Airline Insolvency Review – Administration and Finance

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Airline Insolvency Review – Administration and Finance

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Introduction

1.1 The UK Government has launched an independent review into consumer protection in the event of an airline or travel company failure. This follows the failure of the Monarch Group in October 2017, where 110,000 passengers were left overseas, leading the Government and Civil Aviation Authority to step in to deliver a repatriation programme.

1.2 The Secretary of State has appointed Peter Bucks to lead the review, with support from a secretariat comprising of Government officials and Civil Aviation Authority (CAA) staff. The review is considering both repatriation and refund protection to identify the reforms necessary to ensure passengers are protected. The review has been tasked with considering options to allow airlines to wind down in an orderly fashion so that they are able to conduct and finance a repatriation of passengers with minimal or no Government intervention.

1.3 The review has provided an interim report to the Secretary of State on potential options to tackle the immediate repatriation of passengers of an insolvent airline in July 2018. The review will now produce a final report in Spring 2019 offering the Secretary of State for Transport recommendations on repatriation, refunds and on how the current financial protection arrangements for air-travel holidays can be put on a more commercial basis. Further details about the Airline Insolvency Review can be found in the published terms of reference[1] and an initial exploration of the issues, the options and the principles that these will be assessed against can be found in the call for evidence published in April 2018[2] with further analysis and development of concepts in the Interim Report, published July 2018[3].

1.4 The review is organised into three tasks:

- What practical arrangements are needed to get passengers home if sufficient capacity does not exist in the market?
- How can passengers and the taxpayer be protected from the financial impacts of an airline failure?
- What changes need to be made to the current protection arrangements in light of the answers to the first two questions, and to put them on a more commercial basis?

1.5 Steer has been commissioned by the Airline Insolvency Review to support the Airline Insolvency Review on these tasks with a specific focus on the following two areas:

- **Part 1: Keeping the Fleet Flying**: Potential airline insolvency and airline licensing regimes, which can facilitate an orderly wind down of an airline and make use of the airline's fleet to repatriate its passengers; and

1 https://www.gov.uk/government/publications/airline-insolvency-review-terms-of-reference

2 https://www.gov.uk/government/consultations/airline-insolvency-review-a-call-for-evidence

3 https://www.gov.uk/government/publications/air-insolvency-review-interim-report

- **Part 2: Options to finance and fund the repatriation and refund of UK passengers:** Consider repatriation and refund protection for airline insolvency and identify the market reforms necessary to ensure passengers are protected when an airline or travel company fails. This protection should be provided and paid for with minimal or no government intervention.

1.6 This report outlines Steer's recommendations to the Airline Insolvency Review on these two aspects. The report addresses each part in detail and is structured as follows:

- In Part 1 we first identify the current regulatory and funding constraints to keeping the fleet of an insolvent airline flying. We then consider how the current regime could be improved before making a set of final recommendations.
- In Part 2, we go through a staged options analysis process to propose a new funding mechanism that could improve consumer protection against airline insolvency. This involves identifying the weaknesses of the existing protection regime; a long-listing and then short-listing of potential options; a market-sounding of the proposed options and then a more detailed structuring of a preferred option. We then make a set of final recommendations.

Part 1: Keeping the Fleet Flying

Part 1a: Identifying Constraints to Keeping the Fleet Flying

Introduction

1.7 In this section, we focus on the constraints to "keeping the fleet flying" – a feasibility assessment of how, during an airline insolvency, its own fleet and crew could be used to facilitate passenger repatriation. This is particularly important for large airlines that if they were to fail, there would be insufficient aircraft 'wet-leasing' capacity in the market to undertake a quick and efficient repatriation of passengers.

1.8 Typically, airline insolvencies in the UK have led to immediate suspension of operations, withdrawal of its operating licence by the Civil Aviation Authority (CAA) and the airline being placed in administration. Hence, the airline has been unable to undertake any operation to repatriate passengers stranded away from home, and, where deemed necessary, this function has had to be organised and funded by other parties, including the public authorities.

