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With the continuing liberalization of air transport and the proliferation of various low-cost airlines that compete fiercely for lower fares in ASEAN region, consumer protection has gained increasing attention. Nevertheless, there is a myriad of different sets of aviation codes in each ASEAN state which tends to bring about an adverse impact on consumer's interests. To address the problem, the harmonization of the regional aviation codes in protecting consumer's rights is proposed. See related article on page 3.

A Survey of Consumer Protection Codes in Aviation in ASEAN*

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1. INTRODUCTION

The conduct of business in the aviation industry is governed by a complex web of voluntary codes of conduct and mandatory rules and regulations. Voluntary standards can be instituted by the service provider itself, such as an airline's code of conduct, or set by national self-regulating bodies, such as the Air Transport Association of the United States (ATA), or multilateral association, the International Air Transport Association (IATA). These codes of conduct are in keeping with the general principles outlined in various non-binding recommendations or guidelines established by the International Civil Aviation Organization (ICAO), a United Nations (UN) body. Mandatory rules and regulations are instituted by IATA's binding resolutions, international conventions, such as the Chicago Convention of 1944, and the Montreal Convention of 1975, as well as national/regional competition or consumer protection authorities or sector-specific regulatory body.

In general, competition can ensure efficient services. Competition alone, however, does not necessarily guarantee a fair or minimum level or quality of service that a consumer would normally expect, in particular when consumers lack the information required to make informed choices. Cost pressures have occasionally led to an adverse impact on consumers' interests. Infrastructure limitations and air-space congestion resulting from the rapid expansion of air transportation have also contributed to increased concerns about service quality. For these reasons, many governments decided to step in; however, State regulations may impede effective competition in the market.

For example, the imposition of a minimum service quality standard would tend to impose additional costs on service providers, which would likely lead to higher service prices and fewer service choices for consumers as (less expensive) lower quality service choices are withdrawn from the market. Also, regula-

tions, once adopted, are difficult to withdraw. They are also often rigid, not adaptive to changing market and economic environment. At worst, faulty regulations may lead to distortions in other segments or elements of the market. As a result, self-regulation, when possible, is generally preferred.

Voluntary commitments under a self-regulatory regime can be effective if properly monitored and if the threat of regulation is real in the case of failure. Service providers also prefer to commit themselves to a set of "best practices" under their own initiation, as they are likely to be more practical and at times, more effective, than the regulatory alternative.

For example, in February 2002, airlines in Europe developed the "Airlines Passenger Service Commitment," following consultations with representatives of air travelers, European governments and the European Commission. The code covers 14 areas, including notification of flight delays, cancellations and diversions, baggage delivery, refund policy, check-in convenience, denied boarding, provision of information regarding operating carriers in the case of codesharing flights, etc. Similarly, European airports have developed the "Airport Voluntary Commitment on Air Passenger Service." Issues covered include assistance of passengers in cases of significant delay, provision of infrastructure for check-in, baggage and security and passenger information concerning legal rights. While these commitments are not legally binding, signatories strive to meet the quality standard set out.

Harmonized regional codes of conduct can be more effective in protecting consumers' interests than a patchwork of national codes or regulations. This is because airlines often operate a global network and hence are subject to a myriad of different sets of regulatory and contractual requirements, creating confusion for both the operators and customers alike. The fragmented regime can also prove costly to comply with for operators and confusing for passengers. Thus, a uniform code of conduct, if effective, can avoid the

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excessive regulatory burden faced by carriers, benefiting the industry and consumers. It is therefore worthwhile to explore the possibility of the having a regional code of conduct for the air transport sector, which includes air carriers, airports, computer reservation system (CRS), and the distribution of air transport services.

This study proposes a regional code of conduct for the aviation industry that complements future liberalization in this sector. Such a code will serve to ensure that, when ASEAN airlines are able to operate freely across borders, consumers' interests will be properly protected. Such a code would have to be politically, legally and socially acceptable to all ASEAN States. Presumably, it would not be prescriptive. Rather, it would provide general principles or guidelines that can facilitate convergence of State or private self-regulatory rules in the longer run.

The organization of this paper is as follows. Section 2 describes the general regulatory environment governing aviation in ASEAN States. Section 3 discusses key consumer issues in the aviation-associated industries and examines State regulations or private codes that have been put in place in order to address these concerns. Finally, section 4 summarizes the need for codes and proposes a regional aviation code that may be compiled into the Template Regional Air Service Agreement.

2. AVIATION REGULATORY ENVIRONMENT IN ASEAN STATES

This section is divided into two parts. The first part describes the legal and institutional set up of the regulatory regime governing air transportation in member States of ASEAN. The second part concerns private initiatives in the area of consumer protection in the passenger air transport business.

2.1 State Regulation

Most ASEAN airlines are under the regulatory supervision of a ministerial authority, such as the Directorate of Air Transport in Indonesia, the Department of Air Transport in Thailand, the Civil Aviation Authority of Singapore, the Department of Civil Aviation in Cambodia, Myanmar and Brunei Darussalam, the Ministry of Transport in Malaysia and the Civil Aviation Administration of Vietnam. The Philippines is the only country that has a full-fledged regulatory authority known as the Civil Aeronautics Board, which oversees economic regulation, including consumer and competition issues. Technical regulation, however, is under the purview of the Air Transport Office, the Ministry of Transportation and Communications. It should be noted that regulatory authorities that are ministerial rather than independent bodies are

responsible for both policy and regulatory functions (see Table 1).

In general, the regulatory rules for consumer protection in the aviation industry in ASEAN are not yet fully developed. Most existing regulations concern technical safety, licensing and tariffs issues. Carriers' obligations with regard to, say, denied-boarding compensation, flight delays and cancellation and protection of private information, etc., are not regulated. Rather, airlines are allowed to establish their own "condition of carriage" subject only to the liability provisions as stipulated in the various Conventions to which the country is signatory.¹ For airlines that are members of IATA,² the terms and conditions of carriage usually follow IATA's guidelines. For those that are not members, the terms and conditions of carriage are uncertain.

The emergence of low-cost airlines in ASEAN has raised concerns whether certain basic issues regarding the conditions of carriage should be legislated to protect consumers, in particular when domestic carriers are not members of IATA. Certain ASEAN countries have taken steps to establish specific rules and regulations targeting low-cost domestic carriers. For example, in December 2003, the Thai Ministry of Transport issued the Statement "On the Protection of Passengers of Thailand's Domestic Airlines," following its liberalization of domestic air transport in December 2001. The Statement covers issues concerning flight cancellation or combination and compensation in case there are long delays or accidents. These passenger protection clauses are inserted in the air transport license issued by the Department of Air Transport, Ministry of Transport.³ It is imaginable that once low-cost airlines become prolific in the region, State authorities will move to establish rules and guidelines to protect basic consumer rights in using air transport services.

Consumer issues that are not specific to the aviation industry, such as false or misleading advertisements, are normally handled by the consumer protection authority. For example, on February 18, Thailand's Consumer Protection Board fined three low-cost carriers for misleading advertisements on their airfares. Thai Air Asia, Nok Air and Orient Thai Airlines were each fined 150,000 baht (US\$1 = about 38 baht). Consumers complained that the airlines used large fonts for the promotional prices, but gave details and additional conditions in very small fonts that were barely noticeable somewhere else in the advertisements. Unfortunately, not all ASEAN countries have a consumer protection law and authority. Lao PDR and Cambodia, for example, have laws only on product safety, price control and metrology.

To conclude, domestic regulation of the aviation industry—beyond safety and tariffs issues—is still relatively undeveloped in ASEAN. Hence, adoption of relatively basic rules may imply significant progress for some member countries.

