Flying around the risks

Banks have tried and failed to securitise their aircraft loans. The assets have good obligors, but their complex structures make security and assignment issues a maze.

By using a synthetic structure, devised with Merrill Lynch, Banca Commerciale Italiana vaulted over these obstacles to gain a useful dose of capital relief.

***Alasdair Whyte* reports.**

Ironically, although aircraft have been securitised many times by airlines and operating lessors, the presumably more financially savvy banks have largely failed to find efficient ways of parcelling the aircraft loans on their own balance sheets.

That was the case, even though the loans were often made to the same obligors as those in operating lease securitisations, and even when the best aircraft securitisation banks — including Morgan Stanley and Greenwich NatWest — were mandated to structure the deals.

Three private deals were done before this year, by Hanvit Bank and Korea Exchange Bank (together), Crédit Lyonnais PK Airfinance and De Nationale Investeringsbank, but each structure seemed to have been handmade for its particular user, rather than being a factory produced model that could be replicated elsewhere.

The main obstacle for banks looking to securitise aircraft loans is transferring the assets to a special purpose vehicle (SPV).

Most aircraft finance loans are made to SPVs, which buy individual aircraft and lease them to an airline. However, these SPVs are not the pure creatures we know from securitisation.

They usually have a parent that is not a sleeping partner in the transaction, and with leveraged (or tax enhanced) leases, the bank — or bank syndicate — is not their only source of finance.

They also contain equity from individuals or entities who are not particularly interested in earning a return, but want to enjoy the tax shelter afforded by the depreciation allowance on the aircraft. Such investors provide a cheap source of funds for airlines buying planes.

The airline usually leases the aircraft under a finance lease, meaning that it ends up owning the asset at the end of its life. It will pay 'rent' either to the SPV or direct to the banks.

This number of participants and moving parts makes it very difficult to change the aircraft's ownership securely enough to satisfy the rating agencies that the deal is bankruptcy remote from the leasing SPVs — or cheaply enough to make a securitisation profitable.

Achieving perfected security has traditionally been especially tricky with the common Japanese leveraged lease structure. An article in the Japanese bankruptcy code limits the effect of a lease assignment to the next two payments after default, while another suggests trustees-in-bankruptcy can cancel some contracts, such as leases.

These prohibitions were not thought to

apply to finance leases, but their exclusion was merely a matter of opinion — the law was not clear.

Some of these problems may have been eased or removed by the securitisation laws that Japan has brought in in the last few years, but the investment banks that have tried to securitise this asset have never said much about what was not a pleasant experience.

Leveraged leases also move in and out of fashion, depending on the tax advantages in different jurisdictions, and each deal is designed afresh, so aircraft finance banks often have a wide range of structures on their balance sheets, including syndicated debt. This variety further complicates securitisation.

However, because this form of finance is generally only available to airlines of stronger credit quality — unlike operating leasing, which is often the only choice for weaker carriers — banks knew that if a structure could be developed, aircraft CLOs could have an advantage over operating lease securitisations.

Thinking synthetic

Banca Commerciale Italiana has been well aware of these problems ever since it entered the aircraft finance market.

In 1999 BCI bought a portfolio of aircraft loans from Sanwa Bank, and hired Sanwa's transport finance team along with the assets.

That group, led by Ian Hosier, had been one of the first of a clutch of Japanese banks that attempted to securitise their aircraft loan portfolios as a way out of the painful liquidity crunch in 1998.

Morgan Stanley proved unable to complete its mandate, however, and Sanwa opted to go for an outright sale instead.

However, Hosier's team was still convinced of the benefits that securitisation could bring.

"The deal has twin drivers: reducing regulatory capital and freeing up credit lines for future lending," said Hosier, now global head of transportation finance at BCI in New York. "We don't need to do this now, but the best time to do deals is when you don't have to do them."

With Merrill Lynch as joint arranger and bookrunner, the banks structured a $1bn synthetic deal transferring the risk of airlines defaulting and the resale value of aircraft from BCI's balance sheet.

"It is the first synthetic aircraft CLO in the market, and what makes it special is that other deals have struggled and we think this offers a simple solution," says Burkhard Heppe, a vice-president in Merrill Lynch's credit derivatives group in London.

Unusually for a public synthetic CDO, BCI transferred all the risk first of all to Merrill Lynch with a credit default swap. It is not clear exactly why that happened, but the result will be substantial capital relief for BCI.

The Bank for International Settlements requires a 100% risk weighting for aircraft loans, while credit default swaps with an OECD bank, in this case Merrill Lynch, have a 20% rating.

Merrill Lynch then laid off the risk in various ways, both funded and unfunded (see diagram).

The first loss risk remained with Merrill, but sources close to the deal said Merrill "managed" the risk or "was compensated" for it, and that the economic risk ultimately lay with BCI.