1.9 In order to keep the fleet flying, these outcomes need to be avoided, which in practice means that each of the following aspects of its operation need to be successfully managed:

- Management of airline operations needs to be temporarily in the hands of a body willing and able to undertake a repatriation exercise and to allow an orderly wind-down. This temporary management would have to have an ongoing dialogue with the CAA and any other third parties before and after insolvency so that an orderly wind-down can be achieved.
- Relevant airline staff need to remain available to the airline to undertake continuing flying operations.
- The airline needs to continue to hold an operating licence from its competent authority (the CAA for holders of licences in the United Kingdom (UK)).
- Aircraft leased to the airline need to remain available to it (and therefore not be re-possessed by lessors or detained for lengthy periods by creditors).
- Airport slots need to continue to be available to the airline at coordinated airports.
- Airports, air navigation service providers (ANSPs) and other key suppliers (such as aviation fuel suppliers and ground handling agents) need to be willing to continue to provide services to the airline.
- Insurance needs to continue to be available to the airline.

1.10 Each of these aspects is covered in the sections below.

Management of airline operations

1.11 For any company becoming insolvent, the control of the company is likely to change, with the appointment of an administrator (if going into administration) or a liquidator (if going into liquidation). In some circumstances, the Board of Directors may maintain control, but potentially under changed obligations to business as usual. These options have been covered in detail by Reed Smith[4] in advice to the Airline Insolvency Review working to instructions from the CAA. Reed Smith considered the following possible options for control of the airline under current UK legislation relating to insolvency specifically, under English law:

- compulsory liquidation;
- provisional liquidation;
- director-run repatriation; and
- administration.

1.12 In each case, Reed Smith identified advantages and disadvantages with each option. In our view, the disadvantages in all options are considerable, and may well be insuperable or more costly without specific interventions by the courts to modify the terms under which, for example, liquidation or administration takes place.

1.13 One common theme under all the above options is the potential personal liability of the individuals entrusted with running the airline:

- Insolvency Practitioners (IPs) acting as liquidators or administrators must follow the "purpose" of the liquidation or administration, which revolves around finding the best outcome for creditors. A repatriation exercise is unlikely to meet these conditions, since it increases the debts of the company, while airline operations intrinsically have the potential for risk (from supplier problems or impounding of the aircraft to accidents or even terrorism). IPs can be personally liable in such circumstances, and while some insurance to cover this is possible, not all risks can be insured against e.g. reputational risk or some risks relating to death or serious injuries.
- Company directors, if continuing to be in charge during a director-run repatriation (i.e. without formal administration being in place), are at risk of incurring a liability for "wrongful trading" if the airline cannot reasonably be considered a going concern.

1.14 While the formal insolvency regimes do provide for moratoria against other civil actions against the company, there is usually an interim period: seven days for liquidation, five for administration, during which the insolvency will be known to creditors, but during which the moratorium has not yet come into force. This can be avoided in the case of a provisional liquidation (which can also address the issue of the "purpose" of the process), but only on the basis of a suitable court order. There is no precedent for the use of provisional liquidation to avoid creditor action in this way. In any case, the moratoria only extend to England and Wales, although they can be extended to other EU countries through court action in those countries, but only under current EU rules which may not apply to the UK after Brexit.

[4] Advice to the Airline Insolvency Review on alternative structures within which an insolvent airline's consumers might be repatriated using the airline's existing fleet, September 2018

1.15 In principle, administration and director-run repatriation do not lead to automatic termination of supplier contracts, but in practice such contracts are likely to allow for termination under a broad definition of bankruptcy. In any case, even if the contract conditions are not formally breached, suppliers are unlikely to honour them unless payment is received up-front for services delivered after the insolvency petition, since they would not expect to receive payment for these services as an unsecured creditor of a bankrupt organisation.

