New AFIC structures on the way

Following Aircraft Finance Insurance Consortium (AFIC) deals last year for Korean Air Lines, Intrepid/AirBridge Cargo, Norwegian Air Shuttle, Turkish Airlines and Flydubai, there are now moves to expand the reach of the structure. Michael Marray reports

Airbus is working on a similar platform for its aircraft.

AFIC was developed with the help of Boeing Capital Corporation, and is viewed as a Boeing product -- although in fact there is nothing in its terms that limits which manufacturers can be supported.

In addition, following the private placement of bonds on last year's Norwegian deal, arrangers are working on bond offerings in the public capital markets for 2018.

AFIC has established itself even faster than anticipated, and aviation finance banks view it as a structure with a long-term future, taking its place alongside established products.

Although AFIC is in some ways comparable to the Export-Import Bank of the United States (Exim) or export credit agency (ECA) support, it is also similar to the monoline wraps that used to be common in the asset-backed securities (ABS) market.

For bank lenders, this means that -- instead of the wafer-thin margins that they used to get on Exim deals -- bankers are taking a mixture of single-A or double-A risk of a group of insurance companies (each with a separate exposure).

Thus from the bank lender perspective, AFIC deals are similar to investment grade loans -- although with three credits to analyse.

"The insurance is provided on a several basis, and this several liability gives rise to risk for lenders or noteholders of a defaulting insurer," explains James Cameron, London-based partner in the transportation and space group at law firm Milbank.

Cameron is also a member of the AFIC Working Group that worked closely with Boeing Capital on launching the product in 2017.

This is one of the key differences between AFIC and triple-A rated Exim, US Exim Bank, where the bank lender is effectively taking sovereign risk.

In addition, Cameron notes that Exim has never had a contested repossession of an aircraft, since governments are understandably reluctant to damage their relationships with the agency and can bring pressure to bear on airlines.

"It will sit alongside Exim as a standalone product," says Cameron, with AFIC deals continuing to get done even when Exim eventually returns to the aircraft market.

No requirement for export

Another key difference between AFIC and ECA financings is that it does not have to involve aircraft being exported, and is not restricted by any government requirements or agreements among the ECAs.

Thus AFIC could support Airbus equipment as well as Boeing products, although it remains to be seen whether deal arrangers prefer to wait for Airbus to set up its own similar platform.

"After a busy 2017 we would expect to see increased AFIC volume in 2018," says Cameron.

"Last year we saw bank debt deals and private placements, and the next step is likely to be public deals in the capital markets, and potentially Jolcos with AFIC debt.

There could also be transactions initially using bank loans for warehousing, and then converting to capital markets notes."

Airlines view it as a new way to diversify sources of funding, with insurance companies collecting a premium for the risk of loan or lease non-payment by an airline, which allows a much broader group of banks to lend into low-risk transactions.

Similarly the low-risk nature of bond offerings also will broaden the institutional investor base.

Last year there was one deal involving the private placement of bonds for low-cost carrier Norwegian.

For 2018 the first public capital markets deals are expected.

Bank lenders are looking to the three insurers that directly cover the risk of non-payment by the borrower, two of which insure 25% of the deal.

Another insures 50%, and then re-insures a 25% portion with the fourth member of the consortium.

"Each is liable for their own portion, so the bank lender has to assess the risk of a default by one or more of the three," explains Duncan Batchelor, global head of aviation at law firm Norton Rose Fulbright in London.

"Since the banks are focused on the credit assessment of the three insurers, they do not need to be specialised aircraft lenders -- so a much broader group of banks will be able to get involved in AFIC deals."

Similarly, on bond offerings investors will be looking at the credit of the insurers rather than the airline or aircraft assets.

Batchelor notes, however, that transferability is also an important requirement on bank loan deals, so that banks can sell down into the secondary market, either to banks or other types of investors -- including insurance companies.

"Under the Solvency II prudential regime, insurance companies are looking at new asset classes on the investment side, and AFIC loans and bonds are attractive to many of them," says Bob Haken, partner in the corporate and regulatory insurance team at Norton Rose Fulbright.

