



Insights

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The rise of insurance-backed funding



Supported financing will play a bigger role for future aircraft deliveries

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Privately offered non-payment insurance represents an attractive alternative for airlines globally as it assists them in obtaining more cost-efficient financing, by utilising insurance to protect the lender's exposure to default for the duration of the loan. It also typically offers a high advance rate to strong airline credits with attractive aircraft pricing. It also helps fulfil a market gap left behind by ECAs and debt markets being increasingly selective for aviation credits for new aircraft deliveries since the outbreak of the COVID-19 pandemic.

Supported financing combined with Japanese operating lease with call option (Jolco) presents a cost-efficient, 100 percent financing structure for airlines and aircraft leasing companies. Furthermore, it offers many Japanese financial institutions an option to reduce the lending risks associated with aircraft finance and greater confidence, which has driven interest in the product during the pandemic.

We assume that supported financing will play a bigger role for future aircraft deliveries even though the decision-making process takes longer with deals under increased scrutiny and even if higher risk applies. Nevertheless, the product all-in cost, including margin and up-front fee, attractiveness is limited as it considers both the credit quality of the airline and the asset, making it generally competitive for top tier airlines and selected assets.

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Ali Ben Lmadani
CEO, ABL Aviation



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Boeing delivery funded by *Export Credit Agencies*

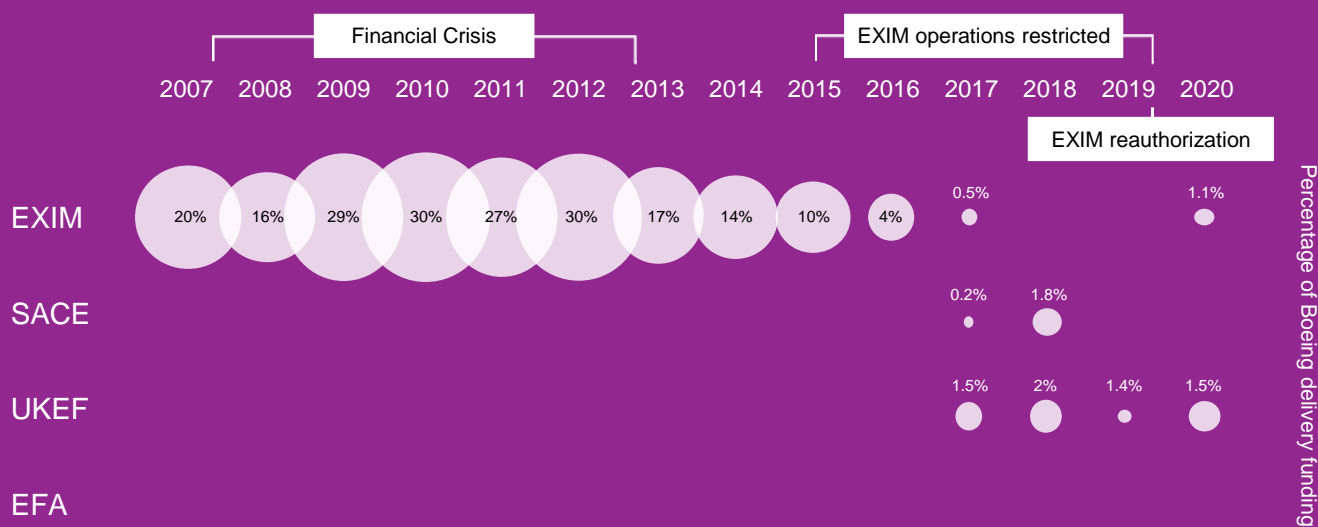


Figure 1. Source: Boeing analysis as of January, 2021

Introduction

Hull insurance existed long before the Wright Brothers flew the first aircraft in 1903, but insurance companies have only directly been in aircraft financing over the last four (4) years. Of course, premiums received on insurance policies have been used for investments in enhanced equipment trust certificates, asset backed securitizations, and unsecured bond issuances of airlines and leasing companies, but until 2017, insurance companies did not participate in aircraft finance deals.

Times have been tough for the industry during the pandemic. There has been less bank debt available for airlines and lessors due to increased credit risk, distressed loan portfolios, and a weak syndication market due to the pandemic.

Several commercial lenders have stepped back from the market and airlines and lessors have sometimes had to turn to less traditional funding sources to finance deliveries.

