

Dodd-Frank reform: How will aircraft ABS deals be affected?

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In 2010, President Obama's government passed the Dodd-Frank Wall Street Reform and Consumer Protection Act, a wide ranging piece of legislation that was created to end the dangerous financial practices that contributed to the 2008 financial crisis.

Among many other measures, the Act set out new restrictions on asset-backed securities (ABS). This is because certain types of securities – those secured against US mortgages, for example – helped to trigger a banking crisis that led to the largest economic meltdown since the Great Depression.

After the US housing bubble burst, most observers agreed on the need for regulation that could curb the industry. The public and mainstream media were angry at the recklessness with which issuers, banks, ratings agencies and the security exchange commission (SEC) had allowed risky deals to be sold to investors as sure bets.

This December, a fresh round of Dodd-Frank regulation is set to pass into law. While some legislation came into effect last year, which only affected mortgage-backed deals, this year's changes will affect all other types of securities.

It is possible that the regulation will create some restrictions on aircraft ABS deals. But given the uncertainty about the impact of the regulations, some sources were unwilling to be quoted speculating on the record.

Despite this, all those who spoke to *Airfinance Journal* are keeping a close eye on the issue and are keenly aware of its significance.

What is the regulation and will it affect aircraft?

The aircraft finance community is grappling with the question of how the new legislation will affect aircraft ABS deals.

The market will not know for sure until issuers begin offering aircraft ABS deals after the regulations have taken effect. In the meantime, lawyers, lessors and financiers are investigating what the impact will be for the securitisation of commercial aircraft operating leases. Most are still undecided, and among those that have decided there is no consensus.

The upcoming changes are applied by Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The most relevant section of the incoming regulation is the part relating to risk retention. Sometimes known as the skin-in-the-game requirement, this section requires future issuers of ABS deals to retain at least 5% of the credit risk of the assets in the collateral.

For some issuers, this will not be a crucial factor. But for others, particularly those that sell the equity of the collateralised aircraft on to investors, this requirement might make ABS deals less attractive than a straightforward portfolio sale.

Kevin MacLeod, shareholder and head of the New York capital markets group at Vedder Price, thinks it is likely that traditional aircraft ABS deals will be affected by the Dodd-Frank regulation.

He notes: "The credit risk-retention rules apply to asset-backed securities as defined by the US Securities Exchange Act of 1934, unless an exemption is available. For aircraft ABS deals with debt securities, the rules will likely apply."

However, others believe that aircraft ABS deals will escape the regulatory restrictions. James Pascale, a partner in the New York office of Milbank, says that aircraft operating leases will not qualify under the regulation.

He says: "I think the concern for aircraft ABS deals needing to comply with US risk retention regulations is an unfortunate case of mistaken identity. While the US risk retention regulations could certainly stand to be clarified, it seems a bit of a stretch to include traditional aircraft ABS."

Pascale explains: "The US risk-retention rules only apply to securities collateralised by self-liquidating financial assets, a term that, although not defined, doesn't equate well to the collateral backing a traditional aircraft ABS deal. Even if we ignore the physical aircraft and accept that an aircraft operating lease constitutes a self-liquidating financial asset, in a typical transaction there is likely too much reliance on cash flows from re-leasing or aircraft sales for the securities to fall within the Dodd-Frank definition."

A banker who spoke to *Airfinance Journal* confirmed that there is "a lot of discussion about whether aircraft are a financial instrument or not".

How would it change the aircraft ABS market?

If aircraft operating leases are going to be affected by the regulation, there are a number of possible outcomes.

Those issuers which treat ABS deals like portfolio sales – by selling the equity (E-note) on to third-party investors – may start to view ABS issuances less favourably. From the lessor's perspective, being forced to retain an equity stake in aircraft that you wish to remove from your balance sheet is undesirable.

It is important to note, however, that issuers complete ABS deals for a variety of reasons.

Marjan Riggi, managing director of financial institutions at Kroll, says the impact of the regulation on issuance levels will vary depending on the goals of the issuer.

She says: "If they are interested in outright sales, issuers can always sell the entire portfolio to a third party who will then securitise the assets; if they want to use ABS as a funding mechanism then they may have to retain part of the risk on their balance sheet if, indeed, the risk-retention rules would apply to aircraft lessors."

Anthony Nocera, managing director of ABS at the rating agency, points out that some recent ABS deals have been done for fleet management reasons. He adds: "The reason you see these companies securitising large pools of aircraft is to sell older aircraft off their books. Several lessors have been using the ABS market for sales rather than financing of aircraft."

If issuers do see the upcoming regulatory change as an obstacle, they may choose to speed up any deals already in the pipeline.

Even if they don't believe aircraft operating leases will fall under the regulatory guidelines, issuers that want to complete deals might try to avoid any potential hassle by ensuring their deals go to market before December.

Vedder Price's MacLeod thinks "there will be some pressure on lessors and sponsors to get deals done sooner."

A banker who chose to remain anonymous agreed that lessors might want to get some deals completed ahead of the changes. He says: "All things being equal, you want to issue now. But the truth is you can't rush these deals – there are too many moving parts."

But for those issuers that tend to retain the equity on ABS deals, such as US asset manager Castlelake, the mandatory retention of an equity interest will have little effect on their strategy.

Evan Carruthers, a managing director at Castlelake, notes that his firm's ABS issuances would not be affected dramatically, because Castlelake has always retained 100% of the equity of the collateral anyway.

Speaking about the incoming regulation, he says: "You have seen risk-retention rules in other forms of structured finance, where the issuer needs to retain a certain percentage of equity. So that concept does exist in parallel asset classes."

"So for us, even if those regulatory rules were implemented, it wouldn't hamper our ability to execute in the ABS market, but it clearly would have an impact on issuers that were looking to execute more of a trade sale, where the servicer or issuer that sold the equipment no longer retained an economic interest in that pool," he adds.

But reflecting on the needs of other lessor ABS issuers, he says: "It would certainly become a slightly less attractive option for the larger leasing companies that are looking to sell large pools of collateral into the ABS market where they sell the E-certificate."

In the absence of a ruling by the SEC, the market is waiting to see how aircraft ABS deals may be affected. In the short term, the changes may lead to a flurry of ABS transactions towards the end of the year, as issuers choose to close deals ahead of any potential change.

In the long term, there may be no change at all. Alternatively, ABS deals could become a less attractive option for the lessors that would use them to divest from certain aircraft portfolios. The latter would clearly be a problem for some companies.

The changes are coming just as the ABS market is returning to its previous strength. Last year, five aircraft ABS deals were offered to the market with a total issuance volume of almost \$3.7 billion – the most new issuances by volume a year since 2008.

It is hard to predict how many deals will cross the line before December, but any upcoming issuer that has the option will probably try to do so.

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