1.16 There are also specific disadvantages of particular options:

- Under compulsory liquidation, all employee contracts are automatically terminated, so it is difficult to see how any repatriation exercise could be staffed.
- Under a director-run repatriation, since there is no formal administration, any temporary funding provided by government or the CAA would be unlikely to be recoverable as the relevant public authority would be an unsecured creditor, in contrast to the situation under administration, where "costs of administration" rank higher than unsecured creditors.

Conclusions

1.17 Our conclusions are that, for a repatriation exercise to be undertaken in a situation of insolvency, a number of interventions may be required:

- The "purpose" of the situation applying to the company needs to go beyond the normal conditions of administration or liquidation. This could either be imposed by a court, or be introduced through legislation in the form of a "special administration" regime for airlines including the purpose of repatriating stranded passengers.
- More specifically, a special administration regime could effectively place the aircraft's fleet and other essential operations under the control of a specially qualified administrator for a limited duration (e.g. during a stay on insolvency proceedings) to allow for repatriation. This will require a skillset beyond that normally provided by existing insolvency practitioners and so a consortium of firms with the combination of skills may be required. This will also be influenced by the extent to which it is possible to retain key employees and suppliers of the airline in administration.
- In any case, liquidity (as per the mechanisms to be analysed under Part 2 of our engagement) will need to be provided to ensure that suppliers do not terminate services and/or contracts. Realistically, such immediate funding is likely to need to be provided from a pre-existing fund, since there will not be time for, for example, an insurance assessment, before funds are needed.

Airline staff

1.18 Airline staff are crucial to the operation of the airline and hence to the potential to undertake a passenger repatriation exercise in an insolvency situation. Many staff have particular skills, and associated licences, which mean that the possibility of operating the airline without such staff is very difficult. Key personnel, including the Accountable Manager and Safety Manager need to be in place to allow the Air Operator Certificate (AOC) to be maintained (see below at paragraph 1.19).

1.19 Crew from other organisations can be available in the situation of an aircraft "wet-lease" (formally an ACMI – Aircraft, Crew, Maintenance and Insurance) arrangement with a leasing company, but there would appear to be little purpose in the insolvent company hiring in aircraft and staff on this basis for the purpose of a repatriation exercise. If this was being undertaken, it would probably be more efficient for it to be directly managed by the CAA, since the latter would be considered to be a completely credit-worthy entity as the counterparty to the ACMI lease.

1.20 The need to retain some of the staff means that some legal models for handling an insolvency are less feasible than others. In particular, a compulsory liquidation, as noted above, would normally lead to the automatic dismissal of all staff, and therefore is a less viable solution. Other models, including provisional insolvency, administration and a director-led operation do not automatically terminate employment contracts and therefore remain viable from this perspective.

1.21 Nevertheless, it is likely that the level of staff attrition in such a situation could be high, since staff would be motivated to look for alternative employment. Assuming normal notice periods, it would not be possible for staff to leave the company of their own volition over the time-period necessary for a repatriation (assumed to be up to approximately two weeks), but some absenteeism would need to be assumed.

1.22 The retention of staff would, of course, be much more difficult if the company (or administrator or provisional liquidator) was unable to pay salaries, or if employees had good reason to believe that salaries might not be paid. In such a situation, the employer would be in breach of contract, which we assume would remove the obligation of staff to observe their notice period. In any case, staff absenteeism would be likely to be high if staff believed they would not be paid.

1.23 Therefore, the key requirement to ensure staff are available for a repatriation exercise is that funding is made available to pay salaries and benefits, and that staff are given convincing reassurances that they will be paid. This is perhaps most straightforward in an administration situation, where staff salaries are treated as costs of administration to be paid ahead of most other debts. However, in all cases, a source of immediate funding is required to pay salaries, and this is likely to need to be external to the company. The body coordinating the repatriation would be well placed to provide such immediate funding, to be reimbursed from whatever mechanism is used to provide ultimate funds for repatriation (as discussed in Part 2 of this study).