Table 1 Regulation of the Air Transport Industry in ASEAN

Country	Consumer Protection Law	Consumer Protection Authority	Regulatory Agency
Brunei	No consumer protection law	NA	Department of Civil Aviation
Cambodia	No consumer protection law, only Management of Quality and Safety of Products and Services Law	NA	Department of Civil Aviation
Indonesia	Consumer Protection Law 1999	National Consumer Dispute Settlement Board	<ul style="list-style-type: none"> • Directorate of Air Transport, Ministry of Transport (economic regulation) • Directorate of Aviation Safety (technical regulation)
Lao PDR	No consumer protection law	NA	Lao Transport Authority
Malaysia	Consumer Protection Act 1999	National Consumer Advisory Council, Tribunal for Consumer Claims	Civil Aviation Department, Ministry of Transport
Myanmar	No consumer protection law	NA	Department of Civil Aviation
Philippines	Consumer Act 1991	Department of Trade and Industry	<ul style="list-style-type: none"> • Civil Aeronautics Board (independent body responsible for economic regulation) • Air Transport Office (ministerial body responsible for technical regulation)
Singapore	NA	NA	Civil Aviation Authority of Singapore
Thailand	Consumer Protection Act 1979	Consumer Protection Board, Office of the Prime Minister	Department of Air Transport
Vietnam	Ordinance on Consumer Protection 1999	Directorate for Standardized Metrology and Quality, Ministry of Science and Technology	Civil Aviation Administration

Source: Data collected by author.

2.2 Self-regulation

Self-regulation may be organized at a global, regional, national or firm level. At the global level, Thai Airways International and Singapore Airlines belong to the largest air alliance, the Star Alliance. Other ASEAN airlines are not associated with a major alliance. Although these alliances do not establish their own codes or service standards, membership is conditional on the quality of its service. The Star Alliance, for example, is seen as an alliance with high-quality services.

At the regional level, the Association of Asia Pacific Airlines (AAPA) comprises 17 airlines,⁴ seven of which are ASEAN national flag carriers. The Association's Secretariat is based in Kuala Lumpur, Malaysia. AAPA's activities focus mainly on providing comments and responses to State policies and regulations, rather than setting a common service standard for member airlines.

At the national level, due to the limited number of operators in the market, carriers' associations are rare in ASEAN States, except for the Philippines and

Indonesia—the archipelago States, that register a large number of carriers. The Indonesian National Air Carriers Association (INACA) approves airfare adjustments for member airlines within the ceiling regulated by the State authority.

At the firm level, only a few ASEAN airlines operating international flights inform the public about their “general conditions of carriage” on their websites, as can be seen in Table 2. The contents cover basic issues regarding baggage rules and liability and denied boarding. For example, Garuda Indonesia and Malaysian Airlines do not disclose their denied-boarding compensation on their websites. They merely inform passengers that a copy of the relevant carrier's denied-boarding compensation is available upon request. Philippine Airlines, on the other hand, indicates in greater detail the specific procedures that will be taken in case of an overbooking of flights and the compensation to which persons who are denied boarding involuntarily are entitled. Interestingly, Singapore Airlines and Thai Airways International, the two largest carriers in the region, do not show their condition of carriage on their websites.

Table 2 ASEAN Airlines' Condition of Carriage as Described on Their Websites

Airline	Condition of Carriage	Denied-boarding Policy	Codeshare	Flight Delays, Cancellation or Re-routing
Malaysian Airlines	Yes	<ul style="list-style-type: none"> Overbooking procedures not specified Denied-boarding compensation in accordance with carrier's policy. A copy of denied-boarding compensation available upon request 	<ul style="list-style-type: none"> Carrier operating the aircraft's conditions of carriage applies Inform customer about carrier operating the aircraft before ticket is purchased. 	<p>For flight delays, cancellation or changes beyond carrier's control:</p> <p>Options:</p> <ol style="list-style-type: none"> Carry on another scheduled service Re-route. If revised route fare is higher, passenger will not be charged; if lower, the difference will be refunded. Make a refund (a) if no portion of the ticket has been used, an amount equal to the fare paid; (b) if a portion of the ticket has been used, the refund will be the higher of: <ul style="list-style-type: none"> the one-way fare from point of interruption to the destination or the stopover, adjusted by the same percentage discount, if any, as is reflected in the original fare purchased; or the difference between the fare paid and the fare for the transportation used.
Garuda Indonesia	Yes	<ul style="list-style-type: none"> Overbooking procedures not specified Denied-boarding compensation in accordance with applicable law and carrier's policy. A copy of denied-boarding compensation available upon request 	<ul style="list-style-type: none"> Inform customer about carrier operating the aircraft at time of reservation 	<p>The same as for Malaysian Airlines except for 3(b): if a portion of the ticket has been used, not less than the difference between the fare paid and the applicable fare for travel between the points for which the ticket has been used.</p>
Philippine Airlines	Yes	<ul style="list-style-type: none"> Carrier's personnel ask for volunteers willing to give up confirmed seats in exchange for a reward. Passengers involuntarily denied boarding would be entitled to compensatory payment. Denied-boarding compensation policy available as part of conditions of carriage 	<ul style="list-style-type: none"> Not available 	<p>The same as for Malaysian Airlines except for 3(b): if a portion of the ticket has been used, the refund will be the difference between the fare paid and the applicable fare for the transportation used.</p>
Singapore Airlines	No			
Royal Brunei Airlines	No			
Vietnam Airlines	No			
Thai Airways International	No			

Source: Collected by author.

This anecdotal fact seems to suggest that the success of a carrier has little to do with its specific condition of carriage, be it the denied boarding or delayed flight or cancellation policy. As long as the problems of overbooking, long delays and flight cancellation do not occur frequently, and the airline adheres to the basic treatment recommended by IATA when such events do happen, customers do not place importance on the “extra mile” that the airline may take to guarantee greater protection. Other factors, such as frequent flyer programs, the quality of in-flight services and facilities, leg room and food, seem to matter more.

3. CONSUMER PROTECTION ISSUES TO BE COVERED UNDER THE PROPOSED REGIONAL CODE

With the continuing liberalization of air transport and the proliferation of various low-cost airlines that compete fiercely for lower fares, consumer interests have received increasing attention in many countries, including ASEAN member States. ICAO⁵ has developed guidance material on consumer interests in areas such as conditions of carriage, fare guarantee, baggage handling, tariff disclosure, denied boarding and a code of conduct for the regulation and operation of CRS. However, some States have decided to legislate certain aspects of the conditions of carriage in order to ensure passenger rights.

The European Union has taken unilateral action to regulate air transport and related services in order to protect consumers’ interests and to guarantee passenger rights. It has issued a myriad of regulations concerning different aspects of consumer protection, as will be examined in greater detail in this section.

The initial approach of the United States to regulation relied mainly on voluntary self-regulation by trade associations. In June 1999, ATA, working with the United States Congress and the U.S. Department of Transportation, developed the “Airline Customer Service Commitment.” The document establishes suggested minimum service standards that member airlines should seek to maintain. These include standards governing ticket refund, codesharing, overbooking, cancellation and holding of reservations, meeting customers’ essential needs during long delays, notification of known flight delays and cancellations, etc.

On February 13, 2001, that Department’s Office of the Inspector General (IG) released a congressionally mandated report analyzing the progress made by the airlines under the voluntary “Customer Service Commitment.” The IG report concludes that, although progress has been made, there are still significant shortfalls, especially in provisions that “trigger” when there is a flight delay or cancellation. These provisions include keeping customers informed of delays and cancellations and also meeting customers’ “essential

needs” during extended on-aircraft time; they are legally enforceable either by requiring their inclusion in the airlines’ contracts of carriage or by regulation.

The introduction of the Airline Customer Service Improvement Act coincided with the release of the IG report. The Act requires that all ATA member airlines incorporate the Customer Service Commitment in their contracts of carriage. It also requires disclosure of the on-time performance and cancellation rate for chronically-delayed or canceled flights when a customer makes a reservation. As such, the customer can hold the carrier legally liable for breach of contract in case of non-compliance. The experience of the United States seems to indicate that a purely voluntary scheme has its limitations in the absence of an effective monitoring scheme and the force of law that stands behind it.

The following subsections will address the main issues concerning consumer protection in aviation and examine the approach that each State has taken to deal with these issues, be they voluntary codes or legally binding regulatory rules.

3.1 Cancellation, Delays and Diversion

Increasingly congested airports and high turn-around time for aircraft spearheaded by low-cost airlines in an attempt to cut costs have contributed to more frequent flight cancellation and delays. While the Warsaw Convention and its subsequent amendments provide for carriers’ liability in cases of flight delays or cancellation, there are also concerns about how passengers are to be informed about the delay or cancellation and how they should be treated while awaiting boarding of the aircraft.

