
The Servicer's Role and Responsibilities

Servicer Responsibilities in the Securitization of Transportation Equipment

The role of the servicer is even more important in securitization of leases or other financings of transportation equipment such as aircraft than in traditional structured financings that securitize financial assets such as credit card receivables or mortgages. In these transactions, repayment of debt requires that the servicer do much more than collect payments. Often, the servicer must re-lease the equipment many times, even assuming the users of the equipment perform on their leases. The re-leasing function is not a fall-back in case credits go bad; it is an expected activity needed to make the deal work on an ongoing basis.

The responsibilities of the servicer in a securitization are, for the lack of a better term, to service or tend to the assets, and thereby maximize cash flows for the benefit of the noteholders. Furthermore, the servicer is charged with the responsibility to insure and maintain that investors' retain a first perfected security interest in the assets and associated collateral throughout the life of the transaction.

Criteria have been developed to analyze securitization of transportation equipment using a combination of structured and corporate finance methodologies. The extent to which the corporate approach is used (and to which the competitive and financial strength of the servicer therefore becomes a rating constraint) depends on how actively the servicer is involved in managing the assets to generate cash flow. Following are questions used to determine the degree of servicer involvement in generating cash flows:

- How frequently are the assets re-leased? As a result, how much of the debt in the securitization can be repaid off the initial leases? This is probably the most important single determinant of credit linkage to the servicer. Typically, a servicer is committed to lease out assets on a nondiscriminatory basis with other managed assets, usually including the servicer's own equipment fleet. If the servicer has excess inventory in its own fleet, or if its competitive position in the industry is deteriorating, it is inevitably going to affect performance of the issuing entity's assets as well.

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- How easy is repossession and re-leasing? Ease of repossession is judged on the basis of legal issues, logistical considerations, skill and experience needed, and so forth. This varies from asset to asset and also between types of lease.
 - Are non-financial services included in the lease rentals? Again, this varies by asset and lease type. Some transportation leases include payments for maintenance and repair services, making equipment available in certain locations, and so forth. In those cases, the servicer is obviously more deeply embedded in the deal.
 - Is there a committed backup servicer? Are non-committed alternative servicers readily available?
 - What legal issues may be involved? Is the issuing special purpose vehicle truly bankruptcy remote from the servicer? Do the bondholders have a direct or indirect perfected security interest in the assets? How likely are legal challenges to rights of repossession?

The answers to these questions make it possible to place a particular transaction on a spectrum that runs from traditional structured securitizations, where the servicer plays a limited and mainly administrative role, to cases where the so-called securitization is close to secured corporate debt.

For securitizations of aircraft operating leases and loans, the following particular responses should apply:

- How frequently are assets re-leased? Aircraft operating leases are typically 3-5 year medium term contracts. Given the often weak credits involved, re-leasing can, in practice, occur more often.
- How easy is repossession and re-leasing? That varies from country to country, based on legal jurisdiction and other factors. Fortunately, aircraft are large, visible assets that often fly internationally and can be seized abroad.
- Are non-financial services included in lease rentals? No; these are “triple net” financial leases, with the operator responsible for all maintenance, insurance, regulatory compliance, and so forth.

The answers to questions regarding the servicer arrangements and legal issues vary from transaction to transaction. Typically, securitizations of aircraft operating leases have either had a committed backup servicer or had a primary servicer that was very strong financially (General Electric Capital Aviation Services or International Lease Finance Corp.).

Standard & Poor’s considers that aircraft securitizations, while requiring more substantial servicer involvement than in securitizations of self-liquidating financial assets, involve relatively less servicer involvement than transactions involving some other transportation assets (e.g., leased marine cargo containers, truck leases, railcar leases). Accordingly, ratings of aircraft securitizations can be considerably higher than the actual or estimated rating of the servicer. In addition, as discussed in the

“Asset Risk Evaluation” section, an evaluation of the servicer’s abilities is an input into determining value declines in cash flow modeling.

In evaluating the servicer’s abilities, analysts will determine the level of expertise and requisite skills to maintain the transaction assets. In keeping with this evaluation, access to the servicer’s employees, records, and systems are of critical importance in determining whether a servicer possesses the necessary resources to service the transaction’s assets. It is of utmost importance that the servicer provide the necessary transparency in its operations for making such an evaluation. This means that the servicer must not only provide access to its staff, but also a full and complete assessment of its historical performance.

The operations review that is usually performed is such that the servicer’s abilities are considered sufficient to service the assets. However, one area of particular focus is the specific nature or uniqueness of the role of servicer plays in a transaction. Analysts will assess the transferability of the servicer’s responsibilities to a successor or back-up servicer. In the more commoditized areas of asset-backed finance, such as credit cards, auto loans or mortgages, there is a wide and deep universe of potential successor servicers. This ease of transferability is one of the primary reasons that securitized debt can be rated above that of the asset transferor or parent corporation.