Non-payment insurance platform

In addition, bankers and lawyers note that, although the non-payment insurance platform (NPIP) was set up by insurance giant Marsh with the encouragement of Boeing Capital, there is nothing that specifies that the aircraft covered have to be exports, or any particular equipment type.

Thus with a few changes it could be used for Airbus or other equipment.

And unlike Exim or ECA deals, AFIC will also be applicable to carriers in the US, UK, Germany and France.

While Exim did not support Boeing deliveries in the US, and European ECAs did not support Airbus deliveries in the UK, Germany or France (with the exception of deals for a total of six A380 aircraft) NPIP has no such restrictions.

This opens the product up to a group of large carriers that may want to diversify their investor base.

"There is no reason why the absolute top-tier airlines cannot use the AFIC structure, and some of them might do so in order to diversify sources of funding, although generally they would find it easier to use commercial debt," says Batchelor.

"The sweet spot is probably the sizeable group of carriers just below that top tier that would benefit from the improved credit rating," according to Batchelor.

"For carriers with very low credit ratings, AFIC insurers themselves would probably not be willing to provide cover."

Thus the structure is expected to be widely used in 2018, in spite of the expected return of Exim to the market.

Similarly, launch of an Airbus product is likely to press ahead along with the return of the European ECAs.

The initial flurry of activity in 2017 shows flexibility of the product, since each deal is tailored to individual agreements between Boeing, the airline/operating lessor, and bank lenders/bond arrangers.

In a recent presentation, Boeing Capital noted that, as part of its charter to find the most efficient aircraft financing solutions, the Boeing finance subsidiary engaged in new market development to bring insurance risk capital to aircraft finance.

Boeing Capital collaborated closely with Marsh, which runs the platform and effectively acts as broker, without taking any of the insurance risk itself.

Also involved, and on the AFIC Working Group, are Citi, Goldman, and Morgan Stanley, as well as law firms Milbank, Allen & Overy and Clifford Chance.

Development of the structure also benefited from the hiring of former Exim executives.

Last year Robert Morin joined AFIC as transaction and business development leader, having been at Exim for over 20 years, overseeing expansion of the agency's aircraft financing programme.

In addition Gabriel Okolski, previously a senior transportation loan officer at Exim, was appointed as credit and financial analyst.

More than $1 billion of new aircraft deliveries in 2017 were supported by AFIC, and some market players believe that 2018 will be even busier.

"Given the early success of this new market, stable growth is projected over the years to come," Boeing noted in the company's 2018 Aircraft Finance Market Outlook.

Boeing added: "We expect the newly created AFIC non-payment insurance market to grow in 2018, potentially to levels similar to the tax equity and export credit markets."

Basel III

For bank lenders, the AFIC product has come along at an opportune moment, since many lenders will have to phase in higher capital requirements for loans on their books, as a result of the Basel III agreement from the Basel Committee on Banking Supervision (BCBS).

Many European aircraft lending banks have been using their own internal risk models to calculate risk weightings on secured aircraft loans.

A bank’s total risk-weighted assets (RWA) number is used to calculate the bank's overall capital requirement.

Introduction of so-called output floors, however, will mean that capital required with the internal ratings-based (IRB) approach, will not be allowed to be less than 72.5% of that calculated using the so called standardised approach to RWA.

Negotiations on Basel III dragged on all through 2017.

A proposal for a compromise at 75% was pushed hard by BCBS Chairman Stefan Ingves, who also serves as governor of the Riksbank, Sweden’s central bank.

Germany concerned about impact

There was, however, strong opposition from Germany, which was concerned about the impact on German savings banks and co-operative banks.

Germany argued that these banks have low-risk business models, and would be hit unnecessarily hard by higher capital requirements.

Germany eventually agreed to a deal involving an output floor at 72.5%.

As part of the compromise package, banks have plenty of time to prepare.

Given the long-term nature of aircraft lending, however, often going out to 12 years, aerospace banks are already having to change calculations on new loans.

The output floor will be gradually phased in, starting at a level of 50% on 1 January 2022, and reaching full level of 72.5% on 1 January 2027.

This is a challenge for many European banks.

US banks are not affected, since they do not use internal models, but already use the standardised approach.

