risk a funder is required to take, the cheaper that capital will be.

The Convention will bring more flexibility in the use of financed rolling stock and encourage the development of both finance and operating leases (due to the new protection afforded to the lessor) and a secondary market, significantly reducing the capital commitments required by the operator (or permitting it to offer more new and efficient rolling stock to customers without increasing its equity). The availability of operating leasing for aircraft has been a key factor in the development of the aircraft sector. Investors and lessors will be prepared to take more residual value risk due to the increased certainty that can be given to a lessor or investor in retaining its interest in the asset against local legal challenges.

Operators themselves constantly lease or sublease rolling stock to other operators as they cross borders. In the former case, registration of the lessor interest will allow the asset to cross borders without the lessor operator worrying that its title or lease interest could be overridden by local operators or their creditors. In the latter case, if the owner's interest under the lease is already registered, that would already put any foreign innocent third party on notice of the prior rights of the lessor.

Lastly, debt financing for rolling stock at present means voluminous documentation – especially in relation to security issues as well as extensive legal opinions and continuing legal uncertainty for all

parties. By significantly reducing the uncertainty, and by developing a universal interest, to cover assets used in various jurisdictions, the Convention should also result in much simpler security documentation, more modest legal opinions, and considerably reduced transaction costs.

6. ADVANTAGES FOR MANUFACTURERS OF ROLLING STOCK

Providing finance to a customer is an excellent means of maintaining a business relationship. At times this can then be a condition for being considered as a supplier. It offers a “one-stop shop” solution to customers. On the other hand, a manufacturer cannot always carry financed assets on its own books since this will have adverse balance sheet and cash flow implications. The solution is finance from third parties with recourse only to the assets financed. By enhancing the ability of a funder to secure its loans/leases, the Convention will encourage funders into the market to support manufacturers. Even if the manufacturer does not provide finance directly but in partnership with a bank or other funder, the improved security position will expand the sources of competitive funding available to the customer and encourage more investment. The enhanced security system will also allow investors in manufacturers to leverage their investment as well as making it easier for manufacturers to finance work in progress.

-However, manufacturers will, in certain circumstances, wish to lease rolling stock to customers on a short-or long-term basis and carry the risk on its own balance sheet. It may be so as to provide interim solutions to customers but leasing can also include the provision of maintenance services thereby assisting in the development of another part of the typical manufacturer’s business. The Convention will give manufacturers direct protection of their interests in leased assets, thereby allowing them to give more comfort to banks providing their working capital credit lines and to demand more flexibility in using owned assets for such purposes (where they are possibly pledged as security for such credit line).

Many of the advantages set out in section 5 above will be applicable, either directly or indirectly, also to manufacturers. Since the Convention should also release even state-owned railways from government spending constraints, it should considerably increase the resources available to buy new rolling stock. In this context, it is interesting to note the example of the UK where years of minimal rolling stock investment has given way to unprecedented levels of new post-privatisation equipment orders, with funding almost exclusively coming from the private markets.

7. SUPPORT FOR BANKS AND LESSORS

Many of the advantages set out above will be applicable, either directly or indirectly, to banks and lessors. Any bank involved in financing rolling stock which can cross national boundaries will be acutely aware of the costs and risks involved. Even if a bank can rely today on a state guarantee of a long-term commitment from an operator, this could easily change in relation to current commitments and create considerable credit issues if such support is not as readily available, as seems likely, in the future. Lessors/pledgees will have significantly improved legal positions by placing third parties on constructive notice of their interest due to operation of the Convention.

As with the aircraft sector, financing of rolling stock is ideal for securitisation and other international financial instruments as well as, in certain cases, cross-border equity investment

programmes. In each case, the Convention should increase the comfort and number of prospective investors, thereby lowering direct and indirect costs.

8. THE IMPORTANCE TO GOVERNMENTS

"Between 1970 and 1998 the share of the goods market carried by rail in Europe fell from 21.1% to 8.4% (down from 283 billion tonnes per kilometre to 241 billion), even though the overall volume of goods transported rose spectacularly." - **European transport policy for 2010: time to decide**, European Commission White Paper, 2001

Generally the rail sector has lost out in recent years to other modes of transport. By contrast, freight movement by road has boomed.

In the coming years, for environmental, social and capacity reasons, the only practical way to expand the transportation sector in many countries, will be through the development of railways. This needs to be financed at a time when the competing needs for government funding support are ever more intense. The Convention will encourage more private capital investment into the rail sector, creating the means by which the development can be financed without state support. It will open up valuable areas of private sector finance and in turn import market disciplines on operations without the need to privatise. It will also encourage new entrants into the market and support an "open rails" strategy. Further, more investment will mean more skilled jobs in the manufacturing side of the industry and ultimately a better product offered to the consumer. It will also increase the value of the state-owned operators. Their owned rolling stock will be easier to use or lease to third parties. The procurement of other rolling stock through operating leases or other secured finance mechanisms "off balance sheet" will be easier, thereby increasing the operator's return on capital. Lastly in Europe, the adoption of the Rail Protocol will be totally compatible and complementary to the new European Railway Agency and the objective of common safety standards and interoperability of rolling stock across Europe.

For many Governments there is also another consideration. The Rail Protocol will be a valuable new tool in relation to provision of aid to developing countries. Many of these countries have inherited a rail system from colonial times that is now badly run down, and the rolling stock is outdated and inefficient. And yet the rail system is essential infrastructure for economic development and is also a highly effective mechanism for delivering food aid. Precious aid however is often prioritised elsewhere. No private sector lender will finance the investment urgently required. By providing security to private sector lenders, the Rail Protocol will open up, for the first time, the possibility of finance from the capital markets for rolling stock even where the operator has a poor credit rating. This is because the financier can now lend against the asset with confidence. As a result:

- the local rail manufacturing and maintenance industry will be stimulated;
- international aid can be focused on paying lease rentals, resulting in lower immediate cash commitments, with the monies paid directly to the lessor;
- a market for operating leases for second user rolling stock (for example, coming from more prosperous countries) is opened up;
- it creates a mechanism whereby the private sector can monitor the efficient usage of certain capital investments taking a load off government and intergovernmental agencies;
- it encourages more prosperous countries, even within a developing area, to lend, lease or permit the use of its rolling stock in other less prosperous and developed parts of the region

9. A VITAL BOOST TO THE FUTURE OF THE RAIL INDUSTRY

The Rail Protocol to the Cape Town Convention will encourage significant capital investment in the rail sector. It will also allow the rail industry to compete more effectively with other parts of the transportation sector for funding, such as the aircraft sector, as well as drive down private sector funding costs and facilitate the development of a true operating lease market. It will also bring major benefits to operators, manufacturers, funders and Governments.

Unlike the aircraft sector, there are few national registry systems in place to give funders (limited) protection. Further, the prevalence of direct or indirect state support for significant operators has discouraged funders from entering into the business (due to fine margins) and encouraged current lenders to ignore the security due to the quality of the credit. On the other hand, there is very limited private sector finance for investment in rolling stock where there is no government guarantee. However, public sector support of the rail industry will decline further in the future and new operators will be needed in the market. In the aircraft sector, that change has already occurred, with generally very positive results. With the introduction of broader and easier private sector funding, the aviation sector has seen unprecedented success, innovation and growth. We can expect a similar development in the next 10 years in the rail sector. We must anticipate and facilitate that change now.

New sources of funding should stimulate substantial additional investment in the rail sector through the involvement of the private capital markets. We have a unique opportunity to influence an exciting and highly practical change in private international law. This will fundamentally affect the way that the rail industry develops in the new millennium.