Export Credit Agencies (ECAs) have typically been a bulwark for airlines struggling to find financing during a crisis (1), but back in July 2015, one of the industry’s leading ECAs went through a crisis of its own.

Due to not having a functioning quorum of Board of Directors, the U.S. Ex-Im Bank stopped authorising deals and it took almost four (4) years up for the U.S. Senate to restore the quorum. Before the quorum was approved, U.S. Ex-Im Bank was unable to approve deals larger than \$10 million, leading to other financiers to think of alternatives, as many airlines relied on this kind of funding. A group of financiers then came up with the idea to develop a private sector version of U.S. Ex-Im Bank. The new funding source would not directly replace Ex-Im, but it would offer the industry an alternative source of funding. This white paper will explore the rise of insurance-backed funding and how it has changed the dynamics of aircraft finance.



Brief history of credit enhanced funding

Since its launch, AFIC has secured the financing of 71 aircraft totalling almost \$6 billion in financings. Meanwhile, AFS has financed at least 15 aircraft since its inception. ABL Aviation made its first foray into the AFIC-supported debt market with the “Jerusalem Jolco”, the the first ever Japanese operating lease with call option (Jolco) funded transaction with AFIC-supported debt for the delivery of two (2) 787-9s for Israel’s El Al Airlines in 2019. One year later, ABL Aviation closed the first ever Jolco funded with the debt guaranteed under the AFS programme. The deal, which featured the first fully remote aircraft delivery, financed one (1) A321neo delivery for Turkey’s Pegasus Airlines.

ABL Aviation deal awards



*Aviation 100
Supported Finance
Deal of the Year*



*Tax Lease Deal of the
Year*

In June 2017, the first credit enhanced structure was formed by insurance giant Marsh and Boeing. Aircraft Finance Insurance Consortium (AFIC) constitutes an alliance of insurers – Allianz, Axis Capital, Sompo International (formerly Endurance) and Fidelis – which provides lenders with loan or bond guarantees for Boeing commercial aircraft sales. Since its launch, AFIC has closed on the financing of 71 aircraft totalling almost \$6 billion in financings.

ABL Aviation made its first foray into the AFIC-supported debt market in June 2019 (2). The deal financed the delivery of two (2) 787-9s for Israel's El Al Airlines. The debt was provided by a Japanese bank while the equity was provided by Japanese investors. ABL Aviation structured the transaction, acting as overall arranger. The deal marked the milestone of being the first ever Japanese operating lease with call option (Jolco) funded transaction with AFIC-supported debt. It won the Airline Economics, "Aviation 100 Supported Finance Deal of the Year" award.

Before long, Airbus caught up with Boeing with its own credit enhanced programme, dubbed Balthazar. A few months later, Airbus and Marsh came out with the structure. Similar to AFIC, insurance companies involved have a minimum of an A- rating, according to Airfinance Journal (3).

Coface for Trade, Liberty Specialty Markets, The Channel Syndicate, SCOR and XL Catrin form the consortium of insurance companies as the initial underwriting panel to provide capacity for funding new purchases from Airbus.

Californian lessor Aviation Capital Group (ACG) also saw insurance-backed funding as a new segment of the market to enter. The Aircraft Financing Solutions (AFS) programme was launched back in March 2018 by three (3) executives that were previously at U.S. Ex-Im Bank. The programme has financed a range of aircraft types, including a 747-8F cargo aircraft back in March 2019 for Russia's AirBridgeCargo Airlines, A350-1000s for Virgin Atlantic Airways and 737-800s for Southwest. The AFS programme financed a new aircraft type, an Airbus A350-900 (4), for Turkish Airlines.

A year before, ABL Aviation closed the first ever Jolco funded with the debt guaranteed under the AFS programme. The deal, which featured the first fully remote aircraft delivery, financed one (1) A321neo delivery for Turkey's Pegasus Airlines. It won the Airline Economics, "Tax Lease Deal of the Year" award.

Since its inception, AFS has financed at least 15 aircraft, according to Airfinance Journal's Deal Tracker. The programme has financed six (6) different aircraft types, including the 787-9, A350-900, A350-1000, 747-8F, 737-800 and A321neo.

