



# The 2011 Aircraft Sector Understanding: Calming the Turbulent Skies

By Dean N. Gerber

In response to the significant reduction in credit available from commercial banks and capital markets in recent years due to the global economic downturn, export credit agencies (ECAs) of the countries that produce commercial aircraft significantly increased their support for new aircraft from approximately 15–20 percent of total deliveries to 30–40 percent. This increased support gave rise to accusations of unfairness in ECA financing availability. It also united rival manufacturers and pitted airlines and commercial banks against governments in a dispute over the role ECAs play in supporting sales of commercial aircraft. In response to this dispute and the perceived inadequacies in the existing rules governing ECA-sponsored financing, representatives from the United States, the European Union, Canada, Brazil, and Japan met in Paris in February 2011 and agreed to a new understanding to the arrangement on officially supported ECAs for civil aircraft. The new understanding, called the Aircraft Sector Understanding (2011 ASU),<sup>1</sup> supersedes the 2007 Aircraft Sector Understanding (2007 ASU).<sup>2</sup>

## The Large Aircraft Sector Understanding

For many years, ECA financing has played a significant role in supporting the sale of new aircraft. The initial arrangement governing the extension of credit or guarantees in connection with the ECA financing of civil aircraft was concluded in 1986 between the United States and the European countries involved in the manufacture of Airbus aircraft (the United Kingdom, Germany, France, and Spain). This arrangement was called the Large Aircraft Sector Understanding (LASU). The LASU provided guidelines relating to the extension of credit or guarantees in connection with the financing of civil aircraft.<sup>3</sup>

The LASU was contained in an annex to the Arrangement on Officially Supported ECAs (the OECD Arrangement), originally signed in 1978.<sup>4</sup> The OECD Arrangement was intended by the

OECD member countries to be a gentlemen's agreement that would create a uniform standard for ECA financing. Today, 30 OECD member countries participate in the OECD Arrangement.<sup>5</sup> Although the OECD Arrangement did not provide a definition of official support, it was understood that it involved government-backed support for an ECA and could take the form of direct credits/financings, interest-rate support, ECA insurance, and guarantees.<sup>6</sup>

It was long hoped that the scope of the LASU would be expanded to cover regional jet-producing countries, so that ECA financings would have a common framework applicable for all civil aircraft. The need for this extension became more readily apparent as the categorization of regional jets and large aircraft increasingly blurred. In addition, many felt the LASU did not foster an efficient system for exchanging information among ECAs or producing reliable data relating to the financing of exports. In order to address these issues, the OECD member countries, following two years of negotiation, signed the 2007 ASU.

## The 2007 ASU

In contrast to the LASU, the 2007 ASU was much broader in scope and was notable for its inclusion of Brazil as a participant (although Brazil was not an OECD member, by virtue of being the domicile of a significant aircraft manufacturer, Embraer, its inclusion advanced one of the main goals of the 2007 ASU). The 2007 ASU established new terms and conditions pursuant to which ECAs could provide support in relation to the financing of aircraft. In contrast to the LASU, the 2007 ASU was more detailed regarding the rules applicable to regional jets and large aircraft and financial terms. It was also flexible in that the participants could amend the understanding as they might deem necessary. The 2007 ASU enhanced transparency and cooperation among the participating ECAs.

One of the main features of the 2007 ASU was the separation of aircraft into three distinct categories. "Category 1" aircraft were large commercial aircraft, "Category 2" aircraft were regional jets, and "Category 3" included all other types of aircraft. The 2007 ASU categorized each aircraft by make and model. Although the list was helpful in enabling manufacturers, airlines, and ECAs

Dean Gerber is a shareholder at Vedder Price P.C. and chairs its Global Transportation Finance team. He also serves as Vice-Chair of the Legal Advisory Panel for the Aviation Working Group in connection with its work on aviation-related matters, including the Cape Town Convention. He can be contacted at [dgerber@vedderprice.com](mailto:dgerber@vedderprice.com). The author gratefully acknowledges the contributions to this article by Ji Woon Kim, an associate at Vedder Price P.C.

to delineate the category to which various aircraft belong, the list was static and not based on any defined variables. This made the categorization of new types of aircraft difficult and potentially contentious.

The terms of the 2007 ASU for regional jets also created concern because Category 2 aircraft received different and, in some cases, more favorable pricing terms than those offered for large commercial aircraft. Some of the advantages included a simpler set of rules for determining the minimum premium rates charged by the ECAs, access to lower premium rates, and a maximum repayment term of 15 years (compared to 12 years for Category 1 aircraft).

