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US Ex-Im Bank's response to the financial crisis

Airlines and lessors have suffered limited access to the capital markets and as the liquidity in bank-supported aircraft finance shut down, aircraft financing became an increasingly hard task. **Joshua Gentner**, Shareholder of Vedder Price explains the United States' Export-Import Bank's reaction to these recent struggles and how it continued to facilitate aircraft financing.

THE RECENT WORLD LIQUIDITY CRISIS had a major affect on the aircraft finance industry. With extremely limited access to the capital markets, most airlines and operating lessors looked to the bank market and export credit agencies (ECAs) to provide financing for the purchase of aircraft. Unfortunately, due to limited liquidity in the aircraft finance bank market, including banks involved in the ECA guaranteed financing market, the ability to find a willing lender became increasingly difficult. Even if an airline or operating lessor was lucky enough to find a bank willing and able to provide financing, they soon found that credit margins had increased dramatically from pre-2008 margins.

The Export-Import Bank of the United States (Ex-Im Bank) recognised the issues facing banks, airlines and operating lessors in the market and sought to address those issues in a manner that would help support the banks involved in the aircraft finance market and facilitate the financing of aircraft. In order to assist banks with existing commitments, Ex-Im Bank created a market disruption clause, the effect of which was that Ex-Im Bank would guarantee the lender on its cost of funds in the event that there was a disruption in the London inter bank offer rate (LIBOR) market. To address the lack of liquidity in the market, Ex-Im Bank developed a take-out option to entice banks into (or back into) the market. Additionally, Ex-Im Bank developed a capital markets product to provide airlines and operating lessors with access to an alternative funding source. As a last resort, Ex-Im Bank provided direct loans to finance aircraft where no alternative source of financing was available.

EFFECTS OF THE FINANCIAL CRISIS

In order to better understand Ex-Im Bank's responses, we must understand the affect the financial crisis had on the aircraft finance market. By the end of 2008, some of the banks that were traditionally involved in aircraft finance had gone out of business; others had made the decision to use their limited capital on 'core' areas of business. In the latter case, this meant that either the bank's limited capital was not allocated to the bank's aircraft group or, in some cases the bank eliminated its aircraft lending group entirely. Additionally, some European banks that had received government support during the financial crisis restricted the use of their capital to support local clients.

In sum, the aircraft finance market was left with fewer banks with those still trading having limited or restricted capital. As a result, the margins on Ex-Im Bank-guaranteed loans rose as high as 130 basis points over LIBOR, compared to margins of 25 basis points over LIBOR in 2007 and LIBOR flat in 2006.

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> *"In early 2009, Ex-Im Bank began work with a number of financial institutions to structure a transaction whereby the airline or operating lessor could issue Ex-Im Bank-guaranteed notes into the capital markets. This would allow airlines and lessors access to a different source of capital at rates that were expected to be substantially lower than those offered by the banks."*

A more dramatic effect of the limited liquidity was that some banks that had signed term sheets were unable to move forward with transactions, leaving borrowers without financing and little time to find any alternatives. Higher credit airlines and operating lessors were able to obtain financing but at drastically increased margins while the rest of the industry was facing a large financing gap.

MARKET DISRUPTION CLAUSE

At the height (or bottom) of the financial crisis, the ability of banks to borrow in the interbank market was extremely limited or non-existent. Those that still had the ability to borrow funds could only do so at dramatically increased costs however, this increase was not reflected in the quoted LIBOR rate. Accordingly, the banks that had signed term sheets faced the possibility of entering into transactions where the agreed margins could result in reduced or non-existent returns. In order to address this disconnect, banks asked their

Fred Hochberg chairman and president of US Ex-Im Bank (third from left) joins Bank and Boeing officials on a tour of Boeing's factory in Everett, Washington.

borrowers to pay the difference between the bank's cost of funds and the quoted LIBOR rate. The banks requested that Ex-Im Bank treat the indemnity as an increase in the interest rate on the Ex-Im Bank guaranteed loan, thereby providing the banks with Ex-Im Bank's guarantee coverage for such amounts. Without the benefit of the guarantee, a bank would be reluctant to proceed as its approvals were based on its implicit funding costs being included in the debt rate and covered under Ex-Im Bank's guarantee.