Although the Basel III package also aims to reduce reliance on use of external credit ratings, and prods banks to do more of their own due diligence, exposure to large, highly rated international insurance companies is fairly straightforward as far as bank lenders are concerned.

Flexible structure

From an airline treasury department point of view, AFIC has the advantage of being a relatively simple structure, while also being much more flexible than ECA deals, where the ECA dictates terms.

After the new Aircraft Sector Understanding (ASU) was signed in 2011, European ECAs decided that Air France, British Airways and Lufthansa should each be allowed to finance two aircraft with ECA cover.

This was unusual since, under the informal “home country rule,” the three European ECAs did not support Airbus deliveries in the three major manufacturing countries -- UK, France and Germany -- while Exim did not support Boeing sales in the US.

The three European carriers took advantage of the exemption by financing two A380 aircraft each, which were not only the most expensive aircraft, but were also less favoured by bank lenders.

Each of those carriers, however, found reception on ECA deals to be very different from what they were used to -- which was being regarded as a prized client in the negotiating room with lawyers and lenders.

Instead of lenders catering to the client, it was the airline that had to satisfy the ECAs.

As one member of an airline team arranging a deal told GTF at the time, "it was painful."

Four insurers in AFIC

AFIC currently consists of four insurers: Allianz, Axis Capital, Sompo International and Fidelis.

The first three provide guarantees directly to bank lenders, with one taking 50% exposure, and the other two taking 25% each.

The insurer taking the 50% position then lays off 25% of the risk to Fidelis.

Thus, the bank credit analysis only includes three insurers.

The three direct insurers are rated as single-A or double-A, which is higher than any airline credit.

Nearly all airlines globally are in junk bond territory.

Lufthansa is one of the few carriers with investment grade ratings -- triple-B from S&P Global Ratings and Scope Ratings, as well as Baa3 from Moody's Investors Service.

Instead of needing asset-based lending expertise to assess different aircraft types and likely residual values, bank lenders are doing a simple calculation on their own internal assessment of the risk of the three insurer credits, combined with external ratings.

This means that a broader group of banks can lend on AFIC deals.

New York-based Apple Bank is a good example.

Apple favours low-risk deals, and was a regular participant on Exim-backed loans and Hermes cover loans before Exim and European ECA business dried up.

ANPI covers multiple risks

The AFIC non-payment insurance policy (ANPI) covers a lender’s credit, aircraft residual and jurisdiction risks.

Marsh manages the platform, and thus acts as broker to the insurers that are actually taking the risk.

In March 2017, Tokyo-based insurer Sompo completed the acquisition of 100% of the outstanding ordinary shares of Endurance Specialty Holdings for $6.3 billion.

Endurance has been integrated into Sompo Holdings through creation of Bermuda-based Sompo International.

Sompo International is rated as single-A by S&P and A1 by Moody's.

Allianz Risk Transfer AG (ART) is the centre of competence for alternative risk-transfer business within Munich-based Allianz Group.

ART offers tailor-made insurance, reinsurance and other non-traditional risk-management solutions to financial and industrial and clients worldwide.

Founded in June 1997, the company is a wholly owned subsidiary of Allianz Global Corporate & Specialty.

Allianz Group is rated as double-A by S&P and AA3 by Moody's.

Allianz has a global team of pilots, engineers and lawyers, and serves clients flying to over 160 countries.

Allianz has a track record of managing large aviation risks, and has an established reputation as a leader in complex co-insurance placements.

Global head of aviation is London-based Michael Hansen.

Bermuda-based Axis Capital has a specialised unit dealing in the airline, aerospace and general aviation sectors.

Axis is rated as single-A-plus by S&P and single-A-plus by AM Best.

Bermuda-based Fidelis Insurance Holdings is a new player in the industry, having been established in 2015 as a specialty insurance and reinsurance provider backed by $1.5 billion in equity capital.

Fidelis is led by industry veterans Richard Brindle, group chief executive officer (CEO) and chief underwriting officer, and Neil McConachie, group chief financial officer (CFO).

Founding investors were funds managed by private equity firms Pine Brook, Crestview Partners and CVC Capital Partners, with the three putting in a combined $650 million.

Principals from all three firms backed members of the Fidelis team at their previous companies.