In March this year, aerospace insurance broker Piiq Risk Partners completed its first insurance-backed aviation finance transaction (5). Its IFLI (Integrated Finance Linked Insurance) allows banks and capital market investors the protection of an insurance-backed aviation finance product when financing new aircraft or refinancing aircraft already owned by airlines or lessors. Piiq says it underwrite and originate deals, as well structure transactions and provide legal due diligence.

The transaction refinanced a Jolco on a 2020-vintage Airbus A350-900 aircraft operated by Scandinavian Airlines System (SAS).

How *credit enhanced* deals work

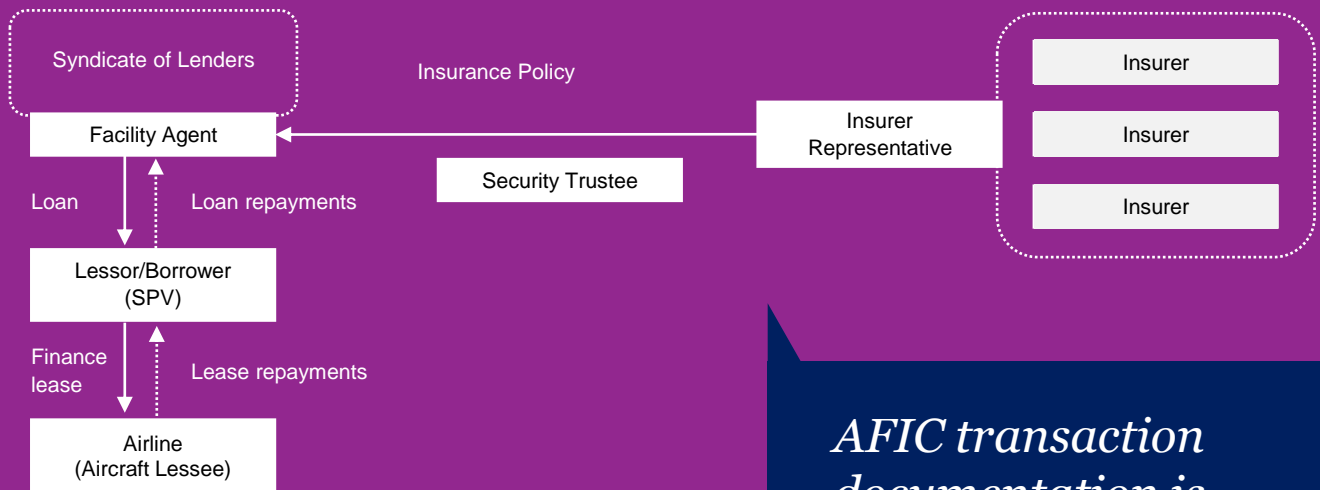


Figure 2. Source: Norton Rose Fulbright, AFIC – Aircraft non-payment insurance – a new aircraft financing product, 2018

AFIC transaction documentation is similar to US EximBank.

Deals are 'credit enhanced' when their credit quality is increased above that of the debt issuer or the underlying asset pool (6). The credit quality is increased by the insurance companies in the alliance, which tend to be investment grade rated (BBB- or above by Standard and Poor's or Moody's).

Such deals typically benefit airlines looking to diversify their funding, and carriers just below top tier that would benefit from an improved credit rating, provided by the insurance companies. Insurance-backed structures also assure banks in the challenging environment that they are not taking on airline risk, but instead joint risk shared with the insurance companies.

The structure of insurance-guaranteed funding is comparable to that of ECA financings. For example, AFIC structures were originally based on U.S. Ex-Im deals — except insurance companies take the place of the ECAs. Insurance deals tend to offer higher margins than ECA transactions, as the insurance company premiums are usually less than the export credit agencies' exposure fees.

In these deals, the insurers typically take on the main role in terms of originating, underwriting, structuring, negotiating, documenting and closing the financing.

Typical deals are structured as a finance lease, using a bankruptcy-remote special purpose vehicle, with funding providing by financial institutions who rely on aircraft non-payment insurance (APNI) policy to minimise risk. There have been APNI deals that have incorporated selling bonds on capital markets too. The deals offer airlines and financiers more flexibility, because they can support a variety of structures as well as finance leases. Such deals have been done in combination with Jolcos (7), French tax leases and recently traditional export credit deals.

Many of these insurance products can also look at different currency options. Although mainly denominated in US dollars, there have been instances of deals involving Euro and Japanese yen.