Boeing strenuously opposed the 2007 ASU's category system, arguing that it would not be a viable agreement in the future when companies such as Embraer and Bombardier began to manufacture larger aircraft.<sup>7</sup> This concern was realized when Bombardier announced its new 110/130-seat, twin-turbofan CSeries aircraft. The new CSeries, currently projected to begin service in 2013, will enter the 100-plus seat narrow-body market, which has been dominated by the Airbus A320 and Boeing B737 families for the last 20 years.<sup>8</sup> Shortly after Bombardier's announcement of the CSeries, Canada proposed to classify the new aircraft as a Category 2 aircraft, instead of Category 1, under the 2007 ASU. Because the majority of Airbus and Boeing aircraft are classified as Category 1, these two manufacturers objected to Canada's proposed classification and criticized the 2007 ASU, arguing that it would "distort competition" if the CSeries was classified as a Category 2 aircraft.<sup>9</sup>

Another area of significant concern following implementation of the 2007 ASU was the so-called Home-Country Rule. This rule, which dates back to 1992, is an unwritten, informal understanding among the four principal ECAs supporting the manufacturers of large commercial jet aircraft: Export-Import Bank of the United States (Ex-Im Bank); Export Credits Guarantee Department (UK); Compagnie Française d'Assurance pour le Commerce Extérieur, also known as COFACE (France); and Euler Hermes (Germany). These agencies agreed not to provide financing for competing aircraft that will be principally located in their own or in each other's countries (including, for this purpose, Spain<sup>10</sup>). The five countries represented by such ECAs are sometimes referred to as "Large Aircraft Countries."

The consequence of the Home-Country Rule in the United States is that the Ex-Im Bank will not finance Boeing aircraft that are to be operated by companies organized or controlled by entities organized in Large Aircraft Countries. As previously noted, the rule is unwritten,<sup>11</sup> and, in the case

of the European ECAs, not acknowledged, due in part to concerns about possible claims of discriminatory lending practices. For many years, U.S. and European airlines expressed little concern over the availability of ECA financing. However, with dramatic changes in marketing conditions starting in 2008 as a result of the global economic downturn, coupled with the proliferation of ECA financing for a variety of non-home-country airlines, U.S. and European airlines suddenly became quite critical of the Home-Country Rule, particularly because the funding costs associated with ECA financing were generally perceived to be below market.<sup>12</sup> The Air Transport Association of America, along with a group of European carriers, called on the OECD to form a new understanding of official ECA support for aircraft to neutralize the perceived advantages given to non-home-country airlines by virtue of their access to ECA financing.

The limited application of the Home-Country Rule to only the Large Aircraft Countries was also a concern. In the past, Canada's primary aircraft manufacturer, Bombardier, did not produce aircraft that directly competed in the same markets as Airbus and Boeing.<sup>13</sup> Bombardier's introduction of the CSeries, however, caused Boeing and Airbus to question why the Home-Country Rule should not be extended to Canada. The two large manufacturers argued that because Canada was a participant in the 2007 ASU, Canada also should recognize the Home-Country Rule. With potential competitors from other countries such as Brazil, China, and Russia on the verge of producing similar aircraft to the CSeries, Airbus and Boeing were also concerned that if Canada was not bound by the Home-Country Rule, these other countries would expect to receive identical treatment.<sup>14</sup>

### The 2011 ASU

In response to changes in market conditions and the disputes surrounding the 2007 ASU, the OECD commenced discussions with various participants in 2010, paving the way for the 2011 ASU. The 2011 ASU seeks "to provide a framework for the predictable, consistent and transparent use of officially supported export credits"<sup>15</sup> and to maintain a level playing field across the global aviation industry among manufacturers, airlines, and ECAs.

