

# TOWARDS NEW LENDING MODELS



**FINANCE**  
Availability of capital is crucial to Business Aviation growth.

By Giulia Mauri, Partner, Aviation & Transport at Verhaegen Walravens and Salvatore Tosiani, Head of Aviation Finance, Banque CIC (Switzerland) Ltd.

A fundamental component to the growth of the Business Aviation industry is the availability of capital to finance aircraft transactions. However, after the 2008 Wall Street meltdown, it looks like the banks have lost their appetite for business aircraft transactions and lenders continue to flee for the nearest exit.

The current European debt-crisis has created a contraction in the lending market while also increasing pressure on the banking system (due to liquidity costs and higher equity ratios for banks per Basel III). Add to this the fact that more equity is consumed per new transaction, along with the all too recent memory of the 2008 mortgage crisis in the US, and it's easy to see why banks are busy reviewing their lending models and criteria.

In this article, we share some of our thoughts on the impact that differences in legal systems and jurisdictions have on lending and to open a debate on the inherent risks of the use of an aircraft as collateral and on methods that could reduce these risks and make an aircraft an attractive form of security.

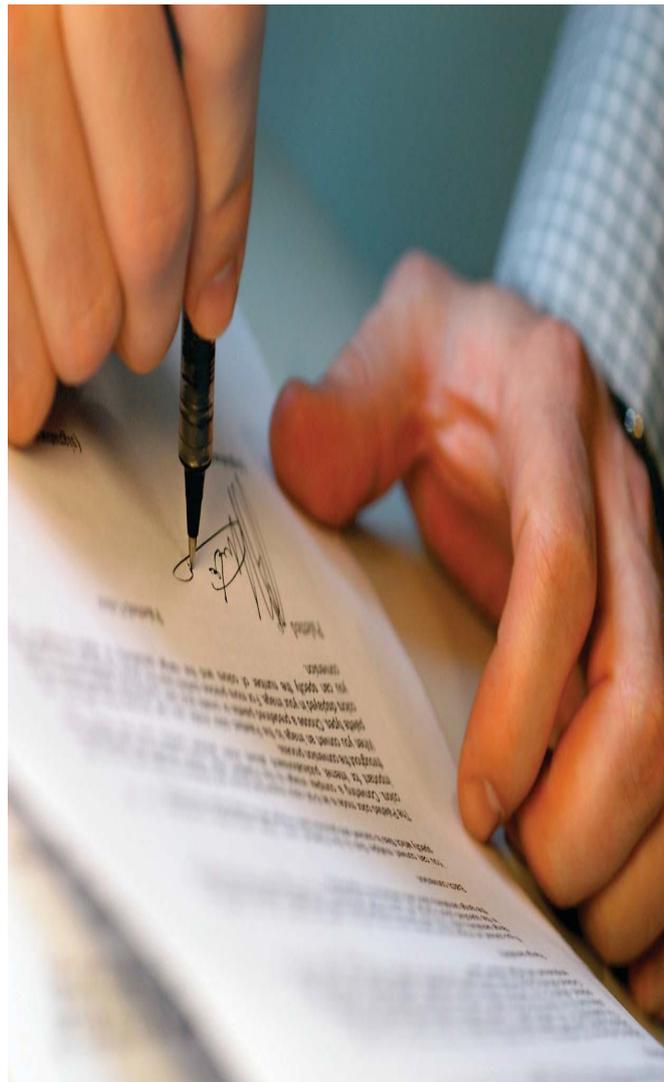
## Asset-Based Lending Versus Credit-Based Lending

As David Labrozzi, President of GE Commercial Finance's corporate aircraft division, said at the JetNet IQ Summit in June 2011: "Between 2004 and 2007, the industry was just frothy with capital. If you weren't a criminal, had a phone and were buying an airplane, you got a loan."

The availability of finance on the market during these boom years was also due to lenders' expectation that the financed asset would maintain its value and could therefore constitute sufficient collateral in case of default. Cash flow and borrower's personal wealth requirements were less stringent, and the so-called soft market value curve was in an ascendant phase.

In fact, the industry was so head-over-heels with the collateral that, as Mr Labrozzi said in a kind of 'mea culpa' for the industry: "lenders sometimes lost sight of the basics".

When the 2008 financial turmoil hit, the business jet market became saturated with second hand aircraft whose prices quickly plummeted. Repossessions became more frequent, and deregistration and final realization of the collateral proved to be more difficult than originally estimated.





Further, the legal implications of complex, cross-border structures and/or securities that were previously overlooked began to surface. The result was that when it came time for repossession, lenders found themselves confronted with local legislation that made it difficult to seize and deregister the aircraft – particularly when the seizure took place in a country other than the country of registration or away from the habitual base of the aircraft.