On these issues, IATA provides for recommendations concerning delays and cancellation of flights in its *Recommended Practice 1724* (RP 1724) with regard to General Conditions of Carriage (Passengers and Baggage), as shown in Box 1. The Recommendation stipulates that the airline will carry the passenger on the next available flight, re-route the passenger, or make a refund equivalent to the price of the ticket. It does not specify how it would accommodate passengers in cases of a long delay, however. IATA’s Resolution 735d on Involuntary Change of Carrier, Routing, Class or Type of Fare states that carriers should bear passengers’ essential expenses (meals and accommodation) in case of involuntary change of aircraft, but it is silent on long delays.

The European Commission has recently taken steps to increase carriers’ obligations in case of a flight cancellation, delay or diversion. It passed a new regulation on compensation and assistance to passengers in the event of denied boarding and of cancellation or long delay of flights, i.e., Regulation (EC) No. 261/2004, which came into effect on February 17, 2005. This piece of regulation replaced the older one (Regulation (EC) No. 898/2002) that incorporated

provisions from the Montreal Convention into regional regulations. The new regulation increased the compensation that European Union airlines would have to pay customers in case of a denied boarding and stipulate the treatment to which a passenger is entitled in cases of flight cancellation, long delays, baggage damage, loss or delay and accidents. Passengers may also claim damages from their tour operator if it fails to provide services that he or she has booked within the European Union.

As for the United States, the Airline Customer Service Improvement Act does not prescribe the minimum level of standard of treatment of passengers in case of flight delays or cancellations beyond the financial compensation required by the Warsaw Convention. The Act simply requires that “large air

carriers” provide the best information to customers regarding delay, cancellation, or diversion and establish a plan with respect to how passengers who must unexpectedly remain overnight during a trip due to flight delays, cancellations, or diversions, are to be assisted. Unlike the European Union’s Passenger Rights, it does not provide for meals or accommodations for long delays, that is, the United States places greater importance on ensuring the availability of relevant information to customers, rather than prescribing the minimum level of treatment of passengers that all carriers must provide. Airlines are free to establish their own policies with regard to assistance as long as the information is made available to passengers so that they can make informed choices in selecting the airlines with which they would like to travel.

Box 1 IATA’s Recommended Practice Regards to Flight Delay, Cancellation or Diversion

9.1 SCHEDULES

We undertake to use our best efforts to carry you and your Baggage with reasonable dispatch and to adhere to published schedules in effect on the date of travel. However, to do so, we may need to use a substitute aircraft and/or the services of another carrier. We may also be obliged to change the time of flights, often for reasons beyond our control, and consequently, times shown in timetables cannot be guaranteed and thus form no part of your contract of carriage with us.

9.2 CANCELLATION AND RE-ROUTING

9.2.1 We reserve the right to substitute an alternative carrier and/or aircraft. If we cancel a flight, fail to operate a flight reasonably according to the schedule, fail to stop at your destination or Stopover, or cause you to miss a connecting flight on which you hold a confirmed reservation, you shall have the option, subject to our agreement, either:

- 9.2.1.1** to be carried on another of our scheduled services on which space is available without additional charge and, where necessary, extend the validity of your Ticket; or
- 9.2.1.2** to be re-routed to the Stopover or destination shown on your Ticket by our own services or those of another carrier. If the fare and charges for the revised routing are lower than what you have paid, we shall refund the difference;
- 9.2.1.3** if neither of the above alternatives is acceptable to you, we will make a refund in accordance with the provisions of 10.2 and we shall have no further liability to you.

9.3 If we are unable to provide previously confirmed space, we shall provide compensation pursuant to our denied boarding compensation policy. (Further information is available from us on request.)

10.2 Involuntary Refunds

10.2.1 If we cancel a flight, fail to operate a flight reasonably according to schedule, fail to stop at your destination or Stopover, or cause you to miss a connecting flight on which you hold a reservation, the amount of the refund shall be:

- 10.2.1.1** if no portion of the Ticket has been used, an amount equal to the fare paid;
- 10.2.1.2** if a portion of the Ticket has been used, the refund will be not less than the difference between the fare paid and the applicable fare for travel between the points for which the Ticket has been used.

Source: IATA. 2001. “Comparison of Relevant Rules, Recommended Practices and Airline Service Commitments.” Working Document. Available at <www.iata.org/NR/ContentConnector/CS2000/SiteInterface/sites/mgr/file/Summary_Commitments_5_01.pdf>.

3.2 Codesharing

The proliferation of codesharing agreements between airlines has raised the concern of many consumers. The major ones are each carrier's liability in a joint-service arrangement. If one's luggage is lost or flight is very much delayed such that a passenger missed a connecting flight on a codeshared flight, which airline is responsible for providing compensation? Is it the airline with which one's reservation was made, or the airline which provided the service?

On this issue, the Montreal Convention stipulates that the passenger can take action against the carrier which performed the carriage during which an accident or a delay occurred, unless there is a specific agreement such that the first carrier assumes the liability. This has been incorporated into Article 15 on the Liability of Carriers in IATA's Recommended Practice 1724 with regard to General Conditions of Carriage. It should be noted, however, that only 52 States are signatories to the particular Convention, among which only one (Cambodia) is an ASEAN member. Hence, the liability regime of ASEAN carriers under a codesharing arrangement are subject to the domestic law of the country concerned.

Another issue of concern about codeshared flights is whether consumers are adequately informed about the details of the flights at every stage in the passenger's journey, in particular flight operators that may not be the same as the operator with which the reservation was made, intermediate stops and changes of aircraft, airlines and airports.

On this issue, ICAO has established the Recommendation on Consumer Aspects of Codesharing, which calls for States to ensure that consumers are fully informed about codeshared flights, as shown in Box 2. The Recommendation does not prescribe the details of the information that should be made available to the passenger, however. IATA's Recommendations spell out that airlines should advise the passenger of the carrier operating the aircraft at the time that a reservation is made. European Union regulations concerning code-

sharing are embedded in its Code of Conduct on Computer Reservation System, which will be discussed in greater detail later on.

Only two ASEAN airlines, Malaysian Airlines and Garuda Indonesia, provide codesharing information in the general conditions of carriage, as shown in Table 2. Malaysian Airlines informs passengers that the conditions of carriage of the carrier operating the flight applies under a codeshare arrangement and that the carrier commits to informing passengers about the carrier operating the aircraft before the ticket is purchased. Garuda Indonesia is silent on the conditions of carriage on a codeshared flight, but commits to informing passengers about the carrier operating the flight when the reservation is made. Other ASEAN carriers' policies with regard to codesharing arrangements are not available.

3.3 Overbooking/Denied Boarding

The practice of overbooking in airlines is universally accepted for efficiency reasons. Since not all passengers that have confirmed a seat on a flight show up, it is the general practice that the airlines will overbook the number of passengers in order to ensure that its capacity will be filled. How a carrier decides which passenger should be "bumped" and how those involuntarily bumped are to be compensated are a major concern. There is no international treaty addressing this issue; the Convention for the Unification of Certain Rules Relating to International Carriage by Air (Warsaw Convention), signed on October 12, 1929, contains no provision on denied-boarding compensation.

IATA's recommended practice stipulates that a passenger who is denied boarding should be entitled to compensation in addition to a full refund of the unused portion of the ticket. Before denying boarding to any passenger, the airline concerned may call for volunteers not to board such flights. Any passenger who accepts the denied-boarding compensation does so as full settlement of any and all claims against the airline.

Box 2 ICAO's Recommendation on Consumer Aspects of Codesharing

RECOMMENDATION ATRP/9-6

THE PANEL RECOMMENDS that States take the necessary action to ensure that consumers are fully informed and protected with respect to codeshared flights operating to or from their territory and that, as a minimum, passengers be provided with the necessary information in the following ways:

- a) orally and, if possible, in writing at the time of booking;
- b) in written form, on the ticket itself and/or (if not possible), on the itinerary document accompanying the ticket, or on any other document replacing the ticket, such as a written confirmation, including information on whom to contact in case of a problem and a clear indication of which airline is responsible in case of damage or accident; and
- c) orally again, by the airline's ground staff at all stages of the journey.