The structure may involve BCI literally compensating Merrill for any losses on the position. Alternatively, BCI may be paying Merrill a constant stream of premiums that will prove a more than adequate reward for holding the risk, even if there are losses. That way, BCI's exposure would be certain and even, rather than unpredictable.

The synthetic structure conveys several advantages to BCI. The bank has the option to substitute up to 20% of the loans in the first five years, providing they meet rating agency criteria — and the synthetic structure makes that easier.

"The synthetic structure gives us greater flexibility even when the deal has been launched," says Hosier. "As long as we meet criteria we don't have to talk to anyone else if we transfer a [loan] tranche.

"Although the pool has an LTV of less than 70% and deals we originate are typically between 80% and 85%, we can still include parts of new deals by carving them up on our own books. We can effectively make two deals without changing the documentation."

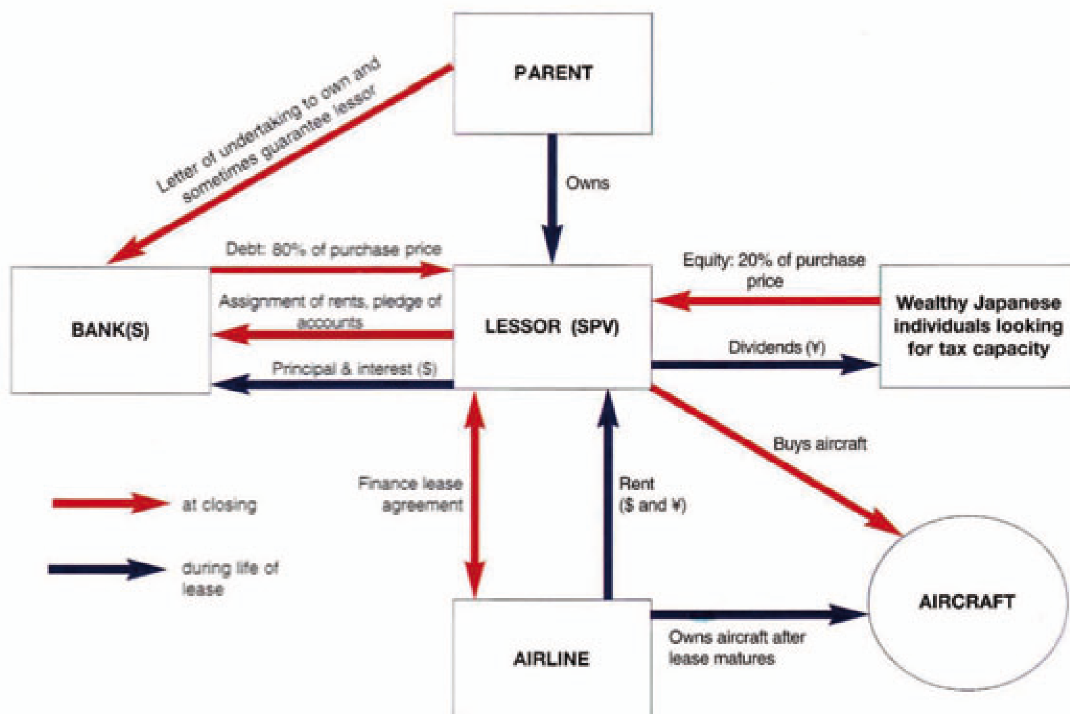
Getting the planes home

However, the real attraction of synthetic

While others remain grounded...

...Leonardo flies.

A typical Japanese leveraged lease



techniques was that they made the deal's security and risk structure easier to manage.

The Leonardo portfolio consists of 127 loans and letters of credit made to 32 airlines.

As long as the airlines continue to make their lease payments — which is not unusual as even bankrupt airlines need aircraft — there are no credit events.

However, if an airline fails to make a lease payment (either to an SPV or directly to BCI), investors in the Leonardo swaps and notes are exposed to losses.

As servicer, BCI will then be responsible for repossessing and selling the aircraft.

This is unlike an operating lease securitisation, like the deals brought by GPA/AerFi/debis Airfinance, Pegasus, Morgan Stanley and so on. In those transactions, the servicer is responsible for finding a new lessee.

Because the Leonardo aircraft are on lease in a number of different jurisdictions, repossession times could vary. But if an aircraft whose lease has defaulted is not recovered and sold within a year, the loss for the securitisation is calculated according to an appraised value of the plane.

For unsecured loans the loss is taken from the market price of the loan 60 days after a credit event notice.

The big innovation was that using a synthetic structure allowed BCI to sidestep many of the security issues that have bedevilled earlier attempts to securitise aircraft loans.