The consequence was that foreclosures were delayed; sending such costs as maintenance, insurance, legal fees, inspections and liens through the roof. All of this made the task of maintaining aircraft records next to impossible, further impacting the value of the aircraft.

Moreover, even when the aircraft was repossessed, lenders found the whole remarketing and reselling process was overly complicated and time consuming. In other words, many lenders were not prepared to effectively manage the sale of a repossessed aircraft. In extreme cases, lenders were too late in discovering that their security was no longer enforceable or simply no longer worth the amount needed to justify enforcement.

**CAUTION**  
Lenders are far more risk-conscious than before when assessing business jet transactions.

Both as a consequence of these events and as a way to better manage risks, financiers shifted from a totally asset-based form of lending towards a credit-based lending model where an in-depth financial due diligence process is carried out on the ability of the final borrower to repay the loan or lease.

Due to these lessons learned and the ongoing volatility in the aircraft market, when assessing a business jet transaction, nowadays lenders are much more attentive to risks. Lenders will attentively look at credit risk, the client, the asset, the structure of the deal and any other issues that need to be assessed in order to fully understand the transaction.

It is paramount for lenders to clearly understand if the borrower (be it an existing or new client, a corporation or an individual) is financially stable. Beside this, lenders will also explore other areas of business where lenders may intervene and support. In other words, in order to facilitate the granting of the finance facility, a clear and transparent relationship has to be built between the lender and the client - and this is only possible if the client fully understands the process and protocol.

### The Structuring of the Deal and its Legal Risks

Legal hindrances to recovering collateral and the high volatility of aircraft market values have contributed to diminishing lenders' appetite for accepting a business aircraft as sole form of collateral.

When evaluating a potential deal, banks no longer limit their analysis to the value of the aircraft, but will also analyze how the deal will be structured so as to limit risks linked to an eventual repossession, as well as to the enforceability of other securities and how the different laws involved may affect this. A well-structured deal with proper transactional documentation carefully drafted may limit risks by taking into account the nature and use of the aircraft as a mobile asset that moves quickly and regularly across jurisdictions, and whose seizure may take place in a jurisdiction other than that of its habitual base or registration.

Indeed, even in Europe, a continent considered as relatively secure, many differences exist among jurisdictions. Such differences relate not only to the type of security that may be taken on

the aircraft, but also to the type of registration that may be obtained for such security and for the title of the owner.

In most European jurisdictions, for example, banks secure their credit by way of a mortgage on the plane. However, in certain jurisdictions, such as Belgium and Austria, the only asset-based security available to creditors is a pledge. The basic requirement for the validity of a pledge is the so-called 'dispossession'. This means the pledgor cannot use the pledged asset.

If applied to aircraft, the use of a pledge becomes particularly inconvenient. Indeed, the borrower/operator under a loan agreement will not be able to grant a pledge to the banks, as the operator will need to use the aircraft. Lending will therefore be structured differently. Instead of a loan coupled with a mortgage on the plane, lenders will be advised to proceed by way of a lease or hire-purchase agreement, or to create a special purpose company that will act as borrower/pledgor and will lease the aircraft to the final user.

If these structures offer an alternative to the classic loan/mortgage lending scheme, they may raise questions as to the accounting treatment of such transactions and the value of the registration of the aircraft with the local civil aviation authority.

Lenders will likely prefer a registration system that gives legal certainty as to the identity of the owner and publicity of any asset-based security existing on the plane. This is the case, for example, of the French registry of civil aircraft, which serves as an owners' registry. Registration of the owner is considered as title to the aircraft. Moreover, in order to be enforceable, any mortgage taken on the aircraft will need to be recorded on the registry.

This is not the case in Belgium. The Belgian registry is an operators' registry where aircraft are registered under the name of the operator. As of the date of writing, the position of the Belgian Civil Aviation Authority is to refuse to issue any form of letter or document confirming that they are aware of the identity of the owner of the aircraft or of the mortgagee.

Needless to say, each and all of these elements will be taken into careful consideration by banks when structuring deals and may have an impact on the final cost of financing.



### Examples

If these issues seem abstract, an example of the application of different laws and their impact at the moment of foreclosure will clarify the importance of properly examining international private law issues before structuring a deal.

For explanatory purposes, take the case of PK Airfinance US Inc. PK had taken an English law mortgage on a Boeing 747-422 owned by an English special purpose company and leased to Blue Airways LC, an Armenian company. The aircraft was registered on the Armenian registry, while the English law mortgage was taken when the aircraft was physically located in the Netherlands – meaning that neither the SPC nor PK were able to repossess the aircraft.

The English High Court refused to give effect to the mortgage, noting that the aircraft was physically in the Netherlands at the time the English mortgage was created and since Dutch law will only recognize a mortgage created under the laws of the state of registration (i.e., Armenia).

