

Aviation - USA

Aircraft portfolio securitisation: innovations and regulations

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September 23 2015

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Introduction

Aircraft portfolio securitisations are an attractive financing option for an aircraft leasing company or investors that seek to finance a diversified portfolio of aircraft on lease to various operators. Securitisations have been used for purposes such as:

- providing long-term financing for continued ownership of a pool of aircraft;
- raising capital for a new portfolio of aircraft to be acquired over a nine-to-12-month period; or
- providing financing for a new equity investor or other parties in connection with the acquisition of a pool of aircraft.

A basic securitisation structure involves the creation of a bankruptcy-remote special purpose company. The company either issues public or private notes pursuant to an indenture or borrows funds from a syndicate of lenders pursuant to a credit agreement. In either case, the proceeds are used to purchase or finance a diversified pool of aircraft subject to leases. The obligations of the issuer or borrower are collateralised by the underlying aircraft and leases whose cash flows are used to service the repayment obligations. Securitisation structures may be enhanced through one or more structured-financing techniques, such as debt tranching, liquidity support from liquidity facilities or cash-collateral accounts, overcollateralisation and requirements to pay down the outstanding indebtedness on an accelerated basis when certain performance triggers are not met.

Securitisations that were done prior to the 2008 financial crisis were structured to meet the stringent guidelines of rating agencies and with the credit enhancement of a guarantee issued by a monoline insurance policy for the more senior classes of notes. The departure of the monoline insurers and the improved conditions of the financial markets have led to advances in portfolio-securitisation structures. The product has become more attuned to the needs of the issuer, and more attractive to leasing companies and aircraft portfolio investors that were previously unable or chose not to conclude securitisations.

Securitisations through debt markets

Before the financial crisis, securitisations were primarily launched in the capital markets. Since 2012, financing has become widely available in both the private debt and capital markets. Spreads differentials have tightened, with transactions completed in the debt market often providing greater flexibility and yielding more favourable coupons and terms.

The advantages of doing transactions in the debt market include:

- lower transaction costs;
- a shorter period to document and close the transaction;
- execution certainty;
- greater flexibility in the composition of aircraft and lease portfolio;
- the ability to limit the sale and transfer of loans to competitors and other selected parties;
- greater flexibility in structuring the covenant package to fit the particular needs of the issuer; and
- less disclosure by the issuer.

Both seasoned securitisation issuers and new securitisation entrants have concluded securitisations in the debt market over the past year.

Structural changes

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Recent developments in aircraft portfolio securitisation structures can be broken down into three categories:

- enhancements that benefit the issuer;
- enhancements that benefit the lenders or noteholders; and
- changes arising from recent regulatory revisions in the United States and the European Union.

Enhancements for issuers and servicers

The securitisations that were completed during the last decade had certain characteristics that were consistent among transactions. First, the securitisations were modelled on the assumption that lease rent was the primary source of funds to service the issuer's obligations. This assumption was not necessarily consistent with the business model of an aircraft investor that expects to hold an aircraft for a shorter period and dispose of it once the asset no longer fits its investment profile.

The model used for the new generation of securitisations has been enhanced to provide for structuring a securitisation to more accurately reflect the leasing company or aircraft investor's business objectives. As a result, some recent securitisations have been less dependent on lease revenue and more dependent on aircraft sale revenue.

In a securitisation that closed in February 2014, the model relied on the ability to sell about 50% of the securitisation's aircraft portfolio following the termination of the initial lease. The sale restrictions contained in Avolon's Emerald securitisation and the General Electric Capital Aviation Service's (GECAS) securitisations were also substantially improved compared to the terms of their prior securitisations.

Another common characteristic of the prior generation of securitisations is that the pool of aircraft consisted solely of a balance of Boeing and Airbus narrow-body and wide-body aircraft, with an overall aircraft portfolio age of less than seven years at closing. Avolon's Emerald securitisation was the first to include regional jets as part of its collateral. GECAS's AABS securitisation was the first to securitise only narrow-body aircraft.

The securitisation that concluded in February 2014 redefined the aircraft portfolio securitisation model by securitising a portfolio of aircraft with a weighted average age of 17.5 years, with one third of its portfolio consisting of turboprops. It can be expected that the trend of expanding the diversification of aircraft in a portfolio will continue. This should have the effect of expanding the number of parties that are eligible to enter into a securitisation.

Securitisation issuers have no employees and rely heavily on a servicer to provide aircraft-related services, including management of existing leases and collection of rent and remarketing after the end of the lease term or following a lease default. One of the advantages to a sponsor in doing a securitisation is that it can continue to earn fees from servicing the aircraft following their sale to the issuer, regardless of whether it retains the equity in the securitisation vehicle. The servicer receives fees for such services, which are based on the amount of rent collected or payable under a lease, as well as additional fees for aircraft sale or disposition.