The SPV risk, for example, is simply not covered by the deal. If an airline continues making lease repayments but the SPV does not pass them on, no payment protection is provided.

And BCI did not need to prove — or transfer — a security interest in each loan. If, after a missed payment, it is found that BCI cannot enforce the loan, there is no protection payout.

This means that BCI keeps all the ownership and repossession risks, but does not need to prove ownership upfront.

The Moody's report states: "This is the first aircraft related transaction where repossession, remarketing costs and increased severity due to down-time in relation to the aircraft have been specifically excluded from the risk that is transferred to investors."

For regulatory capital purposes, BCI must have convinced its regulator that those risks were not really material, or alternatively agreed some form of charge for them.

But the rating agencies take a stern view of such matters, and trying to pass on the full package of risks was the rock that had broken the earlier attempts at securitising the asset class.

A rare dish

Leonardo Synthetic Plc was roadshowed in London and Milan and offered investors a rare chance to buy euro denominated aircraft paper.

Only two other public aircraft deals have been launched in the currency, and they both offered exposure to only one airline — the Iberbond deals launched by Spain's flag carrier Iberia.

Leonardo was also unique among aircraft securitisations in achieving triple-A ratings for its top tranches. Most deals go up to double-A.

The yield was handsome, nonetheless — the tranche priced at 45bp above three month Euribor with a 10.5-year average life.

Rated double-A, the 11.5-year average life 'B' tranche has a coupon of 70bp over Euribor. The junior single-A rated note also has an 11.5-year average life and came in at 115bp over Euribor.

"The bonds were about two times oversubscribed on the triple-A tranche and roughly three times oversubscribed on the other tranches," said Ashley Kibblewhite, head of ABS syndicate at Merrill Lynch in London. "Investors that looked at the deal and liked what they saw did not ask for small tickets. They were not putting in for £1m to £2m but rather for £5m or £20m."

Bonds were bought by a mixture of avi-

ation specialists and general ABS investors. Banks mainly bought the triple-A bonds, while funds took the junior tranches.

"We are extremely pleased with this deal — as the issuer you always want to see pricing as low as possible, and this came in line with our expectations," says Hosier.

The average life of the amortising portfolio is five years and BCI expects to call the notes then, as its weighted average cost will start to rise. To give investors confidence that this will happen, BCI must stop substituting at the five year mark and after that cannot call the deal for another five years, unless there is a change in the assets' risk weighting.

"The swap placements went according to expectations and we were slightly surprised that the bonds were so well received," says Merrill Lynch's Heppe. "There will definitely be more of these deals."

The majority of loans in the portfolio are related to Japanese leveraged leases, Japanese operating leases, overseas foreign sales corporations, commission foreign sales corporations and US leveraged leases.

Japanese equity investors are traditionally considered fairly risk averse, so the portfolio is made up of national flag carriers. Some 76% of the lessees are in Europe, with 13% in the Asia Pacific region and 11% in North America.

Unlike most operating leasing securitisations there is no exposure to Latin America. The Standard & Poor's report notes that this is not a disadvantage because of the weak credit quality of the region's airlines.

Because aircraft are sold in the event of repossessions and substitution is limited to 20% in the first five years, there is more certainty about the pool than there would be with an operating lease deal, where aircraft are re-leased if there is a default. S&P says that this helped the deal achieve a triple-A rating.

The largest exposure is to British Airways (22.2%), KLM (10.9%), Alitalia (10%), Air France (6.6%) and Scandinavian Airline System (4.3%). There is also one operating lessor. Moody's estimates the average credit quality of the portfolio as being in the high single-B range, although not all the lessees have public ratings.

Some 62% of the 155 aircraft are widebodies, like Boeing 747s, which is a larger amount than most operating lease deals — again reflecting the fact that the lessees in Leonardo are flag carriers who typically fly long international routes.

Widebodies are considered less liquid than narrowbody aircraft like the Airbus A320 or Boeing 737, and more susceptible to economic downturns. Smaller regional aircraft account for 12% of the portfolio. Boeing manufactured the majority of the aircraft, although this is expected to reduce as Airbus aircraft are substituted.

At least two other banks are known to be considering aircraft loan securitisations. One of these, Dresdner Bank, is close to launching its deal.

It will be worth around $500m and backed by a pool of aircraft loans and leases that Dresdner bought from a Japanese bank last year, supplemented by various smaller acquisitions.

But unlike BCI, Dresdner will not be using a synthetic structure, perhaps because a true sale deal affords more complete capital relief.

The deal should be ready by the end of June, but it may be placed privately with a single investor. One source said Dresdner would retain ownership risk.

Bankers also expect the structure to be adapted to other asset finance loans, especially in the rail sector — so finally banks may be able to catch up with their clients.

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The Leonardo structure