Another example is the unique case of Belgium. Belgian pledges on aircraft cannot be registered in the Belgian reg-

istry. The Geneva Convention of 1948 on the recognition of rights in aircraft provides that the contracting states undertake to recognize several rights (including mortgages and similar rights) in aircraft, provided that such rights have been recorded in the registry of the relevant country.

Even though Belgium has ratified the Geneva Convention, the Belgian system does not provide for registration of pledges on aircraft on the Belgian registry. The result is that should lenders seize a pledged aircraft in a country, even a contracting state under the Geneva Convention other than Belgium, there is a concrete risk that such country would not recognize the Belgian pledge on the aircraft as a valid form of security.

These examples show how legal differences may increase risks in relation to aircraft finance deals and how they will need to be properly taken into account when structuring and pricing a deal.

### Possible Solutions: The Cape Town Convention

The Cape Town Convention (hereinafter, 'Convention') became effective on March 1, 2006. Since this date, the

**GAINS**  
Better secured lending could bring borrowers significant financial benefits.

## THE DOCKET

### CAPITAL CONVENIENCE

Convention has been applied by the contracting states that include the US, China, Brazil, the Russian Federation and, in Europe, Ireland, Luxembourg.

The aim of the Convention is to create a uniform law applicable to security on movable assets, such as aircraft, rolling stock and space objects. The rules of the Convention address such issues as the type of security that may be taken on an aircraft, available interim measures, and applicable rules in case of bankruptcy by the debtor. The Convention created an asset driven, fully electronic registry accessible 24/7 and located, as to aircraft, in Ireland.

The European Community has ratified the Convention. However, for it to become applicable, each Member State would first need to ratify it.

The Convention is applicable to airframes capable of carrying at least eight people (including crew), jet aircraft engines with at least 1,750 pounds of thrust, turbine aircraft engines with a minimum 550 takeoff shaft horsepower and helicopters capable of carrying at least five people (including crew).

This international instrument is an excellent example of the fact that legal uncertainties are perceived by the international lending community as obstacles to lending or as factors that increase risks and that may ultimately impact borrowing costs.

The Convention has been supported by Boeing, Airbus and Embraer, as it may facilitate the exportation of aircraft to countries considered at risk. Further, such lessors and lenders as AerCap, BNP Paribas and Deutsche Bank have also endorsed the Convention. The Air Working Group, the industry group created to support and lobby for the adoption of the Convention, has been extremely active in supporting its ratification.

Several studies have been prepared to demonstrate the advantages that better secured lending could bring to borrowers and to the aviation industry overall. For example, the impact assessment study prepared by Anthony Saunders



and Ingo Walters under the auspices of INSEAD and the New York University Salomon Center, estimated that the gains of adopting the Conventions measures could reach several billion dollars annually. Although this study is now dated, the AWG is currently working on an academic project whereby in-depth research will be conducted with the goal of highlighting the savings that the Convention has already created.

Suffice it here to mention that the 2011 OECD Aircraft Sector Understanding on Export Credit for Civil Aircraft grants important discount on export credit to countries that have ratified the Convention, therefore showing that a mitigation of risk may lead to better credit conditions.

The creation, ratification and industry support received by the Cape Town Convention demonstrates that legal uncertainties do constitute a hindrance to lending or, at the very least, an element that may determine higher borrowing costs. The support received by the Convention also proves the need for legal uniformity aimed at eliminating obstacles to accessibility of capital in the aircraft finance sector.

#### Open Debate

We believe that, in an international sector like the Business Aviation industry, cross-border lending may be hindered by the difficulties linked to the existence of different legal systems, some of which do not effectively protect lenders' interest.

The 2008 US financial crisis, followed by the current crisis in the Euro-Zone, have made lenders more selective and aware of the many risks involved in financing the acquisition of business jets. Certain jurisdictions, even in Europe, are still considered problematic, as security may not be available under the form of a mortgage and registration may not adequately protect the interests of the lenders.

In light of this, we believe that it would be interesting to open a debate on this topic, similar to what has been done by manufacturers, lessors and lenders active in commercial aviation in forums such as the AWG.

Would the partial elimination of legal hindrances allow financiers to better manage risks? Would an easily enforceable security on the aircraft better support credit committees in their evaluation of collaterals? Would the ratification of the Cape Town Convention give more comfort to lenders?

We believe that our industry has reached a level of maturity that would allow us to push the debate forward on these issues - perhaps under the auspices of the European Business Aviation Association. And in light of the current economic situation - now is the opportune time to launch this discussion.



**SHIFT**  
Financiers have moved from asset based lending to a credit based model.

Giulia Mauri welcomes readers' comments on these topics. She advises national and international clients on all aspects of aviation and transport law, including asset finance and leasing, safety regulations, carrier's liability and litigation matters. She can be reached at [info@bartintl.com](mailto:info@bartintl.com)

