

INTRODUCING GATS



The Global Aircraft Trading System
Dick Forsberg | January 2019



AVOLON 



Dick Forsberg

Head of Strategy, Avolon

Dick Forsberg has over 45 years' aviation industry experience, working in a variety of roles with airlines, operating lessors, arrangers and capital providers in the disciplines of business strategy, industry analysis and forecasting, asset valuation, portfolio risk management and airline credit assessment. As a founding executive and Head of Strategy at Avolon, his responsibilities include defining the trading cycle of the business, primary interface with the aircraft appraisal and valuation community, industry analysis and forecasting, driving thought leadership initiatives, setting portfolio risk management criteria and determining capital allocation targets.

Prior to Avolon, Dick was a founding executive at RBS (now SMBC) Aviation Capital and previously worked with IAMG, GECAS and GPA following a 20-year career in the UK airline industry. Dick has a Diploma in Business Studies and in Marketing from the UK Institute of Marketing is a member of the Royal Aeronautical Society and also a Board Director of ISTAT (The International Society of Transport Aircraft Trading).

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Introduction

Lease novations¹ have been a part of our industry since the first aircraft were traded with a lease attached in the early 1980s. Although novation is an integral part of the process that ensures that the rights and obligations of the lease contract transfer to the new owner of the asset, it is nevertheless burdensome to the lessee, who is required to input time and legal resource to a process involving a wide range of ancillary matters from which no immediate and direct benefit is received. Since transfer of the lessor's obligations requires the agreement of the lessee, a novation cannot happen without lessee involvement and cooperation.

When leasing was only a minor component of the airline industry's fleet ownership mix, the demands made on lessees were small in number and did not warrant serious push-back. Lessees also had much less leverage with the lessors than today, leaving them with little option but to cooperate. However, with trades of aircraft with a lease attached now approaching 1,000 a year, the impact on the airline community has been magnified to a point where a better way must be found to address the purpose served by the novation process.

Owner trusts, which have been prevalent in aircraft ownership structuring under US law for some time, have recently started to become more widely used in other jurisdictions – notably under Irish law – as the leasing community is becoming more familiar and comfortable with their use. Trusts work well, removing the need for novation and most of the associated work streams, but a lack of standardisation and non-recognition of trusts in certain jurisdictions has held back their usage. Members of the Aviation Working Group² ("AWG") have been working to develop an enhanced and standardised form of trust structure that will encourage more stakeholders to consider trusts for their aircraft acquisitions.

The result of that development process is GATS, which offers a simple, practical and standardised enhancement to the existing trust solution and has the potential, in Avolon's view, to be as transformational as Cape Town within the next 2-5 years.

Although there has been a growing trend for lessees to seek to gain commercial advantage from novations or to frustrate and impede the process, this approach is ultimately self-defeating. Like it or not, aircraft trading is a core part of the leasing business model and lessees gaining a reputation for being "difficult" will find that lessors become less willing to participate in their fleet sourcing as they will want to minimise future sale execution risk and ensure that any sales process is as frictionless as possible. The temptation on the part of a lessee to seek to re-open an existing contract and make changes, for example, to maintenance reserve rates or adjustments, must be resisted. Since, under GATS, the underlying lease remains unchanged, there will be fewer opportunities for lessees to open up the underlying lease for amendment.



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¹ Also known as Assignment and Assumption Agreements

² AWG's 32 members include lessors, lenders and OEMs. In existence since 1994, AWG takes on industry issues and seeks consensual solutions, acting as a forum for considering new issues as they emerge, as well as continuing to monitor issues of importance to the international aviation financing and leasing community. The Cape Town Convention is perhaps its most notable achievement to date. AWG has also led work to reform the export credit system and liability and insurance in the case of aviation terrorism

The Problem

A lease novation remains an essential component in the sale process for more than half of all aircraft that change ownership today with a lease attached. Since a naked aircraft trade is now a rare occurrence, this means that over 50% of all commercial aircraft sales are still likely to require lease novations.

A novation process can take two to three months to complete, with the most straightforward still creating several days' distraction from an airline's normal business activities. Multiply this by the number of leased aircraft in an airline's fleet and the fact that each aircraft may be sold several times over its life and the escalating scale of the problem quickly becomes clear. The novation process has become a bottleneck in closing aircraft sales, with more lessees unwilling or unable to keep up with their obligations and starting to push for greater flexibility on transfers under their lease agreements.

With the global fleet forecast to double over the next 20 years, the level of aircraft trading will increase by at least the same rate – probably more rapidly, as the number of lessors and investors continues to expand, new pools of capital are deployed and the overall leasing share of the market grows.

Trading has become a core component in many lessors' business models, serving multiple purposes beyond that of harvesting profit from the ownership of well-priced investments. Aircraft trading validates a lessor's investment and underwriting capabilities. Trading releases equity for re-investment, creating portfolio "churn" that refreshes the portfolio and introduces new opportunities for economic gain. Trading is also a portfolio risk management tool used to reduce asset or counterparty concentrations. In the current business environment, where sale and leaseback transactions offer unattractive (to say the least) economics, portfolio acquisitions may be the only way to maintain a growth strategy in the absence of a direct order stream with the OEMs, or for new entrants to reach a critical mass over a relatively short time period.