Future market developments

Maxed out?

The credit enhanced market is here to stay. Boeing Capital recently noted in its Current Market Outlook (8) that it expects it to have a significant presence in the market for years to come, but there are some challenges in the short-term.

The grounding of the 737 Max from March 2019 has posed challenges for AFIC, which has been a heavy supporter of Boeing's best-selling aircraft. Although the FAA approved it for flight again in last November, Boeing stopped delivering the aircraft in April after an electrical grounding problem. It started delivering the aircraft again on May 19, so hopefully deals will pick up again.

"At the time of the grounding of the Max aircraft in March 2019, the Max aircraft represented approximately 50 percent of AFIC's portfolio by number of aircraft, with AFIC being the largest financier of Max aircraft in the world (having financed approximately eight (8) percent of the Max aircraft that had been delivered through to the time of the Max grounding)", Bob Morin, AFIC's Transaction and Business Development Leader, says.

"As a result, the grounding of the Max aircraft adversely impacted AFIC in that there were fewer aircraft financing opportunities on which to bid. However, despite the impact that the Max grounding had on AFIC's existing Max customers, such adverse effects did not directly flow through to AFIC", he added.

In the meantime, AFIC has looked at financing other aircraft types, including its first ever Embraer regional aircraft in December. The deal financed four (4) Embraer E175 aircraft for Skywest, underwritten by AXIS Insurance and Sompó International. Brazilian Development Bank (BNDES) was the lender.

COVID woes

COVID-19 has also brought challenges. Although ECAs have stepped up their business during the pandemic and deals have emerged that have involved both insurance structures and ECAs, the insurance market has not been immune from pandemic-related pressure.

Through the pandemic, as passenger numbers slump and more aircraft are grounded, insurers have seen a reduction in premium liquidity and a reduced income. Adjustments in liability premiums have been made during the crisis impacting insurers' liquidity flows (9). Furthermore, aircraft groundings reduce hull premiums on aircraft. However, there has been a reduction in insurance claims as a result of less aircraft flying.

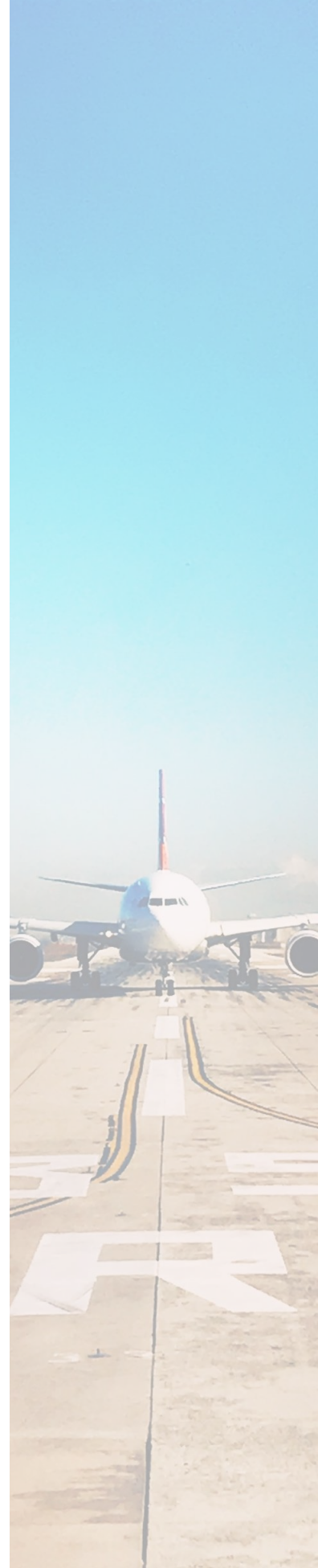
Insurers may become less curious about the aviation market during this downcycle, when their return requirements are not being met. Getting new insurance companies on board for such transactions is now more challenging, as airlines are not as profitable as they were before the pandemic.

AFIC's Morin says that COVID-19 has presented challenges to his insurance product but also some opportunities. "COVID-19 has presented AFIC with some opportunities to support financings for some stronger credits that in normal times may have had access to other types and sources of financing", Morin says.

"Accordingly, AFIC has taken advantage of the dislocations caused by COVID-19 to expand its product offering to include Embraer regional aircraft and to expand its customer base - including airlines in the United States - and more leasing platforms".

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