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Use of Residual-Value Insurance to Support Debt Repayment in Leveraged Aircraft Leases

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In our last Aviation advisory, "Toward a Rational Debt-Equity Framework in Leveraged Aircraft Leases," we discussed issues that an equity investor should consider in negotiating credit documents with the lender in a leveraged aircraft lease sponsored by the equity investor. In this Aviation advisory, we discuss how an equity investor may use residual-insurance to facilitate the placement of debt that does not fully amortize over the lease term, for the purpose of enhancing the equity investor's anticipated return from the leveraged lease transaction.

What Residual-Value Insurance Is

Residual-value insurance is essentially a put option purchased by the lessor. In exchange for an initial payment, the equity investor acquires the right to sell the aircraft to the insurer for a fixed price on a fixed date. The residual-value insurer is truly an insurance company, which may be involved in other lines of insurance as well. Other kinds of residual-value protection instruments, may be offered by the aircraft manufacturer to promote the sale of new aircraft. They are not the subject of this advisory.

Residual-Value Insurance to Protect the Equity Investor's Return

In a leveraged lease, a key date is when the term of the lease is scheduled to end and the lessee scheduled to redeliver the aircraft to the lessor. The lessor may have collected and retained that portion of the rent paid by the lessee that remains after the corresponding debt service payment is made on the aircraft loan, often identified as the "equity free rent" or "free cash rent." The equity investor as lessor also may hold and retain a balance of unapplied maintenance reserves. The lessor may count these amounts in the return it achieves on its investment in the aircraft. At this point the lessor may wish to realize additional return. It may achieve this by extending the term of the lease to the existing carrier, selling the aircraft intact, parting out the aircraft, leasing the aircraft to another carrier, or (in the case of a passenger aircraft) selling or leasing the aircraft after converting it to a freighter.

In this regard, a lessor that acquires residual-value insurance policy protects its ultimate return by having the option to put the aircraft at lease end to the insurer at a given price that produces an adequate return from the lessor's investment. This price would have to be a relatively high amount. To write such a policy, the insurer at the time of the underwriting of the policy would have to be comfortable with the put price based on appraiser projections or other market information that the aircraft will at lease end have a market value at least equal to such price. The premium that the insurer may charge to write such a policy needs to be carefully considered to make sure it fits within the overall economics of the transaction and that it is not too high to make it commercially unviable option.

Residual-Value Insurance to Support Repayment of a Loan That Does Not Fully Amortize

Another way to use residual-value insurance is to facilitate the placement of the leveraged-lease loan, and in so doing reduce the initial equity investment and increase the equity investor's potential return. As far as repayment of principal is concerned, loans can be of three kinds: fully amortizing, partially amortizing and nonamortizing. A fully amortizing loan will have a repayment schedule that reduces the outstanding principal balance over time to zero on the maturity date. A partially amortizing loan will have a repayment schedule that reduces the outstanding principal balance over time to an amount greater than zero on the maturity date. A nonamortizing loan will have a repayment schedule that is interest only; the outstanding principal balance on the maturity date will be the same as the initial amount of the loan, or even higher if a portion of the interest is scheduled to roll up into principal rather than to be paid periodically.

A loan that amortizes fully before maturity presents a starkly different risk profile to the lender than one that either partially amortizes or does not amortize at all. The lender of a fully amortizing loan secured by a mortgage on the aircraft and a security interest in the lease largely focuses on the creditworthiness of the lessee, rather than the value of the aircraft in making the credit decision to extend the loan. The ability to repay the loan out of the proceeds of a sale or a re-leasing of the aircraft will generally become an issue only if the lessee defaults in paying rent and the lender exercises remedies. By contrast, the lender of a loan that does not fully amortize by the end of the lease term must be concerned with how the balance of the loan will be repaid. An equity investor has an incentive to use partially amortizing or nonamortizing debt to finance an aircraft in order to reduce the portion of rent that must be applied to debt service and as such maximize equity-free cash. Furthermore, given that the rent payable by the lessee is generally fixed, the less the amortization of the loan principal during the lease term, the greater the amount that the equity investor can borrow, which in turn may reduce the overall investment in the aircraft. Maximizing leverage in this way can reduce the equity investor's risk in the transaction. It may also however shift the equity-free cash portion of the rent to zero, because the lender will not likely tolerate an equity investor's pocketing any portion of the rent while the lender's loan balance decreases little or not at all. The result then is to shift more of the equity investor's potential return and the ultimate risk of the lender to the sale, re-leasing or refinancing of the aircraft at the end of the lease term. This risk can then be protected by the use of a residual-value insurance policy.

In this situation, at the time the equity investor purchases or back-leverages the aircraft, the equity investor can purchase a residual-value policy. The policy will be assigned to the lender as part of the collateral package (along with the aircraft and lease), and will secure the repayment of the unamortized loan balance at the end of the lease term. The policy does not secure the repayment of interest during the term and does not secure the payment of any amortizing tranche of the loan. The insured value will be a fixed dollar amount equal to the scheduled balance of the loan at the end of the lease term. The premium, payable by the equity investor to the insurer when the insurer issues the policy, will equal an agreed percentage of the insured amount. The policy will give the equity investor, or the lender as security assignee, the right to sell the aircraft to the insurer for the insured value (subject to adjustments as provided below) at the end of the lease term (or to have the insurer pay the excess of insured value over the purchase price in an underwater sale consented to by the insurer). This shifts the ultimate risk of having to sell an aircraft to repay a loan from the lender to the insurer. The lender relies on the credit of the insurer rather than the asset risk (although the lender still gets its security interest in the aircraft in case the insurer does not purchase the aircraft if and when the borrower or lender makes a claim). Offering the lender the benefit of a residual-value-insurance policy increases the pool of lenders willing to make the loan and a larger pool of lenders and competition for the loan may in turn result in more attractive credit spreads for the equity investor to choose from.