Source: <www.icao.int/icao/en/atb/ecp/c269-note.htm>.

Although the recommended practice indicates that airlines should call for volunteers and that passengers denied boarding, voluntarily or involuntarily, should be compensated, the practice is non-binding. Hence, carriers are able to establish their own overbooking and denied-boarding procedures and compensation rules, unless these are regulated by the national regulatory authority. As seen in Table 2, only the Philippine Airlines employs the volunteer scheme as recommended by IATA. It is also the only airline in ASEAN that discloses the exact amount of involuntary compensation in case of denied boarding as required by the Civil Aviation Board. Other ASEAN airlines do not disclose how passengers are “bumped” and the level of compensation to which they are entitled. This may be the case because of the absence of a sector-specific regulatory oversight, as discussed previously.

- *The Development of a Denied-boarding Scheme*

The rationale for regulating denied-boarding procedures and compensation is based on “asymmetric information.” Since the possibility of a passenger with a confirmed ticket being denied boarding is relatively remote,⁶ most passengers are ignorant of the trade-off between the price of the ticket and the chance of being bumped. Even in cases where disclosure about the overbooking is legislated, as in the United States, passengers are informed about overbooking only after the ticket has been purchased, since overbooking often results from last-minute bookings.

Although a passenger unhappy with the compensation for the breach of contract by the carrier may pursue damages in court, they rarely litigate due to the transaction costs involved and because the potential court award is likely to offset those costs. Given the information asymmetry, airlines would tend to abuse the overbooking policy if there is no penalty for doing so. This would also discourage airlines from adopting policies that would help avoid overbooking, such as the issuance of non-refundable tickets (no-shows are rare when tickets cannot be refunded).⁷ Thus, given incomplete information, certain States stepped in to determine the level of compensation that carriers are required to pay passengers that are bumped. For example, currently the Federal Government of the United States sets the level of damages for passengers denied boarding at a maximum of \$400 applicable to all commercial flights in the United States. This rate has been in place since 1978.

The prevailing industry practice with regard to denied boarding, as a result of overbooking, is that whoever arrived at the gate first would get to travel. This is seen as inefficient as passengers who are less concerned about arriving at the destination later than expected may not be bumped off the flight, while those who need to catch another flight may be denied boarding. As a result, in 1978 the United States

pioneered a volunteer auction scheme whereby carriers are mandated to carry out an auction plan to reduce the number of involuntary bumpings. The airlines saved a large sum of money since many passengers were willing to accept sums that were lower than the statutory ceiling of \$400 in case of involuntary denied boarding as determined by the Civil Aviation Board. The rate of involuntary bumping also decreased from 6.4 per 100,000 passengers in 1978 to 1.1 per 100,000 passengers in 1991 in spite of an increase in the revenue share from overbooked passengers from 6.4 percent to 15.1 percent of sales during the same period (Simon 1992). During the period 2000-2002, 2.9 million passengers were denied boarding, and 2.76 million accepted the compensation offered by the airlines. This seems to indicate that the set maximum level of compensation of \$400 is slightly too low since 5 percent of passengers who had been denied boarding were not satisfied with the compensation they received from the carrier.

It has been suggested that the maximum compensation should be eliminated in order to avoid any involuntary bumping. There are concerns that passengers may have an incentive to overstate their damage and hold out for inflated compensation. However, the fear of collusive practices among passengers has proved to be unfounded thus far. The number of passengers involved in any volunteer passenger auction may mitigate such concerns.

- *Existing Regulations Concerning Denied Boarding*

As mentioned previously, the United States Federal Government imposes a mandatory auction system so that volunteers can give up their seats on an overbooked flight and it has set a \$400 maximum as compensation for denied boarding for flights within the United States. It also has strict rules that require air carriers to display “Notice: Overbooking of flight” at each check-in airport counter as well as on the ticket, ticket jacket, or on a separate piece of paper accompanying the passenger’s ticket.

The European Union’s new Passenger Rights that became effective in February 2005 established common rules on compensation and assistance in cases of denied boarding and cancellation of flights for member countries. The new rule requires a call for volunteers and increases the sum of payment to which a non-volunteer is entitled according to the distance of the trip and the length of the delay. In addition, it also prescribes in detail the assistance that carriers would have to provide to the passengers affected.

Another new clause that was introduced in the new European Union’s regulation requires the carrier to offer a choice of compensation options, including a return flight to the original point of departure. IATA strongly opposes the European Union’s new denied-

boarding regulation, in particular the prescribed financial compensation that the Association views as arbitrary because it is not linked to the price of the ticket. Also, the mandatory option of a return flight to the point of origin would hold carriers experiencing a delay liable to other portions of a trip in which it is not involved in case the passenger holds a multiple-coupon ticket. This can prove costly and may prompt airlines to stop interlining. Travelers would then face repeated check-in and baggage claim procedures at each stop and higher fares. As the regulation became effective only on February 15, 2005, it is too early to assess the impact of this groundbreaking regulation aimed at protecting consumers.

3.4 Air Transport Service Distribution and Computer Reservation System

The term “distribution” refers to the sale and marketing of air transport services. Until recently, CRS has been the vital part of distribution, as it provides travel agents with flight schedules, fares, seat availability, seat reservations and ticket issuance. Consumer concerns regarding CRS arise from the fact that each of the CRSs in use to date were once owned and controlled by several airlines. This has led to anti-competitive practices in that each CRS tends to favor its own “parent carrier,” that is, any carrier that directly or indirectly, alone or jointly with others, owns or effectively controls the particular CRS. It does so by setting the order of display of available flights to a city-pair. That is, information on flights operated by “parent carrier(s)” is made to appear first on the screen.

Discriminatory presentation of information is unfair not only to competitors, but also to consumers. As a result, regulations have been put in place to ensure that customers are getting unbiased information regarding their travel options from travel agents using a CRS. ICAO’s Code of Conduct for the Regulation and Operation of CRS prescribes the obligations of both the system vendor (means entities that operate or market a CRS) and subscribers (meaning entities such as travel agents that use CRS under contract with a system vendor for the sale of transport services to the general public) with regard to display of information on CRS and the supply of information to consumers.

Another concern of consumers regarding the use of CRS is the handling of passengers’ private information. On this issue, the ICAO’s Code of Conduct for the Regulation and Operation of CRS requires contracting States to take appropriate measures to ensure that all parties involved in the CRS operating system safeguard the privacy of passenger data, and that these parties are held responsible for data protection. The European Union’s regulation ensures compliance with this provision by requiring the system vendors to—at the minimum—employ software that supports the protection of private data by screening access.

In recent years, airlines’ dependence on CRS has gradually diminished against the rising prominence of the Internet. Consumers are now able to make their own itinerary, ticket reservation and payment on-line, which is less costly. They can do so through a third party, i.e., on-line travel agents that may or may not have conventional retail outlets, airlines’ own websites, or a group of airlines’ website (such as Orbitz in North America, Opodo in Europe and Zuji in Asia and the Pacific). There are thus questions regarding whether the existing ICAO’s Code of Conduct that was designed for the traditional marketing channel is applicable to Internet-based distributors.

Consumer concerns with regard to Internet marketing are wide-ranging. Consumers are generally less protected when they buy services on-line than when they buy from traditional outlets. Most countries have regulations governing e-commerce that can protect consumers against marketing fraud. However, in practice, there is little that a State can do to regulate these web-based air transport service distributors, whose domicile lies outside the national jurisdiction. The exception would be large industrial countries and areas, such as the United States and the European Union, where many of these Internet distributors are registered.

In order to ensure that the requirements of the provision of neutral and accurate information imposed on the traditional carriers also apply to web-based distributors (who are also subscribers to CRS), several States have addressed the issue under the umbrella of airline passenger rights, while others apply general consumer protection law to the Internet transactions. The European Union has revised its Code of Conduct for CRS in 1999 in order to ensure that the scope of the definition of “CRS subscribers” in the regulation covers modern distribution channels as well.