The securitisations that have come to market during the past 18 months have provided for payment of additional servicer incentive fees. Although such fees are subordinated to the payment of debt service, a servicer can expect to receive double the servicing fees over the life of the transaction as compared to the fees received by servicers in the securitisations closed during the previous decade.

Enhancements for noteholders or lenders

The securitisations that have emerged since the financial crisis include new protections for investors. These include:

- payment of additional interest if the securitisation is not paid in full on or prior to its expected maturity date;
- collateralisation of payment obligations to the extent that the securitisation does not generate sufficient cash flow to pay targeted debt service; and
- accelerated amortisation and repayment.

Securitisations are structured with the expectation that the cash flow generated from the pool of aircraft will be sufficient to repay the debt on or prior to a specific date – referred to as the scheduled final payment date – which is usually between six and seven years after the closing date. The legal final maturity date or loan maturity, however, extends much longer (in the case of a capital markets offering, 25 years from the closing date).

Under the indenture, the issuer will not be in default for non-payment as long as it remains current on its interest payments. In earlier securitisations, the issuer was not required to pay step-up interest on obligations that remained outstanding following the scheduled final payment date. As a result, investors were earning a rate of return as low as 1% for the life of the securitisation due to the low London inter-bank offered rate and the nominal spread payable under earlier securitisations on senior classes of notes that had the benefit of a monoline guarantee.

Learning from past mistakes, investors today have required the issuer to pay a step-up in the interest rate after the scheduled final payment date, often as high as 5% above the margin at closing. Today's securitisations also require that the issuer trap all excess cash remaining after the payment of

senior-ranking payments if the securitisation cannot generate enough cash during any two or three consecutive payment dates from inception to meet the required debt service coverage ratio (1.20 in the Emerald securitisation). Such a cash trap has the effect of collateralising the shortfall of cash flow generated by the securitisation compared to the minimum cash flow assumed in the securitisation model. The issuer has the right either to apply such shortfall towards the repayment of the debt or to maintain the shortfall in a collateral account (for application once an accelerated amortisation event occurs). This is a substantial change from previous securitisations which contained no minimum debt service coverage ratio requirement for the first three or four years from issuance.

One additional feature that is designed to protect investors in securitisations that contain aircraft with an older weighted average life is to provide for accelerated amortisation commencing on the fifth to seventh-year anniversary of the securitisation issuance.

In the securitisation that closed in February 2014, the loans are scheduled to be fully amortised over a nine-year period. Commencing the fifth year of the transaction, however, there is a cash sweep of a percentage of the remaining cash following scheduled debt service (50% during year five; 75% during years six to seven and 100% thereafter). Other securitisations have not provided for accelerated amortisation (although securitisations have been previously structured to require little to no payment of principal during the early years, with full cash trap thereafter).⁽¹⁾ It is likely that other securitisations will provide for accelerated amortisation as the market evolves to provide for the securitisation of regional jets, turboprops and portfolios of older aircraft.

New regulatory requirements

Substantial losses were incurred during the financial crisis in the securitisation market. One reason credited for such losses was the failure of the sponsor to have a financial incentive to ensure the success of the securitisation after the sponsor sold the assets into the securitisation.

To address this concern, both the United States and the European Union have proposed new regulations (which are not yet effective) that would require the sponsor to retain a percentage of the equity in the issuer. This change is likely to have an impact on the future structuring of securitisations.

In the United States, under Section 15G of the Dodd-Frank Act, a sponsor is required to retain at least 5% of the credit risk of the securitisation for at least two years following the closing of the securitisation. The United States has yet to adopt implementation rules for this new requirement.

However, under the most recent proposal, the retention requirement may be satisfied in one of two ways:

- establishing a cash reserve account (a typical feature of a securitisation); or
- issuing subordinated equity notes or 'E-Notes' to equity-holders which entitle them to receive payments to the equity under the waterfall.

Therefore, if the applicable implementation rules are consistent with the current proposed rules, Section 15G may have minimal impact on the structuring of future securitisations in the United States for those that are structured properly.

Under Article 122A of the EU Capital Requirements Directive (2013/36/EC), EU-regulated credit institutions are restricted from investing in asset-backed securities unless the originator will retain, on an ongoing basis, a net economic interest of not less than 5%. The EU regulations also impose on the credit institution to conduct diligence on any securitisation interest it acquires, both prior to closing and on an ongoing basis. Each of these conditions will need to be complied with unless EU-regulated credit institutions are excluded from holding an interest in the securitisation.

Comment

Aircraft portfolio securitisations continue to evolve and are becoming attractive to more leasing companies and aircraft portfolio owners.

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Endnotes

(1) For an example please see Airastle's ACS 2006-1 and ACS 2007-1.

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