While this type of market disruption clause was not unusual for commercial financing, it was not previously included in any aircraft transactions supported by Ex-Im Bank and it was their first exposure to the issues presented by the financial crisis.

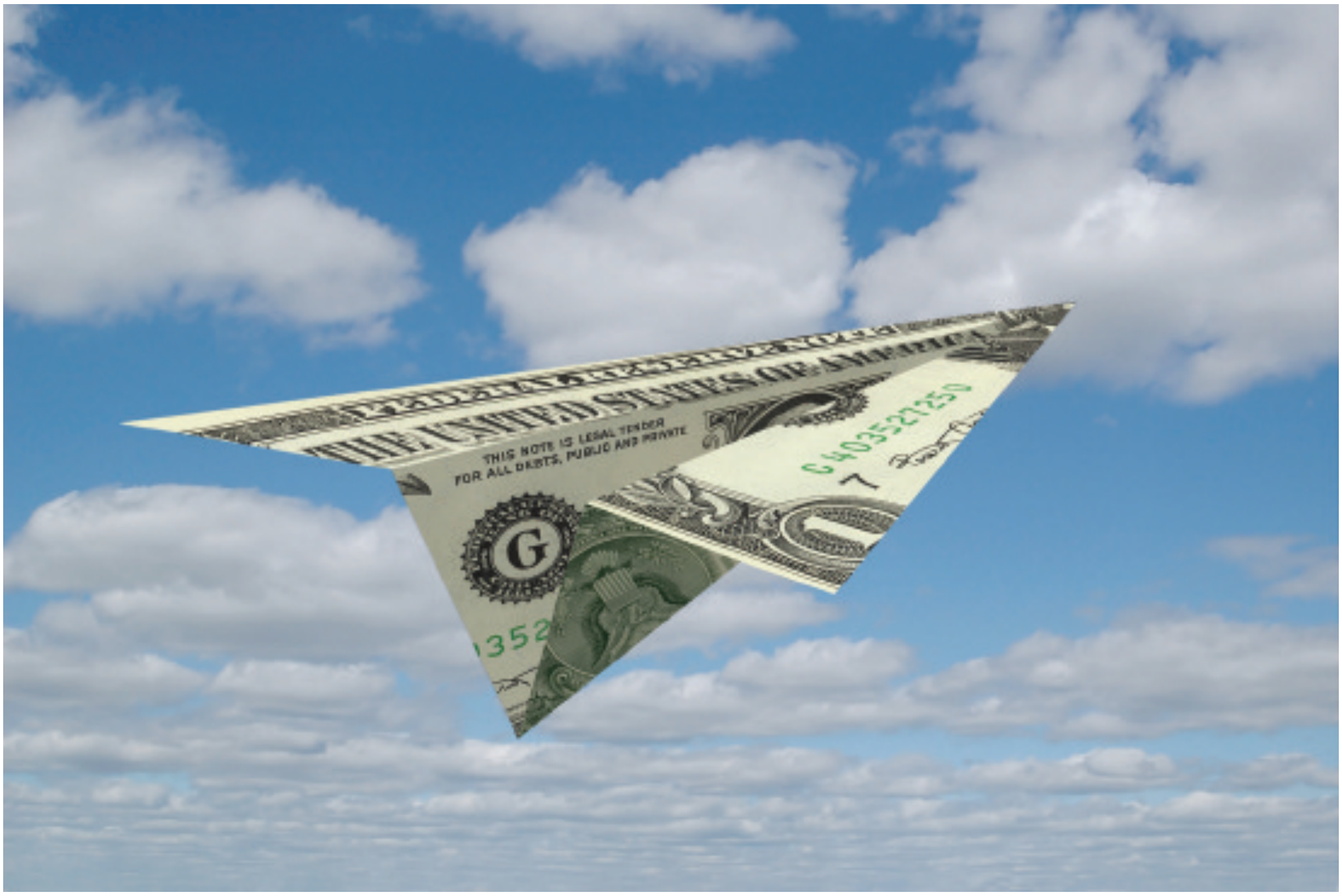
Ex-Im Bank agreed to the inclusion of a market disruption clause that required the borrower to indemnify the banks, to the extent borrowers agreed to include such a clause. However, the request to cover a bank's cost of funds under the Ex-Im Bank guarantee presented a difficult issue for Ex-Im Bank. It recognised that banks would either be unwilling to grant loans using LIBOR if it was not a reasonable approximation of their cost of funds, or they would need to increase their margins to cover the market disruption risk. Ex-Im Bank was willing to extend its guarantee coverage to include a bank's cost of funds if the discrepancy between the bank's cost of funds and LIBOR was due to a true market disruption, not the bank's credit. The resulting issue was how to determine between the two.