Conclusions

1.24 With the exception of a compulsory liquidation, it should be possible to maintain an airline's staffing arrangements to allow for repatriation during an insolvency provided that a funding/liquidity mechanism is in place to ensure ongoing staff salaries and benefits are paid. However, the administrator may need to make staffing contingency plans to cover absenteeism over the period of the repatriation or may even need to bring in additional staff to cover gaps created by attrition that may have occurred in the run up to insolvency. Again, the administrator is likely to need access to a funding/liquidity mechanism to provide this contingency.

Airline licensing

1.25 The licensing regime in the UK provides the regulatory architecture that ensures that airlines are fit for purpose to meet their obligations to their passengers and fly them safely to their destinations. All commercial airlines based in the European Economic Area (EEA) are required to hold an Operating Licence[5], and for the UK, these are issued by the CAA. An Operating Licence can only be granted to applicants who hold a valid Air Operator Certificate (AOC)[6], which covers operational safety of the airline. Holders of the Operating Licence and AOC are able to fly on almost all routes within the EEA, and are also able to apply for Route Licences for flights outside the EEA. The requirements underpinning this regime require the need for appropriate management systems and qualified personnel, including an Accountable Manager and Safety Manager. Thus, for an airline to continue to operate, there must be sufficient funding to ensure that the key personnel, systems and processes underpinning safe operation, are maintained.

1.26 For this purpose, under the Operating Licence, CAA actively monitors the financial health of airlines on an ongoing basis and will increase its monitoring for individual airlines if they appear to be entering financial distress. The requirements for financial adequacy are set out in Regulation 2008/1008, but the CAA is responsible for validating this. In order for an airline to be granted an Operating Licence for the first time, strict financial criteria are applied and a test of "good repute" is applied to the managers (in particular, that they are not bankrupt). There are also requirements for continuous monitoring of the airline's financial health. However, the provisions relating to withdrawal of a licence due to financial problems (Article 9) allow for some flexibility:

- "the authority shall suspend or revoke the operating licence if it is no longer satisfied that this Community air carrier can meet its actual and potential obligations for a 12-month period"; but
- "the … authority may grant a temporary licence, not exceeding 12 months pending financial reorganisation of a Community air carrier provided that safety is not at risk."

1.27 As such the CAA can take action to revoke the Operating Licence, though this is very much an extreme option and has protracted timescales associated with it. Thus, one area to be explored, , is how to alter CAA's powers to give them more options for dealing flexibly and proportionately with emerging signs of financial distress in a UK licenced airline with a view to preventing or managing a failure more effectively. In theory, this could include the following elements as identified in the Airline Insolvency Review's Interim Report:

- **Trigger point** – The power for CAA to intervene when financial resources fall below a minimum level, at which point the CAA could have discretion to apply a temporary licence or special licensing conditions. For example, a trigger point could be when the airline ceases to have sufficient unencumbered financial resources available to affect a two- or three-

[5] An airline with its principal place of business in the UK can be granted an Operating Licence in accordance with CAA's requirements in CAP 1301 ORS1 issued on 1 July 2008. The legal basis for this is Regulation (EC) 1008/2008 on "common rules for the operation of air services in the Community", referred to in the CAP 1301 as the "Licensing Regulation". See http://publicapps.caa.co.uk/docs/33/cap1301ors1jul2008.pdf

[6] An AOC is issued by the CAA in accordance with the Air Navigation Order 2016 (ANO 2016) if it "is satisfied that the operator is competent to secure the safe operation of aircraft" specified by the certificate. This assessment must follow the regulations set out in Commission Regulation (EU) 965/2012 "laying down technical requirements and administrative procedures related to air operations pursuant to Regulation (EC) No 216/2008". In turn Regulation 216/2008 relates to "common rules in the field of civil aviation and establishing a European Aviation Safety Agency [EASA]" and is the underlying legislation for aviation safety within the EU.