The remainder of the capital investment came from individual investors, family offices and institutional investors.

Fidelis pioneers new model

Fidelis has introduced a new model to the insurance industry.

The theory is that, by focusing on either assets or liabilities, legacy insurance models have failed to optimise shareholder returns, and low returns generated by fixed-income investments have been challenging.

Instead, Fidelis follows a total return strategy by tactically shifting capital and risk between insurance and investments to maximise return on equity across market cycles.

Pine Brook was also the backer of Amedeo, an asset manager and a principal investor focused on widebody aircraft leasing, with an initial investment date as majority shareholder of February 2014 -- around the time that Amedeo firmed up an order for 20 A380 aircraft at the Singapore Air Show.

That contract had originally been announced at the Paris Air Show in June 2013.

In December 2017, Amedeo announced completion of a management buyout of majority shareholder Pine Brook.

Financial terms of the private transaction were not disclosed.

Mark Lapidus, CEO of Amedeo, maintains that the relationship with Pine Brook has been a win-win proposition for both parties.

Highly rated bonds

For AFIC bond market investors the yield will be very low.

Nonetheless, it broadens the investor base, providing investors with easy-to-understand credit risk, as opposed to the complexities of understanding aircraft types, and assessing metal risk in the event of a repossession.

Thus AFIC is a way to bring in more institutional money -- alongside riskier but higher-yielding investments.

“Pricing on high-quality aircraft deals has tightened dramatically over the past few years, but we still see strong appetite from institutional investors, since return profiles remain attractive compared to traditional investments, such as bonds”, says Bill Blain, head of capital markets at Mint Partners in London.

“There is a broad spectrum of investors,” he adds.

“Some only take senior debt from top-tier airlines, others like mezzanine from airlines with an interesting strategic story, such as Norwegian, while another group is looking for equity-type returns, and will take metal risk.”

He adds: “We are expecting to see continued growth in involvement in

aircraft from institutional money, but having said that, they are being cautious how they access the market, and want to be alongside a strong leasing company or aircraft management firm."

Blain stresses: "Investors are also being very selective on aircraft type, and liquidity is important, meaning that there is more interest in regional jets than widebodies - and they are particularly nervous about the A380."

Bonds and loans

Korean Air Lines was the first airline to benefit from AFIC insurance.

Korean Air signed a 10-year, €143 million ($176 million) loan with ING Capital in March 2017 to refinance a B-747-8i passenger aircraft, the carrier's first transaction covered by the newly developed Aircraft Non-Payment Insurance (ANPI).

ING Capital in New York was sole lead arranger, lender and agent.

Milbank and Lee & Ko represented Korean Air; Clifford Chance acted for the ANPI providers; and White & Case represented ING Capital.

"With the financing gap left by the continued absence of Exim, we have seen a steady demand for AFIC financing," Gemma Bae, managing director and head of structured export finance for the Americas at ING Capital told GTF.

ING Capital also has received a mandate from Korean Air to arrange another AFIC financing as well as a mandate from a major African carrier, according to Bae.

"This structure gives airlines an attractive cost of financing, but also enables us to provide flexible and innovative financing solutions that are denominated in currencies, such as the US dollar and the euro."

Then in June 2017 Sumitomo Mitsui Banking Corporation (SMBC) and Development Bank of Japan (DBJ) provided a loan facility for the purchase of two B-787-9 aircraft by Korean Air.

SMBC said that providing AFIC debt is an additional financing solution for the aviation industry, as the bank collaborates with affiliates, such as SMBC Aviation Capital and Sumitomo Mitsui Finance and Leasing Co.

Back in 2015 DBJ and Boeing Capital entered into a memorandum of understanding (MOU) to cooperate in developing aircraft financing and leasing opportunities.

The MOU called for DBJ to "advise, arrange and supply financing to support Boeing new-aircraft sales and used-aircraft remarketing."

According to DBJ, the MOU with Boeing was the basis for the AFIC deal.

In September ING Capital closed a second deal, this time with Intrepid Aviation completing its first AFIC financing for one B-747-8 freighter on lease to AirBridge Cargo Airlines.

The financing was arranged and underwritten by ING Capital and Apple Bank.