Turning to ASEAN, the use of the Internet remains limited as the majority of the population still does not have access to a computer or are not sufficiently computer literate to make their own arrangements on the web. The traditional travel agency remains the major distribution channel. Fierce competition in the market has kept these businesses extremely lean. Concerns about misleading or inaccurate presentation of display may be presented in countries where the national flag carrier holds an equity stake in a particular CRS. Five ASEAN airlines namely, Singapore Airlines, Malaysian Airlines, Royal Brunei Airlines, Silk Air and Garuda Indonesia, hold an equity stake in Abacus, one of the three major CRSs⁸ used in this region. In 2003, the Indonesian competition authority found that Garuda had breached the national competition law by requiring travel agents to use only the Abacus reservation system to reserve its tickets. Thus, to ensure that distribution of CRS in ASEAN is fair and efficient, member countries should consider adopting the ICAO’s

code concerning CRS distribution to ensure that consumers are provided with impartial information about their travel options.

4. RECOMMENDED ASEAN CODES

There are three major issues that need to be addressed in designing regional aviation codes of conduct. The first concerns the substances of the codes. Which consumer protection issues need to be codified, and which should be left to the airlines' own policy or the consumers' own preference with regard to price and service quality trade-off? Second, what will be the modality of the regional agreement on aviation codes? Should the codes be binding, subject to a regional dispute settlement mechanism, or should they be voluntary, subject to periodical reviews to create peer pressure? Finally, which institutions or organizations—at both the national and regional levels—should be responsible for implementing and monitoring compliance with the codes?

4.1 Substances of the Codes

The substance of the recommended ASEAN codes will draw heavily on existing codes and regulations that are already available in international forums. As the air transport industry is global in nature,

any regional codes would have to be consistent with those already established at a multilateral forum. To be specific, ASEAN's aviation codes should be based on recommendations, resolutions and guidelines established by ICAO and IATA. Such codes would not be overly prescriptive, as these guidelines and recommendations are specifically tailored to provide flexibility for the individual States to fill in their own details for implementation. Hence, one may avoid the risk of over-regulation that could strangle the fragile competition in the market. On the other hand, these recommendations and guidelines offer basic consumer protection and fair competition rules that have been accepted by both member governments and private operators in the market.⁹ Table 3 summarizes the recommended consumer protection codes to be adopted by ASEAN States.

The issue of carriers' liability lies at the heart of consumer protection issues in air transportation. A global convergence of the liability regime will lessen uncertainties and confusion among operators and consumers alike. Given that seven ASEAN members are already signatories to the Hague Protocol's Amendment to the Warsaw Convention, a regional liability regime based the Protocol could be easily established. If all ASEAN members were able to subscribe to the liability regime provided under the Convention, ASEAN carriers' liability in cases of damage, accidents and flight cancellation, delays and diversions would converge.

Table 3 Recommended Mandatory Codes and Member State's Commitment

Issue	Recommended Mandatory Codes	Commitment of ASEAN States
Carriers' liability in cases of accidents, flight delays and cancellation	<ul style="list-style-type: none"> The Warsaw Convention and the Hague Protocol 	<ul style="list-style-type: none"> Binding commitment to become signatory to the Convention and the Protocol
Cancellation, delay and diversion of flights	<ul style="list-style-type: none"> IATA's Recommended Practice Regards to flight delay, cancellation or diversion IATA's Resolution 735d recommends that airlines cover essential expenses (meals and accommodation) in case of involuntary change of aircraft, but not delay 	<ul style="list-style-type: none"> Binding commitment to ensure that the content of the recommended practice and resolution established by IATA is incorporated into carriers' general conditions of carriage.
Denied boarding	IATA's Recommended Practice – Denied-boarding Compensation (PSC (13)1799)	<ul style="list-style-type: none"> Binding commitment to ensure that carriers establish and disclose denied-boarding procedures and compensation in their general conditions of carriage
Consumer Aspects of Codesharing	<ul style="list-style-type: none"> ICAO's and IATA's Recommendations on Consumer Aspects of Codesharing (information provision to passengers) Montreal Convention (liability of carriers in joint operations) 	<ul style="list-style-type: none"> Binding commitment to ensure that the content of the recommended practice and resolution are incorporated into carriers' general conditions of carriage. Binding commitment to liability regime in cases of codesharing, as prescribed in the Montreal Convention

Source: Collected by author.

The Montreal Convention increased the carriers' liability and eliminated the liability limit in cases of death and bodily injury resulting from accidents. The liability regime established by the Convention may be inconsistent with many member countries' laws that impose a statutory limit to a carrier's liability in cases of death or accident. However, in some countries such as Thailand, liability in air transport is subject to the Civil Code, which does not place a liability limit on any case. ASEAN countries may discuss whether it is in their interest to increase a carrier's liability according to the Montreal Convention.

More importantly, the Convention lays out clear rules governing each carrier's liability in case of a joint operation or codesharing. It is in the interest of ASEAN countries to incorporate these rules into the regional code so that the liability regime of ASEAN carriers that operate under a codesharing scheme will become clear and consistent with global practice. It is therefore recommended that the regional aviation codes prescribe the liability regime in case of joint operation or codesharing.

Concerning cancellation, delay and diversion of flights, IATA's Recommended Practices and Resolutions can help provide a framework for drafting a regional code. IATA's recommended practice with regard to flight cancellation and delays offers various options to passengers, e.g., being carried on another scheduled flight, being re-routed or getting a refund. The refund policy is also prescribed. Most airlines already incorporate the IATA's recommended practice into their general conditions of carriage. So, ASEAN airlines should do the same. It should be noted, however, that in the cases of flight delays, the recommendation leaves open the definition of when a carrier "fails to operate a flight reasonably according to schedule," leaving the interpretation subject to the carrier's discretion. It is therefore recommended that a specific time frame—i.e., the number of hours of delay—be determined so that consumers would know when they will be entitled to alternative travel arrangements, such as re-routing, or to a refund from the carrier.

With regard to denied boarding, the IATA's recommended practice merely states that in case a carrier is unable to provide previously confirmed space, it shall provide compensation pursuant to its denied-boarding policy. The problem is that the denied-boarding compensation policy of most ASEAN airlines is not accessible to consumers, as discussed previously. On this note, at the minimum, the Code should require all ASEAN carriers to make available their denied-boarding policy (perhaps on-line accessibility should be mandated). If the airline's own denied-boarding compensation is not satisfactory—i.e., if the percentage of passengers being involuntarily "bumped" do not fall, then the code may be later revised to prescribe a statutory compensation level that a carrier must offer a

passenger, as in the Philippines, the United States and the European Union.

It should be noted, however, that the initial size of statutory compensation should not be too high such that the carrier's ability to manage load capacity will be seriously constrained. To be able to determine the optimal compensation, the size of the compensation and the number of passengers subject to involuntary denied boarding should be closely monitored, as is the case in the United States as previously described.

Concerning calls for volunteers, past experience indicates that it is in an airline's own interest to minimize involuntary denied boarding by auctioning compensation. Hence, the code needs not make calls for volunteers a mandatory practice. A more important factor is that the size of compensation in cases of involuntary denied boarding must be sufficiently large to provide proper incentives for the carrier to call for volunteers in order to minimize costs.

With regard to the air service distribution, ICAO's Code of Conduct on CRS is relatively comprehensive. It covers both competition and consumer issues associated with the air service distribution system. ICAO also publishes "Notes on the Application of the Code" that will help contracting States in the process of adopting and implementing the Code. The adoption of the ICAO's code will ensure that travel options presented to consumers are accurate, fair and efficient.

Concerning the Consumer Aspects of Codesharing, the ASEAN code may incorporate both the IATA's and the ICAO's Recommendations on Consumer Aspects of Codesharing. The first requires that carriers inform passengers of the carrier operating at the time that a reservation is made, while the latter requires that the carriers clearly indicate at the time of booking which airline is responsible in cases of damage or accident. Most airlines already comply with these recommendations. Hence, incorporating these benchmark practices into the regional code and making the code available to passengers should not impose any additional cost.

4.2 The Modality of the Agreement with Regard to Regional Aviation Codes

The ASEAN aviation codes can be binding, subject to peer pressure, or voluntary. A binding code means that a violation of the code will be subject to the dispute settlement mechanism set out in the regional air transport service agreement. An alternative would be to have compliance subject to peer pressure. This would require an annual review of each member State's and carriers' compliance with the established regional aviation codes. The review should be published and made available to all member countries. However, this process could prove costly and time-consuming. A purely voluntary code is also an option, but is unlikely to

produce any tangible results in the absence of a threat of statutory regulation (the “stick”) or suitable incentive (the “carrot”) and an effective compliance-monitoring scheme.