week continuation of service without needing to generate further revenue. This is dealt with in more detail in Part 2 to this report on a proposed funding and financing mechanism to cover repatriation of an insolvent airline

- **Temporary Licence** – The ability for CAA to issue a temporary licence or special licensing conditions. This could include requirements for an airline to file more frequent financial statements with the regulator or provide data (e.g. passenger manifest, route and booking data), through to requirements to mitigate the impacts of their failure (e.g. passenger monies to be placed in escrow). We note that in the Air Berlin case, the German licensing body (*das Luftfahrt-Bundesamt*, Federal Aviation Office) issued a temporary Operating Licence to Air Berlin to continue to operate after its bankruptcy, consistent with the requirements of Regulation 1008/2008. Based on this analysis it appears that this option would be open to the CAA in similar circumstances.
- **Cash in the bank** – Licence conditions could also include hypothecating or otherwise protecting sufficient financial resources to be used exclusively for the purposes of passenger repatriation, or to continue running for a short period in administration.
- **Resolution plan** – CAA could require an airline to prepare and maintain a resolution plan, similar to those required by the Prudential Regulation Authority for financial institutions. These are sometimes referred to as "living wills". They are effectively a contingency plan that prepares for an orderly wind-down in case the entity becomes insolvent.

1.28 Such changes may address the need for stability and confidence when an airline is in financial distress and allow a regulator to be satisfied and able to maintain licences (on a temporary basis). This could provide an alternative to the more severe option of full revocation of the Operating Licence which as the CAA admit can "*turn a potential failure into an actual failure and may lead to losses on the part of ticket holders and disruption to passengers' travel plans.*" These conditions could therefore be used to avoid, or at least mitigate, the problems which may be encountered during insolvency, such as pre-emptive actions by creditors which may hinder any repatriation exercise, or lack of information in the event that key staff are not available in the event of bankruptcy. The use of such conditions is discussed further in Part 1b below.

Conclusions

1.29 While the licensing regime does impose a financial test on airlines, there appears to be a degree of flexibility across Europe to how this is enforced. Likewise, there appears the possibility for the CAA to grant a temporary licence along with other conditions that might allow for a time-limited repatriation to take place.

Aircraft leasing

1.30 Many airlines lease some or all of their aircraft, with lessors now accounting for 40% of the commercial jet passenger aircraft fleet worldwide[7]. All the major UK airlines, including easyJet, British Airways, Virgin Atlantic and flybe have significant numbers of leased aircraft. Aircraft leasing is regulated under EU legislation, both by Regulation 1008/2008 "common rules for the operation of air services in the Community" and by Commission Regulation 965/2012 "laying down technical requirements and administrative procedures related to air operations". These contain relevant provisions largely relating to the need for regulatory approvals for lease arrangements by national authorities, the CAA in the case of the UK. The EU regulations do not

[7] Flightglobal: *Mid-life aircraft trading patterns and the impact of lessors*, March 2017

specify the nature of the underlying commercial contract but the CAA does require "that there is a valid written lease agreement in place between the air carriers"[8].

1.31 Leasing arrangements between an airline and a lessor are commercial contracts and therefore are affected by an airline insolvency, with lease clauses expected to contain termination triggers due to insolvency (see box below).