This was the first AFIC deal for an operating lessor, and further diversified Intrepid's banking group with the addition of ING Capital.

Intrepid is a privately owned aircraft lessor, headquartered in Connecticut with offices in Dublin and Singapore.

Intrepid's shareholders are Centerbridge Partners and Reservoir Capital Group.

Centerbridge is an investment management firm employing a flexible approach across investment classes, from private equity to credit and related strategies, and real estate – in an effort to find attractive opportunities for investors and business partners.

The firm was founded in 2005 and, as of November 2017, had approximately $28 billion in capital under management with offices in New York and London.

Reservoir Capital Group was established in 1998 as a privately held investment firm with a flexible, investment approach and has

approximately $5 billion in assets under management.

In January 2018 Intrepid Aviation Group Holdings received ratings from Fitch Ratings and Kroll Bond Rating Agency (KBRA), both of which came out with long-term issuer ratings of double-B-minus.

Intrepid was back in late September 2017 with another AFIC deal.

This time London-based Greensill Capital arranged a bond placement to fund a B-747-8 freighter leased to AirBridge Cargo.

"This financing also represents the first private placement for the company, which further diversifies our funding sources," commented Michael Lungariello, CFO of Intrepid Aviation.

The Intrepid deal was the second AFIC bond placement from Greensill Capital, which styles itself as a specialty provider of working capital.

Greensill founder and CEO Lex Greensill formerly led the supply chain finance teams at Morgan Stanley and Citi.

The company has arranged deals in sectors, such as construction, telecoms, aircraft, and power generation, monetising cashflows, such as leases.

Greensill Capital uses a combination of capital plus risk mitigants -- usually insurance -- to create finance products for investors.

Last year Greensill also arranged a deal for Arctic Aviation Assets, a wholly owned subsidiary of low-cost operator Norwegian Air Shuttle.

Norwegian signed up with Greensill for the funding of six B-737max8 aircraft that were delivered between June and August 2017.

List price on a B-737max8 aircraft is $117 million.

Quick deal execution

According to Greensill, it took only six weeks to arrange the Norwegian deal, which is significant, since arrangers that have been trying to bring in new investors -- such as Korean insurance companies -- lament that it can often take many months, particularly for new investors doing an initial deal.

Turkish Airlines (THY) closed an AFIC deal in December 2017, when Crédit Agricole CIB (CA-CIB) arranged the first- ever French tax lease combined with AFIC debt, involving two B-777 freighter aircraft.

The first aircraft with the Turkish Cargo livery arrived in Istanbul on 7 December, with THY Chairman Ilker Ayci calling the delivery a "milestone event" in the airlines' fast growing cargo business.

During 2017 THY expanded from 55 to 73 freighter destinations, and cargo tonnage grew by 29%.

Turkish Cargo has another three B-777 freighters on order, which are scheduled to deliver in September, October and December of this year.

THY is rated as double-B-minus by S&P and Ba3 by Moody's.

Flydubai

Dubai-based state-owned low-cost carrier Flydubai closed a deal in December 2017, in what was the first AFIC transaction for the region.

The financing involved a B-737max8, allowing Flydubai to further diversify funding sources.

SMBC provided debt into the deal.

Around the same time, Flydubai completed its first-ever Jolco, with CA-CIB acting as overall Jolco arranger and debt underwriter.

"With more than 70 aircraft to join our fleet by 2023 this marks the first time that Flydubai has accessed financing models of this kind and reflects our desire to access the most innovative financing structures available in the market," said Ghaith Al Ghaith, CEO of Flydubai.

Flydubai is expanding quickly and is likely to be back with more deals.

During 2017 eight new aircraft joined the fleet, comprising two B-737-800 and six B-737max8 aircraft.

For the first time since Flydubai was launched in 2009, the airline retired (four) aircraft, in line with a policy to maintain a young and efficient fleet.

In December 2017, Flydubai placed its largest-ever aircraft order, for 175 B-737max aircraft.

If 50 options are exercised total list price of the order would be approximately $27 billion.

Flydubai placed its first order -- for 75 B-838max aircraft -- in 2013, and the first five arrived in 2017.

In November 2017, Flydubai began services to Moscow Sheremetyevo, and this is one of the routes being flown by the B-737max.