For a regional code to be meaningful, it would need to be binding. However, binding commitments need not be as “binding” as the word would imply. While States will be bound to take actions or measures according to the prescribed codes, the content of which may be broad, leaving much room for each member State to design its own rules or measures according to its own domestic policy or legal and institutional environment, it is also possible to have a mix of a prescriptive and a general code, depending on the particular consumer or competition issue.

The mandatory and prescriptive codes would presumably cover competition and consumer aspects that are of vital importance to guarantee basic passenger rights and to ensure fair competition in the market. Less prescriptive ones are preferred for issues of less importance. For example, carriers’ liability regime may be subject to a harmonized rule, while compensation for denied boarding may be left to the individual member State’s policy. Some may prefer a strong State regulation; others may be content with self-regulation. The author would recommend the following compliance mechanism for the various issues concerned (see Table 3 for the list of binding commitments):

1. Compliance with a harmonized liability regime (in cases of accidents, flight delay, cancellation or delays for both passenger and baggage) is mandatory for all member States. This may be arranged either by having all ASEAN members become signatories to the relevant international convention or protocol, or to reproduce the liability provisions from the specific convention or protocol into the Regional Air Services Agreement.

2. Compliance with relevant ICAO’s codes and recommendations is mandatory for ASEAN carriers/States since these codes and recommendations have been endorsed by contracting States, which include all ASEAN countries.

3. Likewise, compliance with IATA’s resolutions and recommendations should also be mandatory for all ASEAN national airlines since these resolutions and recommendations have been affirmed by all member carriers, including the seven ASEAN carriers. It should be noted, however, that regional agreements bind only States and not private operators. Hence, the agreement would need to spell out each State’s obligation to pass regulations that would ensure carriers’ compliance. For example, member States may be bound to pass regulations that require carriers to incorporate the relevant codes, recommendations or resolutions into their conditions of carriage that are promptly disclosed and made easily accessible to the public.

4. For certain aspects of consumer issues that are not yet addressed or prescribed by ICAO or IATA, it is recommended that the first step is to give self-regulation a chance. These include issues such as passenger assistance in cases of flight delays, cancellation or re-routing and denied-boarding procedures and compensation. ASEAN States may commit to monitoring self-regulatory initiatives of the carriers in order to assess whether consumers are promptly and adequately protected under such a regime, and whether a replacement by statutory regulatory rules will be necessary. At this point, the simple requirement that all ASEAN airlines disclose their conditions of carriage that contain all key aspects of consumer protection concerns on their websites is itself already a great leap forward in promoting better consumer protection in aviation in this region. In the longer run, the region may explore the possibility and the potential benefits of harmonizing these aspects of conditions of carriage for regional carriers.

4.3 Institutional Arrangements

The ASEAN Aviation Code may be incorporated into a regional air service agreement. It may therefore rely on the dispute-settlement mechanism available under the particular agreement.

Once ASEAN States have ratified the agreement, they would be obligated to amend laws and regulatory rules that will ensure compliance. Each member country must designate the competent authorities responsible for the prompt implementation of the codes, be they the sector-specific regulatory body, the relevant department in the Ministry or the consumer protection body.

On issues that are subject to voluntary self-regulation, the ASEAN Subcommittee on Civil Aviation and Related Services (ASCCARS)¹⁰ may undertake a project to monitor airlines’ policies with regard to denied boarding, delay and cancellations or the handling of private information. Once airlines are required to disclose their general conditions of carriage, it would be possible to track changes in consumer policies of carriers in the region.

It is also important to start building a regional database concerning consumer issues in aviation. ASEAN States should submit statistics on the number of delays, cancellations or re-routing of carriers, as well as the number of passengers denied boarding—both voluntarily and involuntarily—as a result of the airlines’ overbooking policy. ASEAN carriers would be obligated to submit the information to the domestic regulatory authority. The national regulatory body should also be required to conduct random surveys on airlines’ compliance with their established conditions of carriage. With such data, passengers can make better-informed choices when choosing airlines on which they would like to travel. ASEAN States may agree to produce an

annual report on consumer complaints on cross-border air transport, similar to the "Airline Complaints in Ireland 2003-2004," a report produced by the European Consumer Center in Dublin.¹¹

Should statistics reveal that self-regulation does not work in better protecting consumers, the immediate alternative would be co-regulation, whereby the trade association proposes industry rules, and the State implements them. This softer approach can help avoid imposition of impractical or distortionary rules that would not serve the purpose. Only when co-regulation fails should State regulatory measures be considered. The consumer database would assist policy makers in assessing the relative effectiveness and adequacy of a self-regulatory regime.

On this note, ASCCARS should continue to work closely with carriers and their regional associations, as well as with ICAO. In fact, both ICAO and the ASEAN Airlines Meeting (AAM) already attends the ASEAN Senior Transport Officials Meeting Working Group on Air Transportation meetings as observers on a regular basis. Future work may require greater involvement of the private sector, in particular when regulatory measures become more complex in a liberalized aviation market. It should be noted that, according to the ASEAN Transport Agenda Action Plan 2005-2010, the policy directions for intensified cooperation in the ASEAN transport sector include promotion of greater involvement of AAM by way of joint consultation, identification, formulation and implementation of ASEAN transport programs and activities.

ENDNOTES

¹ The Warsaw Convention and its subsequent amendments are the only major international conventions governing the air transport service. It sets out air carriers' liability to passengers in case of accidents, loss of baggage and delays on international flights. All ASEAN countries, except Thailand, are bound by the provisions prescribed by the Warsaw Convention. Thailand does not have a specific law governing the liability of an air transport carrier. It applies the liability and limitations of liability according to the Thai Civil and Commercial Code in cases of damage or loss.

² IATA is a trade organization representing over 2,600 airlines. It provides a forum for collaboration among members and cooperates with ICAO and other international organizations. The Association is also responsible for international tariff coordination and airport slot allocation that receives immunity from anti-trust laws in most major countries. IATA also has a set of "recommended practices and resolutions" that relate to consumer protection and competition issues. It should be noted, however, as in the case of

ICAO, IATA's resolutions and recommendations are not legally binding on member airlines. IATA's Passenger Service Conference Resolution Manual contains the standard practices that have been universally agreed upon by airlines to process passengers and baggage in the international interline environment. National flag carriers of the original "ASEAN 6" are members of IATA. Those of new members are not, namely Vietnam Airlines, Lao Airlines, Royal Air Cambodge and Myanmar Airways.

³ The Statement can be viewed in English at <www.aviation.go.th>.

⁴ AAPA membership consists of Air New Zealand, All Nippon Airways, Asiana Airlines, Cathay Pacific Airways, China Airlines, Dragonair, Eva Air, Garuda Indonesia, Japan Airlines, Korean Air, Malaysian Airlines, Philippine Airlines, Qantas, Royal Brunei Airlines, Singapore Airlines, Thai Airways International, and Vietnam Airlines.

⁵ ICAO is a specialized agency of the United Nations established by the Convention on International Civil Aviation (Chicago Convention) signed on December 7, 1944. It serves as a global body to harmonize or facilitate convergence of regulations of air transport services by establishing codes and recommendations on various consumer protection issues. These are not legally binding on contracting States. They merely serve as model rules for States, trade associations and carriers in designing their own codes, commitments or regulations according to their own needs and environment. All ASEAN countries are signatories to the Convention. Hence, they are bound by the provisions stipulated in the Chicago Convention and are, subsequently, contracting States of ICAO.

⁶ According to the *Air Travel Consumer Report 2000*, published by the U.S. Department of Transportation, the average number of passengers who were involuntarily denied boarding was 1.04 per 10,000, with the minimum number at 0.34 and maximum at 2.36.

⁷ For example, JetBlue does not overbook flights at all, as all its tickets are non-refundable.

⁸ These are Amadeus, Abacus and Galileo.

