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UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

IN REPLY REFER TO:

PROGRAM ANALYSIS DIVISION

B-182682

September 2, 1977

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Stephan P. Carrier
Bureau Counsel
Bureau of Operating Rights
Civil Aeronautics Board
Washington, D.C. 20428

Dear Mr. Carrier:

This letter is in response to your inquiry (B-1-72) of March 10, 1977 to Comptroller General Staats. As you are aware, we were not able to respond within the time you requested. However, it is our understanding that this information will reach you in time to be useful in your investigation into whether and in what manner financial institutions may influence the management of air carriers. Our work that is most directly related to your area of inquiry is still not as far along as we had hoped, so that at this time we are only able to make certain general comments.

While the General Accounting Office has not been involved in a specific analysis of the market in which air carriers seek financing, we have studied several relevant aspects of the economics of the airline industry. One of our recent reports, entitled "Lower Airline Costs Per Passenger are Possible in the United States and Could Result in Lower Fares," analyzed in considerable detail certain aspects of airline regulation and finance. We have also examined several private studies (especially, Air Transport Association of America, "The Sixty Billion Dollar Question" and Donaldson, Lufkin & Jenrette, "Domestic Trunk Airlines: A Shortage Industry in the Making-Fleet and Capital Requirements, 1976-90") as well as a CAB study that provided estimates for future capital requirements in the airline industry.

Currently we are undertaking a study which in part will review certain aspects of the capital markets as they relate to the airline industry. At issue is the free and sufficient accessibility of airlines to the financial markets. In this study, we will be interested in determining the conditions set forth in loan (lease) agreements between airlines and their lenders (lessors). Our concern is with the effects that these agreements may have on the economic standing of the firm and on the efficiency of the capital markets. Our main interest is not with regard to whether the loan agreement constitutes control in the legal sense, as is your stated interest.

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We realize that there are varied legal precedents which limit financial institutions to only a fiduciary relationship with a firm engaged in real production. It is not the intention of GAO to imply that there should be less diligence in maintaining these fiduciary relationships.

However, it appears to us that a most essential part of an investigation into the question of possible control of airlines by financial institutions is to develop a clear understanding of why airlines may have become vulnerable to some compromise in their managerial prerogatives through their dealings with institutional lenders. If the airlines have free access to the capital markets, there is nothing inherent in the debtor/creditor relationship which would yield this type of control to the creditor. We believe that a close investigation of the financial situation of airlines reveals a situation which is conducive to creditor involvement in the management decisions of the borrower. It would seem that actions taken to prevent undue airline dependence on creditors should deal with underlying causes of this dependence as well as the nature of specific debt agreements.

The airline industry has large capital needs. During the period 1965-75 capital expenditures, including leases for trunk lines, totaled about $15 billion. A significant proportion of this was financed externally and has resulted in a large outstanding long term debt and a highly leveraged capital structure. Projections of future needs for replacement aircraft and for new aircraft to meet increased demand suggest that the airlines will continue to need substantial sums from capital markets.

Aside from the general economic conditions which determine the relative ease of credit availability, it will be the airline industries' earning potential as well as their financial condition which will determine their success in raising funds in the credit markets. The volatility of profits and highly leveraged capital structure have limited the accessibility of airlines to the open credit markets in the past. Recent downturns have all but cut off the largest airline companies from any open market credit transactions. This has created increasing reliance on insurance companies, their traditional source for long term funds, and banks, many of which have financial troubles of their own.

The control issue comes to a clear focus when typical long term financing procedures of the airline industry are detailed. The sources for the long term funds used in financing capital equipment are usually obtained either through the direct placement of bonds to financial intermediaries or through lease arrangements with leasing company subsidiaries of the financial intermediaries. Although these financing methods are logically and financially distinct from each other, they possess an important common characteristic. Both entail contractual relationships that are tailored to conditions specific to the individual lender and borrower. This contractual nature facilitates the ability of lenders

to extract nonmonetary considerations in the form of certain constraints from the borrower. The lender may view this as a risk premium above that already incorporated in the interest rate. (The conditions specified are quite varied and to interpret them as management control could only be determined through a case by case analysis.)

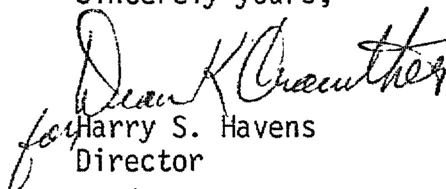
Institutional factors may also contribute to creating conditions which could lead to involvement of financial institutions in airline management decisions. For example, New York State has laws which restrict an insurance company's investments to businesses with minimum standards in selected financial ratios such as a minimum interest coverage ratio. Insurance companies which would otherwise provide funds to airlines may be unable to do so. This may lead to a situation where the potential lender would be more interested in airline management's manipulation of certain accounting numbers than they might ordinarily be.

It thus appears to us that the trunk carriers are encountering a situation that encourages the use of financing instruments most likely to facilitate creditor involvement in airline management. We have already mentioned several of the key factors that contribute to the present financial conditions of many of the trunk carriers--highly leveraged capital structure, low and volatile profitability, and institutional constraints. The factors in turn are no doubt related to revenue and cost characteristics of regulated trunk carrier service.

In summary, we feel that efforts to assure the integrity of the fiduciary relationships between financial intermediaries and trunk carriers are important. However, we also believe that any inquiry such as yours should also stress why the airline companies would yield managerial rights to their lenders.

We hope our comments will be of use in your investigation.

Sincerely yours,



for Harry S. Havens
Director