

Managing Collateral Risk Using Aircraft Appraisals

Many bankers who finance aircraft believe that items such as appraisals are a cost overhead that can be avoided. After all, it is much easier to look up a number in a book; the person who is borrowing the money for this aircraft is well known and well established, so the overall risk to the bank is small – right? Unfortunately, the only constant in life is change itself and there are a wide variety of things that can and do impact the bank's risk level over time. For example, the customer's situation can change (divorce, bankruptcy, death, job loss, etc.), the aircraft itself can change (damage, lost log books, higher than average usage, changes in avionics, changes in the market, etc.), and the bank's situation can change (personnel changes, acquisitions, etc.). Within a few months the individuals who were involved with the original loan decision may be gone and without proper documentation no one knows what the lending decisions were or what they were based on. What's worse, no one knows anything about that particular customer. Although no one can plan for every contingency, bank employees should have an obligation to the corporation to properly manage the risks associated with any loan. One area that can be easily addressed is the documentation of the aircraft and its evaluation. This is where a properly executed, professional appraisal can help.

Unfortunately, many banks do not understand what constitutes a professional appraisal report. It is amazing that if the collateral were real estate, accepting a number from a web site or book would be unthinkable as would information from the owner or selling broker. However, when aircraft are involved many high dollar transactions occur every day with the proof of collateral being little more than a slip of paper with a number scribbled on it. So, what constitutes a professional appraisal, how do you know you are getting one, and why should you get one?

Let's start with the bank's objective to manage risk. It is important to have a number that is referenced against current market values as well as the property in question. The information should be gathered by a trained professional who has an aviation background and is completely unbiased or disconnected from the deal itself. This individual should also belong to an established organization which follows recognized standards and ethics. Otherwise, the individual will not be much help when questions come up about the evaluation or the aircraft. Although there is no legal requirement for anyone who calls themselves an aircraft appraiser to be certified, it makes more sense to use an individual who has undergone scrutiny and training by a professional organization instead of someone whose only background may be a subscription to an aviation publication. Now let's examine the documentation and evaluation options that are available to banks to help them manage risk.

The first method uses information obtained from a published guide or website. This type of solution represents the highest risk to the bank for many reasons. In the case of websites, much of the material is copyrighted and expressly forbid its use in commercial applications (even though banks have accepted web printouts as evidence of collateral). Beyond that point, the tools normally do not allow enough flexibility to configure a specific aircraft correctly. For example, if an aircraft has added avionics, many tools will not “remove” the equipment that is being displaced thereby overvaluing the aircraft (i.e., the aircraft now has two radios instead of one). There is also the question of where the aircraft information comes from. It is unlikely that the individual using a published guide will take the time to physically examine the aircraft and records so they most likely will rely on the person selling the aircraft. The seller will tend to gloss over any negatives for obvious reasons and may not present the evaluator with a realistic view of the aircraft in question. Furthermore, the person who performs this evaluation by default becomes the “expert” in that he must support and defend his assumptions. Although they should be unbiased toward the aircraft or the deal, the person performing this analysis is usually the banker, seller or selling broker – all of whom have a financial stake in the outcome of the deal. This type of analysis certainly provides a value, but it is unclear how unbiased or qualified the person using the tool is, and a number that is not referenced against a specific aircraft carries very little significance. This type of reporting does not really meet the definition of an “appraisal” and for the purposes of managing the bank’s risk we really need something more.

The next option is the “desktop appraisal”. The desktop appraisal also presents an unnecessary risk to the bank. The desktop appraisal begins to put “distance” between the appraiser and the property in question. That makes it difficult, even for a professional appraiser, to support the report since the aircraft was not personally examined and no maintenance records were reviewed. The question also has to be asked – Where does the appraiser get his information? In most cases, it is the sales brochure or information from the seller, broker or dealer. Is this information balanced or does it only highlight the aircraft’s positives? How will damage history or missing log books be determined? Is the person performing this evaluation qualified or certified? Here again the bank has a number, but it is referenced to an aircraft from a sales brochure or a description from a seller or broker that may or may not represent reality. If the aircraft is later found to have major damage history or missing log books, the appraiser can simply say – “I never saw the aircraft or any records” thereby not addressing the bank’s need to properly manage risk. There are times when the aircraft in question cannot be physically examined; but, these situations should be “exceptional” and not the normal course of business. The bottom line is that the bank really needs something more than this solution provides.

Another option is the Certified Appraisal Report provided by a professional aircraft appraiser certified by a nationally recognized organization that follows a recognized appraisal standard. A properly executed Certified Aircraft Appraisal

Report involves a physical examination of the aircraft and its records along with an inventory of the aircraft's equipment and systems. The professional appraiser is an unbiased party and as a result their fees are not contingent upon a specific value being reported. The final estimate of value is referenced against a specific aircraft at a specific point in time by a trained professional who is impartial to the outcome of the report. This type of report becomes much easier to defend as questions of value, contents or condition arise over time. Furthermore, as the market the aircraft change, it is very easy for the professional appraiser to provide the bank with an updated evaluation based on the Certified Appraisal Report taking any aircraft or market changes into account. This type of solution reduces the bank's risk significantly and provides irrefutable evidence of condition and value.

The bank is always free to lend money on any aircraft or transaction as it sees fit. An appraisal report does not change that fact. The objective of the report is to provide the banker with trustworthy information that helps him understand the collateral and manage the risk of a specific transaction. It is a document that can substantiate the decisions being made both now and in the future. If the bank finds itself in a courtroom defending a decision it made years ago, it becomes critical to have a trained professional and detailed report ready to help support the bank's position. All factors being considered, the cost of a professional appraisal is small compared to the risk of not having one completed.