⁹ ICAO's recommendations, resolutions and guidelines are formed according to the findings from the Worldwide Air Transport Conferences that are attended by over 30 international organizations and delegations from 188 contracting States, which include representatives of the government, academia and the industry. IATA's recommendations, on the other hand, are endorsed by over 265 airlines operating approximately 94 percent of all internationally scheduled air traffic.

¹⁰ The Subcommittee was established by the Committee on Transport and Communications (COTAC)

¹¹ Report available at <www.ecic.ie/resources/publications/>.

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The Economic Impact of Small Business Credit Guarantee

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1. INTRODUCTION

After the 1997 financial crisis, the Thai government developed several programs designed to stimulate and stabilize the economy. Strengthening and striving for the development of small and medium-sized enterprises (SMEs) has been an urgent arrangement. In Thailand and many crisis-affected countries, SMEs are generally one of the main drivers of economic recovery, because SMEs contribute substantially to GDP and account for a large number of jobs for local people. Access to financial sources is important to the operation of firms, especially for newly established SMEs which do not have sufficient collateral and reliable financial records to ascertain that they represent acceptable credit risk. In the presence of fundamental information imperfections in the credit market, where there is a high degree of asymmetric information, the aforementioned causes make lenders reluctant to provide financial support to SMEs. Without external financing, SMEs would not be able to expand their business or even to survive in today's highly competitive business environment.

To provide SMEs with opportunities for growth and prosperity, certain mechanisms are needed to correct an imperfect credit market. The literature suggests that credit guarantees may be one important financial tool that helps lessen market imperfections arising from the presence of asymmetric information. Although the establishment of a credit guarantee scheme is conceptually an important tool for reducing the asymmetry, the following questions arise: Does a credit guarantee really contribute to the growth of the economy? If it really does, how does a credit guarantee play a role that affects an economic sector in terms of employment opportunities and the financial cost of SMEs? The objective of this paper is to answer these questions in the context of Thailand's credit guarantee system. This research is based partly on a more comprehensive study entitled "Social and Economic

Impact from the SBCG's Credit Guarantee Scheme" conducted by TDRI for Small Business Credit Guarantee Corporation (TDRI 2006).

2. THE ROLE OF CREDIT GUARANTEE IN THAILAND

In Thailand, to stimulate lending or facilitate additional credit to SMEs, the government set up a specialized financial institution named "Small Business Credit Guarantee Corporation (SBCG)," which is under the supervision of the Ministry of Finance. It was established on December 30, 1991 under the Small Business Credit Guarantee Corporation Act B.E. 2534 (1991 A.D.). Its initial registered capital was 400 million baht. SBCG was later recapitalized in 2000, with the injection of 4 billion baht from the Ministry of Finance. Parliament has already approved recapitalizing SBCG with an injection of funds equivalent to 2 billion baht in 2006; however, the recapitalization has not been undertaken yet.

The main objective of SBCG is to assist SMEs that seek a guarantee for the unsecured portion of loans in obtaining adequate credit from financial institutions. The institution currently provides three main types of credit guarantee scheme:

(1) *Normal guarantee*: SBCG provides a guarantee on the non-collateralized portion of a loan. However, the maximum guarantee is limited to 40 million baht; the amount cannot be more than 50 percent of the total loan.

(2) *Automatic guarantee*: For this type of scheme, a pre-approved credit guarantee is given to participating financial institutions. It facilitates faster guarantee approval with less paperwork. The maximum guarantee amount on the unsecured portion of the total loan is 3 million baht.

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(3) *Risk participation*: This newly launched scheme allows SBCG to share the guarantee risk with financial institutions. The maximum guarantee is 40 million baht.

Currently, SBCG charges SMEs a guarantee fee at the annual rate of 1.75 percent of the guaranteed amount; it must be paid in advance. The SBCG committee has already approved increasing its gearing ratio from 5 times to 7 times its capital funds in 2006 in order to play a more active role in facilitating additional credit from financial institutions.

According to the statistics on credit guarantees in Tables 1 and 2, we observe that guarantee approval, measured in terms of the number of projects (guarantee amount), has increased substantially during the past few years, from 1,109 projects (4,112 million baht) in 2002

to 3,376 projects (7,543 million baht) in 2005. Among four types of guarantee schemes, the risk participation scheme has currently constituted the largest part of guarantee approvals, accounting for about 97 percent of total guarantee approvals in 2005.

Table 3 further demonstrates that there has been a surge in guarantees outstanding. Apparently, the outstanding commitment has increased by about 13 times from about 1,327 million baht in 1999 to 17,317 million baht in 2005. As of May 2006, Kasikornbank (K-Bank) shares the largest part of the outstanding SBCG guarantee portfolio. Its share accounts for almost 40 percent of the total guarantees outstanding, followed by Small and Medium Enterprise Development Bank of Thailand (SME Bank) with 13.03% (See Figure 1).

Table 1 Number of Approved Projects Classified by Scheme

Type of scheme	2002	%	2003	%	2004	%	2005	%
Normal	157	14.16	140	7.07	53	1.37	3	0.09
Automatic	926	83.50	982	49.60	500	12.90	71	2.10
Non-Performing Loan (NPL)	26	2.34	12	0.60	3	0.08	2	0.06
Risk Participation	-	-	846	42.73	3,319	85.65	3,300	97.75
Total	1,109	100.00	1,980	100.00	3,875	100.00	3,376	100.00

Source: Small Business Credit Guarantee Corporation.

Table 2 Guarantee Amount by Scheme (Unit: millions of baht)

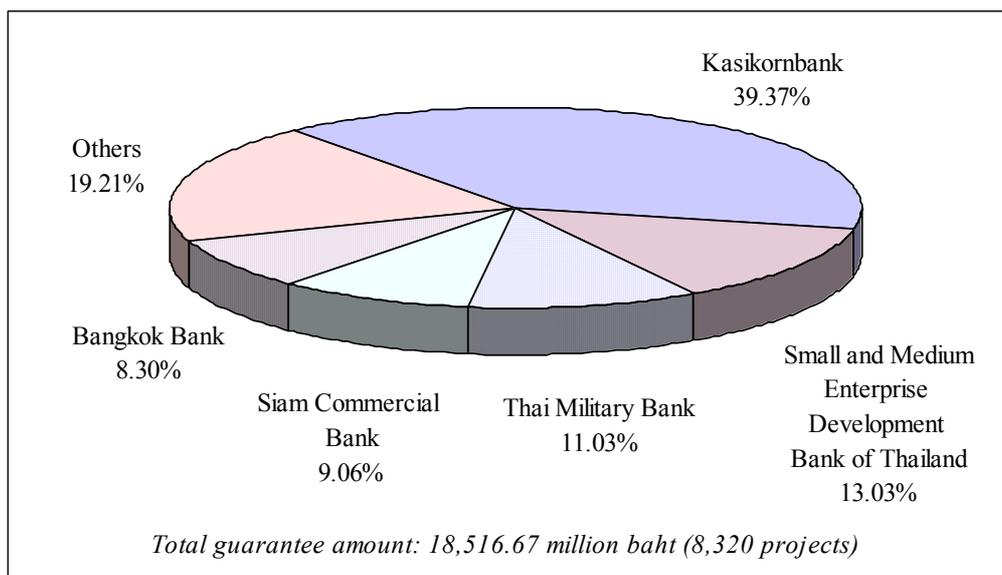
Type of scheme	2002	%	2003	%	2004	%	2005	%
Normal	1,287.31	31.30	1,156.26	26.53	348.67	7.50	27.00	0.36
Automatic	2,665.68	64.82	3,050.85	70.01	1,280.70	27.56	139.46	1.85
Non-Performing Loan (NPL)	159.58	3.88	53.37	1.22	3.67	0.08	8.28	0.11
Risk Participation	-	-	97.58	2.24	3,014.22	64.86	7,369.01	97.68
Total	4,112.57	100.00	4,358.06	100.00	4,647.26	100.00	7,543.75	100.00

Source: Small Business Credit Guarantee Corporation.

Table 3 Guarantee Commitment

Year	No. of Projects	% Change	Amount (millions of baht)	% Change
1999	780		1,327.40	
2000	975	25.00	1,975.35	48.81
2001	1,663	70.56	4,147.50	109.96
2002	2,531	52.19	7,454.41	79.73
2003	4,099	61.95	10,025.81	34.50
2004	5,526	34.81	12,548.31	25.16
2005	8,025	45.22	17,317.81	38.01

Source: Small Business Credit Guarantee Corporation.