Due to concerns over self-interest, Ex-Im Bank was not able to accept a certificate from the bank as evidence that the discrepancy was a result of a market disruption. Neither the banks nor Ex-Im Bank were willing to request evidence of a market disruption from other banks.

As Ex-Im Bank has exposure to a large number of banks, Ex-Im Bank is in the unique position to know if other banks are making similar claims, which would be an indication of a market disruption. Accordingly, by late 2008, Ex-Im Bank began including a market disruption clause in its standard aircraft financing documents that its guarantee would cover the differential between the bank's cost of funds and LIBOR to the extent approved by Ex-Im Bank. With a market disruption clause in place, banks with existing commitments were able to close transactions with the comfort that a disruption in the market would not cut into its margins.

TAKE-OUT OPTION AND CAPITAL MARKETS

In early 2009, Ex-Im Bank took additional steps to address the funding liquidity issue facing banks. Using a newly developed agreement, called the 'take-out option agreement', Ex-Im Bank agreed, for a fee, to give a lending bank the option to put its floating rate Ex-Im Bank-guaranteed loans to Ex-Im Bank at par if any one of six specified trigger events occurred. These would primarily relate to the bank's financial condition and funding costs, such as if the bank's credit default swap rate increases by more than 33 per cent. The purpose of the take-out option was to allow banks to put their



loans at par to Ex-Im Bank to free up the banks' capital when times are difficult. It was Ex-Im Bank's expectation that this flexibility would entice banks to bring their capital back to Ex-Im Bank-financed transactions and increase liquidity and competition. By early 2010, four banks closed 12 transactions that included a take-out option agreement.

While the take-out option agreement increased liquidity in the bank market there was still high demand for financing and limited bank capital. In early 2009, Ex-Im Bank began work with a number of financial institutions to structure a transaction whereby the airline or operating lessor could issue Ex-Im Bank-guaranteed notes into the capital markets. This would allow airlines and lessors access to a different source of capital at rates that were expected to be substantially lower than those offered by the banks.

This was not the first time Ex-Im Bank had structured transactions involving the issuance of Ex-Im Bank-backed paper into the capital markets. In the early 2000's, Ex-Im Bank completed several transactions that provided for Ex-Im Bank-supported notes to be issued into the capital markets, however, at that time, the appetite for that paper was limited to short-term securities with maturities from three months to four years. In order to provide the benefit of full 12 year financing to airlines, those transactions had to contemplate the re-financing of short-term notes and set up backstop financing in the case where notes could not be refinanced in the capital markets. With the frequent rollovers and requirements for backstop financing, these transactions tended to be very complex, costly and somewhat cumbersome. Accordingly, as margins on bank transactions began to decrease in the early to mid 2000's, these capital markets structures fell out of favour.

"When bank liquidity reached its lowest, some airlines could not find a bank willing to provide an Ex-Im Bank guaranteed loan. In these circumstances, the bank provided financing in the form of a direct loan."

In 2008 and 2009, the appetite for government-backed paper had changed and there was a market for longer-term fixed rate US Government paper. This, together with increasing bank margins, created the ideal circumstances to create a capital markets financing structure using Ex-Im Bank guaranteed notes as a viable alternative to bank financing – without the roll-over and back-stop financing issues prevalent in the earlier Ex-Im Bank capital markets transactions.

As the capital markets transaction structure developed, Ex-Im Bank used the mantra of "simple, consistent and seamless" as its guiding principle. Ex-Im Bank wanted the capital markets structure to be easy for issuers and investors to understand. The structure also had to be consistent from transaction to transaction so that investors would be able to invest in any transaction with the knowledge that each was substantively similar. Finally, the transition from a traditional Ex-Im Bank guaranteed loan transaction to a capital markets transaction had to be seamless and efficient. The goal was for a product that airlines and lessors could transition to easily and with a minimal increase in cost.