Exim and ECAs return

Exim is widely expected to return to the aircraft market in 2018, after an absence of two years.

The most recent delays have involved the Senate blocking President Trump's nominee to head up the bank.

The Senate committee voted 13-10 against appointing former New Jersey Republican Congressman Scott Garrett as Exim president.

Garrett helped led a 2015 effort to shut down Exim, referring to the agency's support for companies, such as Boeing and General Electric, as "corporate welfare."

Coincidentally, the European ECAs ceased doing business around the same time for unrelated reasons.

In March 2016 Airbus disclosed that there had been inaccuracies relating to historical use of overseas agents in applications to UK Export Finance (UKEF) for support.

UKEF referred this information to the Serious Fraud Office and advised Airbus that it was unable to support delivery of further Airbus exports pending the outcome of enhanced due diligence in accordance with the requirements of the Organisation for Economic Co-operation and Development (OECD) Recommendation on Bribery and Officially Supported Export Credits.

UKEF finally returned to the aviation market in March 2018, with support for two A330 aircraft operated by RwandAir.

Both aircraft were delivered in 2016, with the second (an A330-300) being handed over to RwandAir in Toulouse on 30 November; the first aircraft was an A330-200.

Both aircraft are powered by Rolls-Royce Trent 772B engines.

At the time they were ordered in 2015 the two aircraft had pre-delivery payment (PDP loans provided by Eastern and Southern Africa Trade and Development Bank (TDB), which was at that time known as PTA Bank prior to rebranding.

By the time of delivery the following year, however, UKEF had suspended signing off on loan guarantees, pending the investigation.

UKEF support for the export of Airbus aircraft is provided alongside that of the French and German ECAs, with each agency supporting a percentage of the financing cost of the aircraft broadly in proportion to the percentage of the aircraft manufactured in each country.

Typically one of the three ECAs will lead a transaction, with the other two providing counter-guarantees.

The UK-made proportion of an Airbus aircraft can be up to 38%, depending on aircraft type and engine.

If Rolls-Royce engines are fitted, UKEF support is boosted accordingly.

Parallel structure

Having helped establish the AFIC, the return of Exim support will be used in parallel by Boeing.

Hermes, UKEF and Bpifrance Assurance Export (which has taken over from Coface in providing French state guarantees for exports) are also expected to be busy in the coming months, but Airbus is also pressing ahead with the development of its own AFIC-like structure.

And there are also other credit enhancement structures being developed elsewhere in the market.

ACG and Exim step up

In early March, California based Aviation Capital Group (ACG) announced formation of its Aircraft Financing Solutions (AFS) group.

The AFS initiative will focus on development and marketing of credit-enhanced financing structures that provide airline customers more alternatives and greater access to additional sources of capital for aircraft purchases, while providing improved risk-adjusted returns for lenders and capital providers.

"This initiative provides ACG with a compelling complement to its core operating lease services, enabling us to offer a broader set of fleet financing solutions to airlines," said Khanh T Tran, president and CEO of ACG.

"Our AFS group will work closely with ACG's marketing team to expand services we offer to airline customers on a wide range of aircraft types."

To help launch the AFS initiative, three former Exim executives -- Robert Roy, Andrew Falk and Robert Lewandowski -- will join ACG as managing directors to help lead programme development, transaction underwriting and management.

Exim announced in late March the launch of a reinsurance programme that works with the private sector to share risk and provide an additional $1 billion in loss coverage for a significant portion of the agency's existing portfolio of large commercial aircraft financing transactions.

The programme is described by Exim as the "largest public-private risk-sharing arrangement for a US government credit agency.

This transaction represents the maximum allowable coverage permitted under Exim's charter and fulfills a 2015 congressional reauthorisation mandate to engage in risk-sharing with the private sector to minimise the agency's and taxpayers' liability for potential future losses.

Exim worked with Aon Benfield, the global reinsurance intermediary of Aon plc, the world's largest insurance broker, to complete this $1 billion reinsurance programme that was led by XL Catlin, Liberty Specialty Markets and Everest, among a group of 10 reinsurers.

The programme was funded by fees generated by the original commercial aircraft transactions and will not cost US taxpayers additional funds.