The insurer will price the policy based on the projected fair market value of the aircraft at the end of the term, how distant the end of the lease term is, and how much of a cushion there is in that value over the insured value. The insurer also will price the policy based on the assumption that the aircraft will meet the redelivery conditions set forth in the lease. The downside for the equity investor is that it has to pay a premium to the insurer; this, however, is usually financed out of the increased principal amount of the loan the equity investor is able to arrange because the loan does not have to amortize fully.

The policy will specify the date on which the insurer must make a payment if the policy is drawn on. That payment date will be either last day of the lease term or a date that is a short grace period thereafter. If the lessee has the right under the lease to terminate the lease term early, or to extend the lease term, the policy would have to provide for a corresponding adjustment in the payment date. The initial premium will be based on the earliest possible termination date, with additional premium payable as either early termination options expire or renewals of the lease term are exercised.

In this scenario, the lender and the insurer do not expect that equity investor will allow the policy to be drawn on. If it is, the insurer will pay only enough to repay the loan balance, meaning the equity investor will not realize any return from the residual value of the aircraft. Therefore the equity investor will be expected to sell the aircraft at the end of the lease term for a price higher than the insured value, or re-lease and refinance the aircraft. This may facilitate the decision of the insurer to underwrite the policy in the first place.

Additional Provisions

Remarketing of Aircraft

As discussed, the equity investor will ordinarily seek to sell or refinance the aircraft at the end of the lease term. However, if the aircraft is not sold for a price at least equal to the given insured value, the policy will be drawn on, presumably by the lender as assignee of the policy for security purposes. When the policy is drawn on, the insurer must pay the insured value and (unless it declines its right to do so) immediately take title to and delivery of the aircraft (unless the aircraft has already been sold in a sale consented to by the insurer). The insurer is then free to put the aircraft into storage at its expense to try to wait out a down market, if it wants. The insurer will likely prefer, however, to sell the aircraft as soon as possible in order to recover as much of its payment of insured value as it can. Therefore, the policy may provide that unless by a certain milestone date before the end of the lease term the equity investor has entered into a sale agreement or at least letter of intent to sell the aircraft to a third party on the last day of the lease term, the insurer may thereafter also remarket the aircraft. The equity investor will seek to avoid having this co-marketing period commence. The reason is that the insurer will be incentivized to offer the aircraft on the market for a price no higher than the insured value. If the aircraft is sold for insured value or less, the equity investor will not realize any proceeds of the sale. There also is the risk of some confusion in the market, as buyers see that two different remarketing agents — one working for the equity investor and one working for the insurer — are offering the same aircraft for sale, and at different price points.

Lessee Default During Lease Term

Residual-value insurance represents a bet by the insurer that the aircraft in lease redelivery condition will have a value at least equal to the insured amount on a given date. That does not mean that the lease term must continue to the scheduled expiration date. The policy may provide that if the lessee defaults, the lessor may repossess and store the aircraft until the payment date and, during the storage period, correct any discrepancies from the lease redelivery condition. The policy also should permit the lessor to lease the aircraft to another carrier for a term that ends on or before the policy payment date, provided the redelivery conditions are substantially similar to those of the original lease or the aircraft is otherwise brought into redelivery condition as specified in the original lease. The right to lease to another carrier may be subject to the consent of the insurer on the grounds that the maintenance reputation of the carrier can have some effect on the residual value of the aircraft.

Aircraft Redelivery Condition

The lender takes the risk that the lessee may default in payment of rent during the lease term, which would lead to nonpayment of periodic debt service on the loan. At the end of the term, the insurer stands ready to pay out insured value to repay the scheduled balance of the loan. However, there are lessee-related risks that the lender bears at the end of the lease term that could prevent the lender from receiving a full payment of insured value. In exchange for the payment of premium, the insurer takes market-value risk. If it cannot resell the aircraft for at least insured value, the insurer will take a loss. But the insurer does not take the risk of a default by the lessee. Therefore the policy will provide that payment of full insured value is subject to the aircraft's meeting the lease redelivery conditions at the time the insurer must make its payment. The policy will provide that if the lessee does not comply in full with the redelivery conditions of the lease, the value of the discrepancies will be tallied up and deducted from the insurer's payment of insured value. The policy may further provide that if the value of the discrepancies exceeds a threshold specified in the policy, the insurer is excused from making the payment at all. However, the policy should specify a liberal cure period — say 90 days — to rectify discrepancies and so save the obligation of the insured to make payment at as close to full insured value as can be achieved. The policy and loan documents may allocate to the equity investor the task of reporting on and managing compliance with return conditions. But it is nevertheless incumbent on the insurer and lender to monitor compliance with return conditions. Similarly, the insurer will assume the aircraft is redelivered in the hard-time condition that is the benchmark set forth in the lease — e.g., half-life or full-life. The lessee will not actually be required to cause the aircraft to meet this standard, but will be required to pay return compensation (either directly or out of available maintenance reserves). This compensation will be deducted from insured value, whether or not the lessee actually makes the payment.

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