In addition to outright aircraft sales, the level of ABS securitisations has also been running at record levels for the past number of years and appears set to continue at elevated levels into the future. ABS transactions, which also regularly utilise owner trusts to hold legal title to the aircraft in the vehicle, extended to almost 600 aircraft over the past couple of years.

The novation process typically comes at the end of a sale process that may have involved protracted negotiations, but where the target closing date is tied to a quarter- or year-end, driven by P&L targets, shareholder expectations or funding availability and timing is critical. Although it is prudent to make the lessee aware of the up-coming trade well in advance, it can be the case that the lessee is not notified about the sale until the trade has been agreed, on the premise that they should not be asked to prepare for an event that may not happen. This serves to shorten the timeline in which the lessee is asked to perform their role in the process, which accentuates the resource pressure they are being asked to bear.



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The industry, through the Aviation Working Group, has been working on novation alleviation measures for a number of years. In 2012, a template lease novation document was jointly released by AWG and IATA, with a view to standardising the process for both lessors and lessees. However, this early version, which took the form of a 25 page legal document and required considerable input from the lessee, quickly proved to be unworkable and was not adopted by the industry.

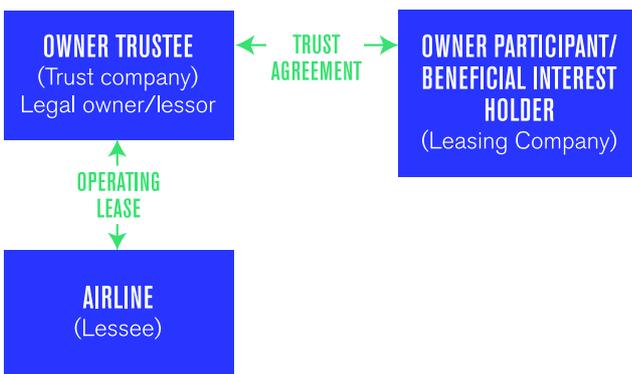
AWG began work on an improved version of a novation and an assignment and assumption template in 2015 and this became available for use at the end of 2017, since when it has been adopted by the majority of lessors. The new template is shorter and clearer and reduces to a minimum the representations and warranties required from the lessee. It is being actively used by the lessor community, has been generally well received by lessees and will be the preferred way forward where novations continue to be required.

The Solution

The growing use of owner trusts beyond US law jurisdiction is encouraging, but needs to be accelerated.

In an owner trust structure, the owner trustee (usually administered through a trust company e.g. Wilmington Trust) holds legal title to the aircraft on trust for the benefit of a third party, called the beneficial interest holder or owner participant. The owner trustee leases the aircraft to the airline pursuant to an operating lease in the same manner that a limited liability company owner would (Figure 1). When the aircraft is sold, instead of transferring legal title to the aircraft to a new entity the owner participant transfers its interest in the trust to the new entity and that entity becomes the new owner participant / beneficial interest holder. As the legal owner (the owner trustee) does not change, the lease remains in place and the need for a novation or lease assignment/assumption is avoided. The tax attributes associated with the aircraft need to pass through to the beneficiary – some tax jurisdictions do not permit this and a trust structure will then not be used. In the USA, the aviation industry is very familiar with owner trust structures, which provide financing, management and tax planning benefits.

FIGURE 1: OWNERSHIP TRUST STRUCTURE



Following a number of years' of collaborative work by its members, AWG has now unveiled an enhanced trust framework, the Global Aircraft Trading System (GATS). GATS has been designed to build on the benefits of existing owner trust structures to standardise and streamline the process of buying, selling and financing aircraft, thereby reducing the resource burden on airlines as well as lessors and financiers.

Under GATS, each aircraft will be owned by a trust, created online, with sale of the asset effected by an electronic transfer of the beneficial interest in the trust (rather than the sale of the metal) and leaving the existing lease and other transaction

documents in place. This removes the requirement for a novation and all of the associated costs and resources. A schematic of the GATS process is in Appendix 1.

The adoption of a trust solution builds on the Cape Town Convention framework, which requires signatory countries to recognise trusts. This will help to drive momentum on expanding recognition of GATS trusts into new jurisdictions in step with their adoption of Cape Town. Initially, GATS will be applicable to aircraft held in trusts established under Irish, US and Singapore law. To date, US and Irish owner trusts have been used to lease aircraft into more than 60 jurisdictions.

By keeping the entire process on-line and electronic, title will be kept secure through an e-ledger system utilising cutting edge blockchain technology to prevent fraud and misuse. Standardisation of documents relating to the establishment of the trusts and the transfer of the beneficial interest in the trust and the associated processes will ensure consistency and clarity and maximise simplicity. As evidenced in other sectors, this will help to build investor confidence over time leading to growth in the capital base and the size of the investor pool.