Figure 1 Percentage of Guarantee Amount by Financial Institutions (as of May 2006)

Source: Small Business Credit Guarantee Corporation.

Overall, a substantial increase in guarantees by SBCG reflects greater benefits to SMEs as they have additional working capital or funds for business expansion. However, a rise in the guarantee commitment may impose some losses on SBCG due to the failure of some SMEs to service their debt obligations to financial institutions. The possible risk of losses comes in the form of expenses on subrogation payments, subrogation provisions, and provision for defaults. In order to minimize risks from providing guarantees to SMEs, several measures have been implemented. The launch of the risk participation scheme is one important measure used by SBCG to reduce its risk exposure. Given the risk-sharing nature of this guarantee scheme, the risk participation scheme imposes on financial institutions the risk of sharing loss with the guarantee corporation if SMEs fail to make repayments. To avoid such loss, the financial institutions must pay more attention to the selection of the SMEs applying for a guarantee. This should therefore benefit SBCG.

3. SBCG CONTRIBUTION TO THE THAI ECONOMY

In order to examine whether credit guarantees make any contribution to the economy, this section analyzes the impacts of credit guarantees by investigating how such a system affects employment opportunities and the financial costs of a firm. We obtained related data from the credit files of SBCG and also from a survey of 41 SMEs.

3.1 Employment Opportunities

Based on the statistics from the Office of SMEs Promotion, SMEs create about 60 percent of the total jobs in Thailand. To analyze whether credit guarantees can assist in the creation of job opportunities, this section studies employment elasticity that serves as a useful way to examine how the change in employment is associated with a differential change in economic output. The study assumes that loans from guarantees are used to produce outputs, which in turn affect employment in the economy. Following Dhawan (2004), we analyze the elasticity of employment with respect to output by estimating the following simple equation using pooled cross-section data during the period 2002-2005.

$$\ln(\text{Employment}_{it}) = \beta_0 + \beta_1 \ln(\text{Output}_{it}) + \varepsilon_{it} \quad (1)$$

where i and t denote firm and year respectively. *Employment* represents the number of employees in a firm. Revenue from sales, net profits, or loan amount is used as a proxy for economic output; ε is disturbance.

Table 4 shows only the elasticity of employment with respect to each variable that is used as a proxy for output at time t or at $t-1$. Using the output data at time t from the sample of surveyed SMEs, 2,594 persons were employed in 2005. If a firm uses funds obtained under the guarantee service by SBCG to generate 10 percent growth in net profit or revenue from sales, such growth may generate employment of about 76 to 104 persons. Assuming that the elasticity of employment remains

stable, if total employment from the database of SBCG is used, 10 percent growth in net profit or revenue from sales may create additional jobs for about 2,974 to 4,024 persons. Owing to the limitations on data availability, it is not possible to make inference that additional funds under the SBCG guarantee directly help increase employment opportunities, although the overall result suggests a positive relationship between employment and total loan amount.

Table 4 Elasticity of Employment with Respect to Output

Independent Variable	Elasticity of Employment	
	at <i>t-1</i>	at <i>t</i>
Revenue from Sales	0.3480 ^{***}	0.3985 ^{***}
Net Profit	0.2988 ^{***}	0.2945 ^{***}
Loan Amount	0.4599 ^{***}	0.5600 ^{***}

Note: ^{***} Denotes significance at the 1 percent level.

Source: Authors' calculation.

3.2 Financial Cost of SMEs

The literature (e.g., Stiglitz and Weiss 1981; Freedman 2004) suggests that information asymmetry generates moral hazard and adverse selection problems, which make a financial institution reluctant to lend to a firm that is small or young, and does not have reliable financial records. However, through close and continued interaction and relationship with the financial institution, the firm can provide a lender with sufficient information about its operations, prospects and performance. As a result, a good and long track record through continual interaction with the institution may assure the institution about the firm's debt-servicing capacity and, consequently, make it easier for the firm to obtain financial support. Diamond (1984, 1991) suggests that a financial institution plays an important role in monitoring private information of a borrower. Acquiring a borrowing firm's credit record and monitoring its management behavior, the institution can learn from the information to anticipate the firm's future actions and to decide whether to cut off lending, to extend a loan, or to condition the loan's covenants.

Filling this gap with a credit guarantee by a reliable intermediary such as a state-owned guarantee corporation may similarly ensure financial institutions about the future cash flow of the firm. Therefore, this should reduce its expected cost of lending and increase its willingness to provide funds. This section examines whether a credit guarantee lowers the interest rate charged by a financial institution. Using pooled cross-section data during the period 2000-2005, we

estimate an ordinary least squares regression in the following form:

$$\text{Ln(Interest rate}_{it}) = \beta_0 + \beta_1 \text{SICGC}_{it} + \beta_2 \text{Ln(Loan Amount}_{it}) + \beta_3 \text{Ln(MOR}_{it}) + \beta_4 \text{Private}_{it} + u_{it} \quad (2)$$

where *i* and *t* denote loan and time respectively. *Interest rate* is the rate charged on the firm's loan *i*. *SICGC* is a dummy variable that takes the value of 1, if the portion of the total loan *i* is guaranteed by SBCG, and 0 otherwise. In the regression, we control for loan- and firm-specific characteristics as well as for the underlying cost of debt. The loan amount is the total loan size obtained from a financial institution at time *t*. To control for changes in the underlying cost of debt, we use the minimum overdraft rate (MOR), which is determined by the financial institution at time *t*. *Private* is a dummy variable with the value 1, if the financial institution is privately owned, and 0 otherwise. The sample of 94 loan transactions and other credit-related data has been obtained from the survey of SMEs and the credit files collected by SBCG. The regression result is presented as follows:

$$\begin{aligned} \text{Ln(Interest rate}_{it}) = & 1.823 - 0.081 \text{SICGC}_{it} - 0.047 \text{Ln(Loan Amount}_{it}) \\ & (3.84) \quad (-1.7) \quad (-2.96) \\ & + 0.437 \text{Ln(MOR}_{it}) - 0.023 \text{Private}_{it} \quad \text{AdjR}^2 = 0.155 \\ & (2.24) \quad (-0.46) \quad n = 94 \end{aligned}$$

The result suggests that loans guaranteed by SBCG may have a lower interest rate charged by financial institution compared with those loans without the SBCG guarantee service. More specifically, the interest rate charged is on average lowered by about 1 percent. The reason for the lower cost of guaranteed debt is that SBCG enters into contract with financial institutions to encourage them to extend credits to SMEs, and also ensures repayments to the financial institutions when the SMEs become delinquent. However, when the guarantee fee of 1.75 percent is taken into account, the total financial cost is higher for the guaranteed loan.

Two other factors, including loan size and the movement of the underlying cost of debt, are also important determinants of the interest rate charged by a financial institution. There is a positive relationship between the market rate and the loan rate, indicating that an increase in the market rate such as MOR raises the loan rate. Moreover, when the loan size is large, the interest rate charged is lower because the per unit cost of the loan becomes lower.

4. DISCUSSION AND CONCLUSION

It is clear from the study that the Small Business Credit Guarantee Corporation has played a vital role in

facilitating additional credit to SMEs, especially in the post-crisis period. By offering credit guarantees, SBCG helps SMEs that do not have sufficient collateral for the desired credit. In effect, SMEs could increase investment, expand business, and generate more employment opportunities. This study has also evaluated the potential impacts of credit guarantees on employment opportunities and the financial cost of SMEs. The analysis shows that additional credit for SMEs may indirectly have a positive impact on employment. Furthermore, it is estimated that the interest rate, exclusive of guarantee fee, on guaranteed loans of SMEs is lowered by about 1 percent, compared with interest rates on loans that are not guaranteed by SBCG. When the loan guarantee fee is taken into account, the total financial charge on a guaranteed loan becomes higher. Regardless of the risk level of SMEs, the guarantee fee is charged at 1.75 percent, which is considered as a fixed cost for SMEs. Nevertheless, each SME is exposed to different risk factors. It is worth studying the possibility of adopting a flexible, risk-based guarantee fee for different types of SMEs.

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