The 2011 ASU attempts to bring ECA financings more in line with market conditions and minimize the support of the ECAs as a factor in the choice by buyers/borrowers among competing aircraft.<sup>16</sup> Significantly, the 2011 ASU makes no distinction among the various types and categories of aircraft models. The terms and conditions stipulated under the 2011 ASU apply to all new civil aircraft for any ECA financing.<sup>17</sup>

The 2011 ASU emphasizes the risk profile of

buyers/borrowers and requires that the ECAs classify all buyers/borrowers into one of eight risk categories, reflecting their senior unsecured credit ratings. The risk categories are determined by the ECAs and are recorded and maintained by the OECD Secretariat.<sup>18</sup> These categories are valid for a maximum period of 12 months commencing from the date recorded by the OECD Secretariat<sup>19</sup> and are binding on the buyers/borrowers at all stages of a transaction.<sup>20</sup>

These risk categories are important in two respects. First, official support for buyers/borrowers with the highest risk classification (BBB- and higher) cannot exceed 80 percent of the net price<sup>21</sup> of the aircraft. For all other risk classifications, the maximum official support for an aircraft cannot exceed 85 percent of its net price. The lower advance rate for buyers/borrowers with the highest ratings was designed to make ECA financing less desirable for these buyers/borrowers (who can more readily access the commercial markets for financing).

Second, the risk categories determine the number of structural enhancements or “risk mitigants” applicable to a transaction. The ECAs are required to include these risk mitigants based on the risk categories of the buyer/borrower, and the weaker the risk category, the greater number of risk mitigants required to be included. Risk mitigants are divided into two categories: “A” and “B.” The “A” risk mitigants include (1) a 5 percent reduction from the maximum support available (each 5 percent reduction amounts to one “A” risk mitigant), (2) a straight-line amortization profile, and (3) a reduced repayment term not to exceed 10 years.<sup>22</sup> The “B” risk mitigants include (a) a security deposit in either cash or a standby letter of credit (an amount equal to one quarterly installment of principal and interest equates to one “B” risk mitigant), (b) the lease payments in an amount equal to one quarterly installment of principal and interest payable in advance, and (c) maintenance reserves in form and amount reflecting market best practices.<sup>23</sup> An ECA also may replace one of the “A” risk mitigants with a 15 percent surcharge on the applicable minimum premium rate.<sup>24</sup>

In addition, ECA financings must be structured as eligible asset-backed transactions. An eligible asset-backed transaction must include the following components: (1) a first-priority security interest on the applicable aircraft and engines; (2) if such transaction is a lease structure, an assignment of and/or first-priority security interest in the related lease payments; and (3) if allowed under applicable law, cross-default and cross-collateralization of all aircraft and engines owned by the same parties under such transaction.<sup>25</sup>

The 2011 ASU establishes a maximum repayment

term of 12 years, but this may be extended to 15 years on an exceptional basis provided a 35 percent surcharge is added to the minimum premium rates.<sup>26</sup> The amortization profile in respect of the ECA-supported debt may either be “mortgage-style” (equal payments of principal and interest) or “straight-line” (equal principal payments, with interest payable on a declining basis); provided, in either case, repayment is made on a quarterly basis. The 2011 ASU also allows for repayment on a semiannual basis provided a 15 percent surcharge is added to the minimum premium rates.<sup>27</sup>

The 2011 ASU requires that the ECAs charge buyers/borrowers a minimum premium rate (MPR) based on a percentage of the amount officially supported by the ECAs.<sup>28</sup> The MPR may be paid either up front or over the life of the transaction and is based on a 12-year repayment term. The MPR corresponds to the risk category of each buyer/borrower<sup>29</sup> and is determined using a complex equation involving (1) the minimum risk-based rates, which correspond to the buyer/borrower’s risk category (and are set annually using a four-year moving average of the annual Moody’s “Loss Given Default”), and (2) a market-reflective surcharge, which serves as a reflection of broader market conditions (which is based on Moody’s “Median Credit Spreads”).<sup>30</sup> Although complex, the new premium rates are intended to balance ECA pricing with commercial market pricing at any point in time. The pricing mechanism also uses publicly available measures (for transparency) that can be easily accessed by bankers in order to determine spread volatility.

The 2011 ASU allows for up to a 10 percent reduction in the MPR if the following conditions are satisfied (this is the so-called Cape Town Discount): (1) the ECA-supported financing relates to an “aircraft object” within the meaning of the Cape Town Convention,<sup>31</sup> (2) the operator of the aircraft is situated in a country that appears on the list of states maintained by the OECD Secretariat for the reduction of the MPR, and (3) such financing relates to an aircraft object that has been registered on the International Registry established pursuant to the Cape Town Convention. In order for a country to be included in the list of states, such country must (a) be a contracting state under the Cape Town Convention, (b) have made the qualifying declarations under the Cape Town Convention set out in Annex I to the 2011 ASU (these include declarations relating to insolvency protections, expedited remedies, and choice of law), and (c) have implemented the Cape Town Convention and the requisite qualifying declarations into its national law.<sup>32</sup>