[8] CAA ORS4 no. 1241 (September 2017)

KEY TERMS PERTAINING TO INSOLVENCY IN A TYPICAL LEASE AGREEMENT

A typical aircraft lease agreement will contain a number of key clauses that protect the lessor against the insolvency of the lessee and thus manage the risk of non-payment by the lessee or seizure of the lessors asset by another creditor. A summary of these key terms are below:

- *Conditions Precedent:* A lease agreement will typically require that the lessee has an operating licence and AOC from the lessee's aviation authority. Likewise, the lessee must hold valid insurance. If the lessee cannot meet these obligations (e.g. an authority has withdrawn the licence) then the lessee cannot renew any lease and will be in default and the lessor has a right to recover the aircraft. This is important as any action by the aviation authority must provide seamless continuity in licensing otherwise leases will be withdrawn and aircraft unavailable. As such the issuing of a temporary licence would need to be immediate and recognized by the lessor
- *Events of Default:* In addition to not holding a valid licence, AOC or valid insurance policy, a lessee will also be in default under the following circumstances related to insolvency:
    - A specific event associated with insolvency – example drafting is *'the Lessee suspends payment of its debts, or is unable or admits inability to pay its debts when they fall due, or is found* ***bankrupt or insolvent'***
    - The lessee is late (normally no later than 5 days) in making any lease payments

  Insolvency is therefore an immediate trigger for an aircraft to be withdrawn and returned to the lessor and strict non-payment terms mean that aircraft may allow the lessor to exercise its security rights even before insolvency has been formally declared.

- *Recovery:* If the lessee is in default then the lessor will typically have the right to immediately demand the return of the aircraft and will typically use a security deposit (pledged at the beginning of the lease) as liquidated damages. However, most agreements do state drafting along the following lines *'the lessor may at any time,* ***provided that the Event of Default is continuing****, by written notice terminate the agreement and return the aircraft to the lessor'.* This drafting is likely to allow the space for the lease to continue if liquidity can be provided that the lessor is 'kept whole' and is paid all monies owed.

1.32 In general, entry into administration provides for a moratorium on legal actions, but Reed Smith noted that, in the context of the moratorium on legal actions triggered by administration, "the protection of the moratorium does not extend to the Operator's aircraft leases", which are, instead, covered by the Cape Town Convention, to which the UK is a signatory (ratified and coming into force in November 2015). The convention is an international treaty and therefore typically have primacy over the contractual terms in individual lease agreements (see box above).

1.33 The UK has adopted a particular option of insolvency regimes within the Convention ("Option A"), which means that the lessee must give up the aircraft to the lessor or cure all debts, by the end of a "waiting period" of 60 days. The lessor can seize the aircraft after the waiting period without any further legal intervention and, in Reed Smith's opinion, this means that the lessor is less likely to try to re-possess the aircraft before then. Reed Smith also noted that in its experience, creditors have always availed themselves of the rights afforded by the Convention.

Conclusions

1.34 The implication is that the Cape Town Convention does facilitate the operation of an airline during insolvency, for a period of approximately two months, which is more than sufficient for any repatriation exercise. However, it seems likely that the lessor would need to receive payment for the leasing during any administration (as a "cost of administration" with higher priority than unsecured creditors), so that the availability of funding would be needed to guarantee that the aircraft assets would not be seized.

Airport slots

1.35 Airport slots in the UK are governed by the EU Slot Regulation (EEC 95/93) "on common rules for the allocation of slots at Community airports". Congested airports may be designated as "schedules facilitated" where there are some congested periods, or as "slot coordinated", where slots are allocated by an independent slot coordinator. In the UK, the following airports are "level 3" or slot coordinated[9]:

- Heathrow, Gatwick, Stansted, Manchester, Luton, Birmingham, Bristol, London City.

1.36 The following UK airports are "level 2" or schedules facilitated:

- Edinburgh, Glasgow, Newcastle, Liverpool, Leeds Bradford, East Midlands, Aberdeen, Belfast International, Belfast City, Southampton.

1.37 Airport slots are available to air carriers holding a valid operating licence (on a specific date before the start of the relevant IATA season for which the slots are granted).

