Supported finance evolves

Export credit support for large aircraft assets has been unavailable for nearly two years now. As a result, the industry is developing new ways to provide supported finance using insurance-based products. Daniel Budofsky and Charlotta Otterbeck, partners at Pillsbury, review the entrance of non-performance insurance into the market.

Recently, the insurance broker and risk management company, Marsh, launched the Aviation Finance Insurance Consortium (AFIC), an aviation insurance consortium, offering a non-payment insurance product geared to bank-funded financing transactions for aircraft purchases. Marsh announced that two of the senior officers of AFIC were joining from the U.S. Export-Import Bank (Ex-Im Bank) where they also had senior positions. This is a notable example of an industry solution to two converging trends: the changing role of export credit agencies (ECAs) in aircraft financing and the implementation of Basel III capital rules in Europe and the U.S.

HISTORICAL ROLE OF ECAS IN AIRCRAFT FINANCE

ECAs have historically played an important role in the aircraft financing sector. An ECA, such as Ex-Im Bank, is a quasi-governmental institution that provides loans, guarantees or insurance to facilitate exports of goods and services (especially to buyers located in developing countries and emerging markets) when conventional lenders view the attendant commercial or political risks of financing such exports as too great. The use of ECAs in aircraft financings reached its peak in the years following the global financial crisis in 2008-09 when funding from bank lenders and the capital markets became severely constrained. By 2012, ECAs accounted for approximately 33% of delivery financing of all aircraft worldwide. Since then, however, the role of ECAs in aircraft financing has diminished. This is due, in part, to the implementation around 2013 of the OECD 2011 Aircraft Sector Understanding (the "2011 ASU") which introduced new unified terms, conditions and procedures for ECA support. The 2011 ASU was viewed as making export credit support less competitive relative to other sources of funding. Another important factor in the fall-off in the importance of ECAs is the effective shutdown beginning in 2015 of export credit by Ex-Im Bank in the U.S. and the suspension of export credit to Airbus in Europe . By the end of 2016, the volume of export credit in aircraft finance reached an all-time low.

COMPREHENSIVE NON-PERFORMANCE INSURANCE

One alternative to export credit is comprehensive non-performance insurance (NPI). NPI is a form of insurance cover offered by an insurance company that pays an insured lender for a loss caused by the failure of the borrower to make payments in accordance with the terms of a lending agreement, regardless of whether the cause of nonpayment is commercial or political. Bank demand for this type of policy – similar to ECA credit support – developed after Argentina's crisis in 2001-02 when some lenders had difficulty collecting under pure political risk insurance contracts which generally required both a loan default and expropriation of the borrower.

From the perspective of a bank lender, NPI may be preferable to other forms of risk mitigation such as syndication, unfunded risk participations and credit default swaps. The key advantage of NPI is the potential for regulatory capital benefits under risk weighted regulatory capital rules applicable to banks, as further discussed below. By comparison, in syndication, the bank transfers a portion of the risk to the other members of the lending syndicate. Syndication, however can be administratively and legally complex, requiring the appointment of agents and the negotiation of intra-syndicate rights and obligations. Similarly, unfunded risk participations and credit default swaps, under which lenders offload risk through bilateral contractual agreements with other lenders, require negotiation and may be subject to complex regulatory requirements applicable to derivatives. Perhaps more importantly, the foregoing risk mitigation techniques may result in the lender sharing with the syndicate members, risk participants or swap counterparties (i.e., its competitors) its commercial relationships with borrowers or the pricing details of, or innovations in, its financings.

TREATMENT OF NPI UNDER BASEL III

Brief Overview of Risk Weighting under Basel III. Basel III is a comprehensive set of reform measures developed by the Basel Committee on Banking Supervision, to strengthen the regulation, supervision, and risk management of the global banking sector. In July 2013, the Federal Reserve Board finalized a rule (the "Final Rule") to implement Basel III capital rules in the United States, increasing the minimum requirements for the quantity and quality of capital held by U.S. banking organizations. Consistent with the international Basel framework, the rule included, among other things, a minimum ratio of common equity tier 1 capital to risk-weighted assets of 4.5% and a common equity tier 1 capital conservation buffer of 2.5% of risk-weighted assets. The rule also raised the minimum ratio of tier 1 capital to risk-weighted assets from 4% to 6%. In short, the calculation of the "risk weight" of an asset (including

a credit exposure) drives the amount of capital that must be held and therefore unavailable for lending; i.e., the higher the risk weighting of a credit exposure, the higher the cost of funding for the bank.

In the U.S. these rules, codified in Regulation Q, provide for two methods of calculating risk-weighted assets: the "standardized approach" and the "advanced approach." Under the standardized approach, the bank must assign different risk weights to exposures depending on which of several defined categories of exposure it fits. For example, exposures to the U.S. government are assigned a 0% risk-weight; corporate exposures require a 100% risk weight; and an exposure to a sovereign that has experienced a default within the prior 5 years must be assigned a 150% risk weight. Under the advanced approach, banks which qualify to use it may use a more complex system of assigning risk weights based on internal modeling. In each case, these risk weights are multiplied by an amount, determined pursuant to the respective method, reflecting the amount of the exposure.

Reduction of Risk Weighting through Risk Mitigants. Basel III rules allow for the effective reduction of the risk weight of an exposure as a result of certain credit mitigants such as eligible guarantees, credit derivatives and collateral. The general mechanism for this in the case of guarantees and credit derivatives is that the banking organization may substitute the risk weight of an eligible guarantor (that has issued an eligible guarantee), or an eligible credit derivative protection provider (that has written an eligible credit derivative), for the risk weight applicable to the exposure. The amount of this benefit is limited to that portion of the exposure that is covered by the eligible guarantee or credit derivative.

Under Regulation Q, to be an "eligible guarantee" the instrument must be unconditional and meet certain other standards and conditions. As originally included in the Final Rule, an eligible guarantee must be issued by an "eligible guarantor" , a term which explicitly excluded monoline bond insurers and re-insurers. Subsequently, in response to industry comments, U.S. bank regulators eliminated the requirement that an eligible guarantee be provided by an eligible guarantor for exposures (other than securitizations) for the purpose of the advanced approach to risk weighting. However, they retained the requirement for purposes of calculating risk-weighted assets under the standardized approach.

NPI as a Risk Mitigant. As a result of the application of these rules, a bank that lends to a buyer of an aircraft (or any other borrower) and buys an NPI policy with respect to the loan would obtain a capital benefit, reducing its cost of funding, so long as the NPI policy were considered an "eligible guarantee". In the U.S., under Regulation Q, the guarantee would need to meet numerous conditions including, among others, that it is unconditional and enforceable. In addition, as described above, a bank that uses the advanced approach could enter into NPI with any type of guarantor, including monoline insurers; however, any bank using the standardized approach could not. This is potentially an important point for U.S. banks since certain states impose the requirement that financial guarantee insurance be done as a monoline business.

CONCLUSION

The introduction of AFIC as a supplier of NPI for aircraft purchases provides bank lenders with a capital-advantaged alternative to export credit in light of the reduced availability and desirability of ECA products. NPI might also make sense as credit protection in capital market transactions although the lack of the capital benefits may make it less attractive. Instead, NPI's suitability for such transactions will depend more simply on whether the premiums charged by NPI providers will be greater or lesser than the implied valuations assigned by investors to the non-payment risk associated with the aircraft purchaser.