The 2007 ASU was implemented subject to a fairly lengthy transition period and many aircraft financed by the ECAs during the period prior to

implementation of the 2011 ASU were subject to grandfathering rules that, in the case of the large commercial aircraft, allowed LASU rules to apply. The 2011 ASU also has grandfathering rules that, depending upon the circumstances, would allow for the continued application of the 2007 ASU and, in some cases, the LASU. The 2011 ASU provides that aircraft delivered by December 31, 2012, in the case of large commercial aircraft, or December 31, 2013, in the case of regional aircraft, will be financed under the terms of the 2007 ASU (so long as a firm contract in respect of such aircraft was signed by December 31, 2010). In addition, a subset of aircraft (for each of the 2011 ASU participants, up to 69 large commercial aircraft and 92 regional aircraft) also may be eligible for financing on the terms of LASU.<sup>35</sup>

### What Does the Future Hold?

The 2007 ASU was in effect for only three years before being renegotiated. Will the 2011 ASU suffer the same fate? The answer to this question may depend on a number of factors:

(1) Because the 2011 ASU contains provisions extensively grandfathering and great-grandfathering terms of the 2007 ASU and the LASU, the full impact of the 2011 ASU will not be seen for at least a few years.

(2) The 2011 ASU did not address the issue of whether the CSeries should be made subject to the Home-Country Rule, even though this was one of the primary precipitating factors for the renegotiation of the 2007 ASU. Therefore, if Canada seeks to finance a CSeries in any of the Large Aircraft Countries, there may be some repercussions in the form of matched home-country financing by the U.S. and/or the European ECAs. This may lead to further negotiations of the 2011 ASU terms.

(3) The 2011 ASU roughly doubles premiums contained in the 2007 ASU. The markets are generally taking a wait-and-see approach as to how the 2011 ASU will work in practice, but market conditions will certainly impact views on the 2011 ASU pricing terms.

(4) Neither Russia nor China is a party to the 2011 ASU. With the Sukhoi Superjet about to enter service and Chinese Comac models due in several years, this may change, which may also lead to further renegotiation of the 2011 ASU's terms.

The 2011 ASU, although complex, attempts to balance a number of competing interests, with its primary goal being to create a more level playing field. It will, in time, reduce the volume of ECA financing, as its pricing formula significantly adjusts the relationship between ECA financing and the commercial markets by minimizing competition. By providing a greater link to market financing terms, the 2011 ASU will increase the transparency of ECA

pricing. The increased pricing levels should remove some of the pressure on the ECAs regarding the Home-Country Rule, but concern will escalate if new market entrants (such as the Bombardier CSeries) are financed with ECA support in any of the Large Aircraft Countries. The 2011 ASU mandates a formal review of its procedures and provisions in 2015, but any participant may, upon three-months' notice, request a review before then. With all of the uncertainty relating to the overall impact of the 2011 ASU, an early review of its terms is likely.

### Endnotes

1. Org. for Econ. Co-operation & Dev. [OECD], Arrangement on Officially Supported ECAs, Annex III, OECD Doc. TAD/PG(2011)3 (2011), available at [http://www.oecd.org/officialdocuments/displaydocumentpdf?cote=tad/pg\(2011\)3&doclanguage=en](http://www.oecd.org/officialdocuments/displaydocumentpdf?cote=tad/pg(2011)3&doclanguage=en) (2011 ASU).

2. Org. for Econ. Co-operation & Dev. [OECD], Arrangement on Officially Supported Export Credits, Annex III, OECD Doc. TAD/PG(2008)29/FINAL (2008), available at <http://www.oekb.at/en/osn/DownloadCenter/export-services/international-relations/OECD-Arrangement-2009.pdf>.

3. The LASU applies to airplanes with 70 seats or more as well as comparably sized aircraft configured for cargo-carrying purposes. The OECD Arrangement (of which the LASU is a part, see the discussion at note 4 *infra*) also contained guidelines for regional jets, but because the related terms for these smaller aircraft were more general in nature and the arrangement did not cover Brazil (home of a major regional jet manufacturer), it was of limited effect.

4. Organization for Economic Co-operation and Development [OECD], *Arrangement on Officially Supported Export Credits*, OECD (1978).

5. The OECD member countries are Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, South Korea, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States.

6. The LASU, the 2007 ASU, and the 2011 ASU provide guidelines for the most favorable financing terms an ECA can offer in connection with the financing of aircraft. Nothing would prohibit an ECA from approving a transaction that mandated more restrictive or onerous terms from those contained in the applicable understanding.

