Aircraft non-payment insurance - Credit risk under an expected loss perspective

Aviation Finance / Project Finance

Aircraft non-payment insurance (NPI) decreases credit risk for investors by lowering the expected loss. A contract's default probability is lower with the insurance policy in place. In the case of default, the severity of a loss decreases with the number of insurers involved.

NPIs are effective risk mitigants under the light of expected loss

Scope believes the use of NPIs substantially reduces the expected loss for investors in aviation finance transactions. Central to the appeal of NPIs is the high credit quality of the insurers involved which decreases the contract's default probability. The probability of joint default of airline and insurer is substantially lower than the airline's standalone default probability.

The risk decreases in line with the number of insurance companies involved, assuming a certain level of independence between the insurers.

Being exposed to multiple insurers is a material net credit positive. The more insurers, the lower the severity in case of default, despite the higher probability of an insurer defaulting. Scope uses an expected loss approach that captures the net credit positive impact of NPIs in aviation finance transactions.

Expected loss analysis is the analytical approach most appropriate for risk analysis of secured credit exposures. Risk analysis becomes distorted if only probability of default is considered: a larger number of insurers results in higher likelihood of seeing an insurer default. However, more insurers mean that the share per insurer is lower, and therefore the severity of one insurer defaulting is significantly reduced compared with having only one insurer involved.

Non-payment insurance decreases default probability

NPI decreases transaction risk by lowering the contract's default probability. Insurers assume the risk of default by the airline if there is NPI in place. The NPI covers investor's credit, aircraft residual and jurisdictional risk. Principal with accrued interest will be paid by the insurers in the case of a missed payment by the airline. A contract default will only occur if the airline and at least one of the insurers default simultaneously. The contract default probability is the joint probability of default between the airline and insurers.

AFIC is one of the NPIs available to airlines. In the case of AFIC, the insurance is provided on a several basis. There is no joint liability between the insurers. Each insurer is liable only for its own share. All insurance companies must default simultaneously for the program to have no value. The principal and interest of the investor are therefore partially covered even in the case of an airline defaulting simultaneously with some of the insurers. The investor still has security in the asset should all risk presenters default within the same timeframe.

Risk decreases further when a lessor is involved

The risk decreases further if the transaction is managed by a lessor or an asset manager. Lessors normally have external and internal capabilities to repossess and remarket an aircraft if all insurers and the airline were to default within the same timeframe. The lenders must repossess and remarket the aircraft themselves in the absence of a lessor or asset manager. Lenders normally contract an asset manager to complete this process. A lessor or asset manager that has been involved since day-one is more familiar with the transaction and can start the process of repossession and remarketing at the first sign of problems if necessary. Asset managers contracted at the time of default will need time to familiarise themselves with the transaction and start the process. The increased time needed also increases the credit risk because aircraft are depreciating assets.

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Non-payment insurance – the origins of a new aircraft-financing option

NPIs lower the credit risk in the transaction

US Export-Import Bank (EXIM) and European Export Credit Agencies (ECAs) were unable to offer export credit support to Boeing and Airbus aircraft for about two years. During this time, Marsh LLC together with Boeing developed a financing option similar to export credit guarantees, known as, the Aircraft Finance Insurance Consortium (AFIC) programme.

Non-payment insurance provides credit risk insurance for the lenders. The insurance policy performs similarly to the guarantee offered by EXIM.

Lower credit risk reduces the costs of debt for airlines

Airlines can apply for AFIC financing and benefit from reduced cost of debt because of the lower credit risk. Insurers can offer a lower cost of debt because they are better diversified than investors. Insurers can fully rely on expectations that are only valid when there is a granular book of exposures.

Airlines or lessors finance the aircraft using debt provided by the lenders and the lenders receive an insurance policy covering non-payment of principal and interest. The insurers do not provide any financing. They offer the insurance policy in exchange for an insurance premium that is paid in full on the drawdown date.

The insurance coverage insures the lenders against an airline default and non-payment. Both principal and interest to the lenders are covered by the insurance companies. The AFIC programme includes four insurance companies, all rated at least A, with the insurance coverage on a several basis. Two insure a 25% portion while the third insurer covers the remaining 50%. The fourth insurance company re-insures half of the 50% portion.

NPIs offer more flexibility than export finance

AFIC was intentionally designed to offer insurance coverage for Boeing aircraft. Marsh S.A.S, a separate Marsh entity, has worked together with a pool of highly rated insurance companies to launch Balthazar. Balthazar offers a very similar product as AFIC for Airbus aircraft. We are likely to see more of these financing options arise as this product can be replicated both for other aircraft manufacturers and other aviation assets.

NPIs offer more flexibility than export finance. The NPI product named Balthazar, which is currently being introduced, will allow the airline and financing parties to use their own transaction documentation. Up to 100% of the purchase price can be financed using NPI. NPIs can also deal with different structures such as Japanese Operating Leases with Call Option (JOLCOs).

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