However, in the case of aircraft or other operating assets, the transferability of a servicer’s functions is far more arduous. Whether aircraft, railcars, or containers, there is usually a small and select world of potential servicers. Also, unlike a transaction based on financial assets, aircraft require a servicer with specific and unique abilities to maintain a transaction’s assets at maximum efficiency. An aircraft servicer’s ability to maintain and redeploy aircraft is specific to very few companies and is to some extent correlated with its corporate credit rating.

Even if there are several potential successor servicers available, they may be an unacceptable choice to the initial servicer for business and competitive purposes, since most are probably the initial servicer’s competition. What company would want to open itself up and divulge such things as customer lists and propriety secrets to its rivals?

Accordingly, divorcing or negating the initial servicer risks from that of the rated securities is more problematic. As a result, an effective back-up servicing plan will be required for most transactions involving aircraft. The same would apply to securitization of aircraft engines. Without such a plan, the rating of the securities may very well be limited significantly by the rating of the servicer. To date, no transactions consisting of aircraft have been constrained by the servicer corporate credit rating, either because the servicer was highly rated, or because an adequate back-up servicer plan was incorporated into the transaction documents. However, even with a committed backup, a financially weak servicer or one with a modest competitive position in the

aircraft financing industry may not be able to issue debt rated as highly as in the transactions analyzed so far.

Servicing an Operating Lease Transaction versus a Loan Portfolio Transaction

Over the past few years, Standard & Poor's has rated aircraft portfolio based mainly on operating leases. Ratings for another type of portfolio transaction can be expected: those based on loans. The servicing requirements for a loan portfolio are not as extensive as that for an operating lease portfolio. Unlike an operating lease portfolio, a loan servicer will not have to re-lease or perform maintenance on aircraft. This is because unlike an operating lease servicer, an aircraft that is collateral for a loan will be sold as is and not re-loaned at the expiry of the loan. However, similar to an operating lease servicer, a loan servicer will have to be proficient in repossessing and selling aircraft. The next section provides a description of the principal servicing responsibilities, noting which pertain to operating servicers and which to loan servicers.

Individual Functions of an Aircraft Servicer

The four major responsibilities on which an aircraft portfolio servicer will be evaluated are its ability to redeploy off-lease aircraft, to sell aircraft, to repossess aircraft, and to maintain off-lease aircraft.

Redeployment of Aircraft

In an operating lease transaction, an aircraft can be expected to be re-leased several times. This is due to the fact that operating leases are generally of a maximum term of 5 years while the term of transaction may be in excess of 20 years. Depending on the aircraft's age, it is reasonable to expect that an aircraft can be re-leased two to three times over the life of the average securitization. It is therefore the responsibility of the servicer to find new lessees for aircraft. Analysts will review a potential servicer's re-leasing procedures and track record to judge its proficiency in redeploying aircraft which come off lease or for those aircraft which are repossessed. The servicer will need to provide its re-leasing policies; specifically, the necessary lead time necessary before expiry of a lease to locate a new lessee. The servicer will also need to provide its historical results; that is, its ability to re-lease aircraft and how long off-lease aircraft are on the ground or not re-leased.

Sale of Aircraft

A key component of principal payment is the sale of aircraft. Throughout the life of an operating lease transaction, the servicer will have to determine whether it makes economic sense to either sell or re-lease aircraft. For a loan portfolio transaction, the servicer will have no other course of action but to sell the aircraft at the loan termination date. Therefore, the servicer must demonstrate its abilities to sell aircraft at the optimal price. Aircraft sales are expected to occur during a recession in the aviation industry. Consequently, the rating analysis will incorporate the servicer's own history, industry history, and the portfolio's aircraft composition to determine appropriate residual values.

Repossession of Aircraft

In any portfolio transaction, it is the servicer's responsibility to collect monthly loan/lease payments from the respective obligors. It is also the responsibility of the servicer to monitor an airline that is in arrears on its loan/lease. If the servicer determines it is necessary to take possession of the aircraft due to payment delinquency, then it needs to co-ordinate the return of the aircraft. In most cases, aircraft are returned voluntarily. However, there are times when an amicable return of the aircraft is not an option. If this should occur, the servicer will need to use legal measures to seize the aircraft. In some cases, the servicer may have repossession personnel on staff or out-source the repossession function to a third party. In either case, a review the success rate regarding repossession of aircraft will be necessary.

Aircraft Maintenance

A servicer's responsibilities regarding maintenance of aircraft are generally most burdensome for an operating lease transaction, since for a loan portfolio, aircraft generally are sold "as is" at the termination of the loan. When aircraft are in the possession of the airline, the airline is responsible for performing all the necessary maintenance. However, when an aircraft is in the control of the servicer, regularly scheduled maintenance must be performed if the aircraft is going to be re-leased.

This maintenance can be anything from a routine "A" check to a full overhaul known as a "D" check. In addition to maintenance, the servicer may be required to reconfigure the interior of the aircraft for re-lease. A detailed understanding of the servicer's maintenance abilities and the portfolio maintenance needs will be required for rating a transaction. A further discussion on determining maintenance requirements is presented in the "Maintenance and Related Issues" section.