7. Kostya Zolotusky, *Point-to-Point*, BOEING: E-NEWSLETTER, no. 16 (Spring 2010), available at [http://www.boeingcapital.com/p2p/rlv18y2010\\_66.htm](http://www.boeingcapital.com/p2p/rlv18y2010_66.htm).

8. *Bombardier Bites Back at Airbus and Boeing—Suppliers Share Wrap*, CENTRE FOR ASIA PAC. AVIATION (Feb. 5, 2010), available at <http://www.centreforaviation.com/news/share-market/2010/02/05/bombardier-bites-back-at-airbus-and-boeing--suppliers-share-wrap/page1>.

9. Mary Kirby, *Bombardier Sees Progress on New OECD Aircraft Sector Understanding*, AIR TRANSPORT INTELLIGENCE, Feb. 4, 2010.

10. Although the Spanish ECA, Compañía Española de Crédito a la Exportación (also known as CESCE), does not actively participate in financing Airbus aircraft, the rule extends to Spain due to the many Airbus manufacturing facilities located in Spain.

11. While unwritten, the Ex-Im Bank Charter evidences that the U.S. Congress is well aware of the understanding. If one of the principal ECAs violates the Home-Country Rule in a manner that constitutes "noncompetitive financing," Congress may authorize the Ex-Im Bank to offer similar terms to U.S. sellers to match the terms of the offending ECA agency. 12 U.S.C. § 635a-3(a)(2)-(3) (2006). This statute also extends to ECAs located in other countries with significant aircraft manufacturing facilities, such as Canada and Brazil. *Id.* § 635a-3(a)(1).

12. U.S. and European airlines viewed ECA financings as a form of subsidy for non-home-country airlines by either allowing non-home-country airlines access to advantageous financing terms that may not have been otherwise available to them in the commercial

market or allowing creditworthy non-home-country airlines access to below-market financing, in either case, putting U.S. and European airlines at a disadvantage by cutting into their market share with “subsidized” aircraft. *Air Transport Association Calls on U.S. Government to Conclude New Aircraft-Sector Understanding on Export Credits*, THE STREET (Dec. 16, 2010), available at <http://www.thestreet.com/story/10949877/1/air-transport-association-calls-on-us-government-to-conclude-new-aircraft-sector-understanding-on-export-credits.html>.

13. *Bombardier Bites Back at Airbus and Boeing*, *supra* note 8.

14. Daniel Michaels, *Talks Aim to Curb Jet Subsidy*, WALL ST. J., Mar. 31, 2010, available at <http://online.wsj.com/article/SB10001424052702303601504575153731035217058.html>.

15. 2011 ASU, *supra* note 1, art. 1(a)

16. *Id.*, art. 1(c).

17. A new aircraft is defined as “[a]n aircraft, including buyer furnished equipment, and the engines installed on such aircraft owned by the manufacturer and not delivered nor previously used for its intended purposes of carrying passengers and/or freight and . . . [s]pare engines and spare parts when contemplated as part of the original aircraft order . . .” *Id.*, art 8(a).

18. *Id.*, app. II, art. 4.

19. *Id.*, app. II, art. 15. The 2011 ASU provides a mechanism whereby the risk categories may be updated or modified by the participating ECAs from time to time at the request of any participating

ECA. *See id.*, app. II, arts. 6–13.

20. *Id.*, app. II, art. 3.

21. “Net price” means the price for the applicable aircraft invoiced by the manufacturer or supplier thereof, after accounting for all price discounts and other cash credits, less all other credits or concessions of any kind related or fairly allocable thereto. *Id.*, app. VI.

22. *Id.*, art. 20.

23. *Id.*

24. *Id.*

25. *Id.*, app. II, art. 19.

26. *Id.*, art. 12.

27. *Id.*, art. 13.

28. *Id.*, art. 11.

29. *Id.*, app. II, art. 18.

30. *Id.*, app. II, art. 28.

31. The “Cape Town Convention” refers, collectively, to the Convention on International Interests in Mobile Equipment and the Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Aircraft Equipment, in each case concluded in Cape Town, South Africa, on November 16, 2001.

32. 2011 ASU, *supra* note 1, app. II, arts. 35–37.

33. To be eligible for financing under the LASU, the aircraft must have originally been scheduled for delivery on or prior to December 31, 2010, in accordance with a firm contract concluded no later than April 30, 2007.