1.38 In the case of coordinated airports, "grandfather rights" apply to slots operated by existing carriers over a particular IATA season (i.e. the summer or winter Seasons), which mean that those carriers automatically retain the rights to operate the corresponding slots during the following season of the same type (so grandfather rights accruing from use of slots in one summer season give rights to the corresponding slots in the following summer season). However, such grandfather rights for slots are lost (the slots are returned to the "pool") if the slots were not operated for 80% of the time during the relevant IATA season.

1.39 Based on the above, a bankruptcy of a UK airline could potentially lead to consequences relating to slots at coordinated airports, so the implications of the Slot Regulation are important to the continuing operation of an insolvent airline, as well as to the possible recovery of the monetary value of airport slots.

1.40 If an airline becomes insolvent and loses its operating licence, then it is no longer able to hold airport slots. As such, it will lose its "grandfather rights" to such slots. However, in the recent Monarch Airlines bankruptcy, the administrators were able to retain the airline's slots for the

[9] Source: IATA

following summer season, following a decision in the Court of Appeal (see Monarch Case Study box), and were able to trade the value of the slots on the secondary market. In the Air Berlin case, the airline was able to retain its slots during the period while it continued to operate (on the basis of a temporary Operating Licence) following its insolvency.

1.41 The situation when Monarch went bankrupt which the court decided allowed the administrator to retain the slots was partly due to its particular timing. From the point of view of a repatriation exercise, this is not particularly relevant, but it is worth noting that the value of slots may potentially be used as a source of funding (though not liquidity) for some of the costs of repatriation.

1.42 We note that there is a specific provision in the Slot Regulation which allows for slots to be retained when an airline is in financial difficulties (Article 10, Clause 4 (c)), which states that the 80% utilisation provision for retaining grandfather rights would not apply in the case where there was: "serious financial damage for a Community air carrier concerned, with, as a result, the granting of a temporary licence by the licensing authorities pending financial reorganisation of the air carrier".