GATS will reduce the level of requests to airlines under the novation process and the streamlined process will include the airline's KYC process for the new owner. GATS also reinforces the "no increased obligations" provision required by airlines, since no lease provisions are required to be changed.

Standard GATS forms will also facilitate the transfer of existing trusts into the GATS framework, if required. The use of GATS for future trading of new, and subsequently used, aircraft will be voluntary and may not be suitable for all jurisdictions, although AWG is working to secure global acceptance of trusts. However, the pace of adoption is expected to be faster than was the case for Cape Town, since it is driven by industry participants rather than governments.

GATS was first announced at the ISTAT EMEA industry conference in Prague last September and is scheduled to go live with paper-based Transitional GATS documentation in Q1-2019, moving to a permanent on-line system before the end of 2019, once the e-ledger has been tested and made available. These timings are subject to final documentation and agreement, however extensive work has already been completed and a heavy schedule of drafting and review is being driven by AWG.

A short-list of bidders to manage and maintain the platform is now under review, with a final selection expected shortly. A modest fee structure, payable by the lessors, will be applied to GATS transactions with a view to making the platform self-funding and sustainable without external support.

Conclusion

GATS brings a material enhancement to the application of trust structures to aircraft ownership utilising blockchain technology to streamline, simplify and secure title transfer. By providing lessors and investors with improved access to and confidence in owner trusts, their utilisation, especially outside US legal jurisdictions, will be accelerated, thereby reducing the requirement for novations.

Although initially best-suited to aircraft that have delivered into individual trust structures from new, the system can also accommodate existing aircraft owner trusts. The majority of aircraft currently delivered and in service, however, would first need to be novated into a trust in order to benefit from GATS on any future trading activity. This option should be considered i) in the event of a sale where the buyer is willing to enter and maintain the aircraft in a trust or ii) when a used aircraft is inducted into a follow-on lease, thereby providing a lasting legacy for the remainder of the aircraft's life.

Whilst not suitable for all jurisdictions, it is hoped that GATS will become the preferred option for structuring aircraft ownership going forward and should be considered as an "opt out" rather than an "opt in" solution for lessors and lessees. If embraced by the industry, it is likely that within two to five years, GATS will be viewed to be as significant and transformational an innovation as the Cape Town Convention.

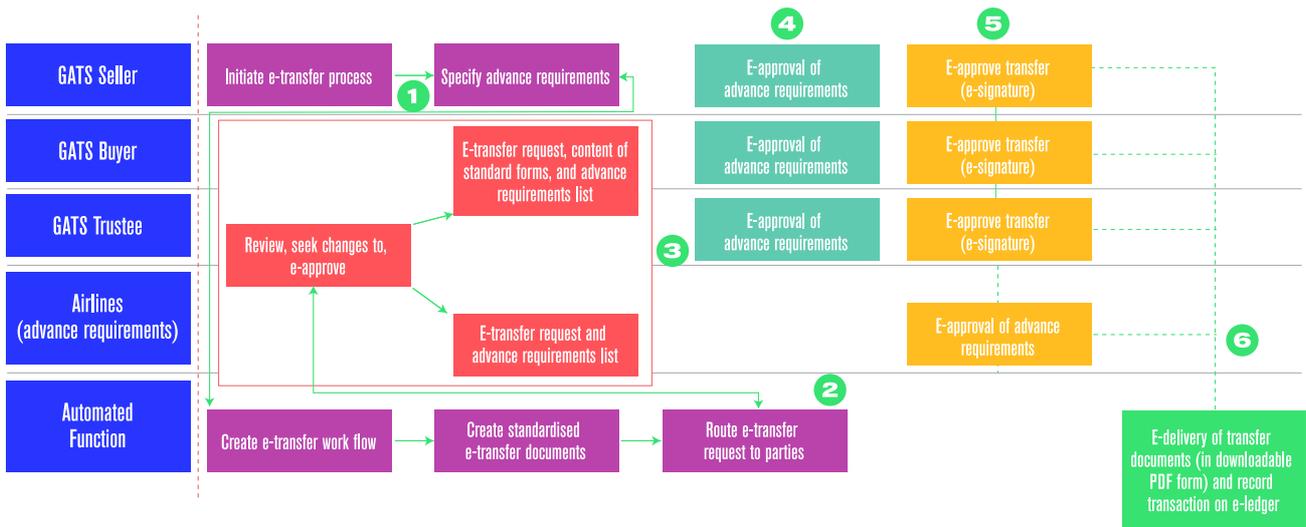


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APPENDIX 1: PROCESS SCHEMATIC (SOURCE: AWG)

GATS – Transfer beneficial interest (electronic process)

ANNEX





Avolon Holdings Limited
Number One Ballsbridge
Building 1, Shelbourne Road
Dublin 4, Ireland

info@avolon.aero
avolon.aero