The capital markets structure developed by Ex-Im Bank uses a bank loan to finance each delivery on its delivery date. With the potential for issues or delays with delivery dates for aircraft, all of the parties wanted to create a structure that would avoid the possibility of pricing a transaction in the capital markets and having to unwind the transaction due to a delay in delivery. While using bank loans to initially finance aircraft still subjects issuers to a break funding indemnity if the delivery is delayed, the parties avoid having to unwind a capital markets transaction. An additional benefit of funding deliveries using a bank loan was that the issuers could finance a number of aircraft using bank loans and thereafter pool them to create an issuance in an amount that is optimal for the capital markets. By using the guaranteed loan structure as the base for the capital markets structure it was very easy and cost efficient for airlines and lessors that had financed aircraft using Ex-Im Bank guaranteed loans to transition to the capital markets structure.

Once the airline or operating lessor had financed a critical mass of aircraft using bank loans it was the airline's or lessor's option to elect to enter into the capital markets. Once the airline or operating lessor notifies the bank that holds the relevant bank notes of its intention to go to the capital markets, the bank is required to sell the notes it holds at par to the initial purchasers. The initial purchasers then re-sell interests in the notes to investors in the capital markets. The 'seamless' portion of Ex-Im Bank's mantra was to make sure the transition from the guaranteed loan financing to the capital markets was not document intensive and could be quickly and efficiently accomplished. Ex-Im Bank simplified the mechanics of the process by having all notes held by an indenture trustee. Accordingly, no notes physically change hands as the indenture trustee holds the initial notes on behalf of the bank and capital markets notes on behalf of the investors (through DTC). Regarding documents, an offering memorandum must be prepared and certain certificates and opinions must be provided to the parties in connection with the transition to the capital markets. Due to the 'consistent' aspect of Ex-Im Bank's mantra, the memorandums for each transaction are substantially similar. The procedure for transitioning to the capital markets is very simple and similar to the procedure used to convert floating rate Ex-Im Bank guaranteed bank debt to fixed rate. With simplified mechanics, limited requirements for documents and a familiar procedure, the transition from a guaranteed loan to the capital markets has been seamless and efficient.

While the purpose of developing the capital markets structure was to provide an alternative funding source, as discussed above, the structure still contained a bank-funded component. Notwithstanding the limited liquidity in the bank market, banks were willing to provide this financing as the banks assumed that the borrower would eventually exercise its right to issue the notes into the capital markets and would repay the banks loans in a very short period. This assumption was backed by economic incentive as the margins on the bank loans were as high as 100 basis points over LIBOR while margins on capital markets paper was roughly 50 basis points over mid-swaps (or roughly the equivalent of 35 basis points over LIBOR). Some banks offered rates that were held at a lower margin for a period (usually up to one year following the delivery of the aircraft), after which the rate exploded, thereby incentivising the borrower to enter into the capital markets prior to the increase in the margin. While the banks still had to use their limited capital, they had the benefit of earning the fees for making its loans with the reasonable reassurance that its loans would be refinanced in very short order.

Robert Morin, VP of US transportation division at US Ex-Im Bank.

With a cost-efficient alternative to bank financing, many airlines and operating lessors elected to use the Ex-Im Bank capital markets structure. As of the end of May 2010, more than 10 transactions had closed using the capital markets structure and there had been 11 issuances into the capital markets.

DIRECT LOANS

When bank liquidity reached its lowest, some airlines could not find a bank willing to provide an Ex-Im Bank guaranteed loan. In these circumstances, the bank provided financing in the form of a direct loan. In 2008-2009, Ex-Im Bank made five direct loans to three different airlines to finance the purchase of aircraft. Ex-Im Bank uses the same finance lease structure for its direct loans as it requires when providing a guarantee. An Ex-Im Bank direct loan is not an alternative to a bank providing an Ex-Im Bank guaranteed loan. Ex-Im Bank's mission is to provide financing where it is not available or uneconomic and it does not compete with private markets. Direct loans are a last resort and Ex-Im Bank only makes this option available when commercial bank financing or other financing is not available.

The financial crisis left banks with limited capital and airlines and operating lessors with limited financing options. Ex-Im Bank quickly reacted to these issues and took action to assist banks with existing commitments to help increase liquidity in the bank market and to fill the financing gap. If Ex-Im Bank had not taken the steps it did to fill the financing gap, it is likely that a number of airlines and operating lessors would have been unable to meet their existing commitments.