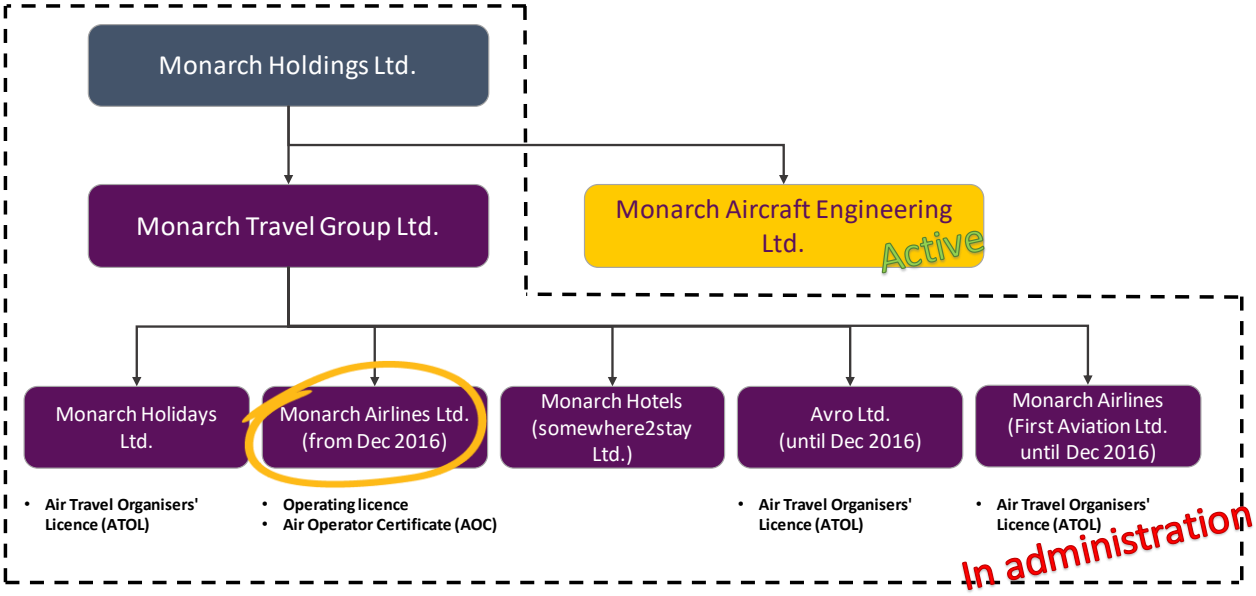
Conclusions

1.43 It therefore appears that there are mechanisms, consistent with both UK law and European regulations, whereby slots are not immediately lost by an insolvent airline. While the Monarch case appears to set a precedent under English law, the particular timing of the bankruptcy in relation to IATA season dates was helpful to the case and might not apply in another case. However, the grant of a temporary Operating Licence by the CAA (as was explained in the section under licensing) would appear to provide a mechanism to avoid loss of slots in any event.

CASE STUDY: MONARCH AIRLINES

Monarch Airlines went into administration at 04:00 on Monday 02 October 2017 as part of the Monarch Travel Group and Monarch Holdings going into administration. The figure below shows the structure of the Monarch group of companies and the Civil Aviation Authority (CAA) licences relating to the group's subsidiaries[10].

Figure 1 - Structure of Monarch Group of Companies in October 2017



Source: Steer, ABTA, Financial Times, Companies House

At the time which Monarch Airlines went into administration, it still had the financial resources to continue flying for several weeks more[11], however it had reached the point where the directors' saw no reasonable prospect of continuing, so in line with their legal duties instructed that Monarch Airlines cease trading, along with the wider Monarch Travel Group.

This point was reached when Monarch Holidays failed to renew its Air Travel Organisers' Licence (ATOL) on 30 September 2017, or within the 24-hour grace period extended by the CAA through to 01 October 2017. Monarch Holidays failed to renew its ATOL primarily because of a lack of liquidity, which would have impacted its cash ratio. In September 2016, the Group's majority shareholder agreed to make available £165m to support ATOL renewal[12]. A similar injection of funds was not made available in 2017.

An ATOL allows the holder to sell package holidays and is granted by the CAA which applies a risk-based approach to evaluating the likelihood of an ATOL holder failing and consequential

[10] Avro Ltd. and First Aviation Ltd. both used to sell ATOL-protected flights on behalf of Monarch Airlines, but ceased trading in December 2016. The only transactions for these subsidiaries were related to the recognition of revenues and costs as previously booked flights departed.

[11] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/724883/airline-insolvency-review-interim.pdf

[12] https://www.ft.com/content/5648b990-a777-11e7-ab55-27219df83c97

detriment to the consumer. As part of this evaluation the CAA assess the liquidity and financial resources available to the ATOL holder. The table below show that ratios that are monitored for ATOL holders.

Table 1 - ATOL financial criteria

Ratio	Calculation
Current ratio	Current assets/current liabilities
Cash ratio	Cash/current liabilities
Leverage ratio	Total liabilities/total assets
Return on assets ratio	Net profit/total assets
EBITDA margin ratio	EBTIDA/revenue
Revenue growth ratio	Revenue/prior year revenue
Revenue variance ratio	Revenue/projected revenue

Source: Civil Aviation Authority

The loss of its ATOL would have meant that Monarch Holidays would no longer be able to sell package holidays. An airline does not need an ATOL to sell flights and flight-only passengers are, in any case, not protected under the ATOL scheme. The failed renewal of Monarch Holidays' ATOL in October 2017 was not directly responsible for grounding Monarch Airlines from a regulatory perspective. Failure to renew the ATOL licence would have likely led to parts of the Monarch Travel Group being placed into administration, but not the airline directly. ATOL-protected revenues only accounted for about 5% of the Monarch Travel Group revenues[13].

However, the airline was heavily loss-making[14] and was put into administration to stem further losses at this time, along with the wider Monarch Travel Group, despite having the resources to continue flying for several weeks more. It was reported that the directors/owners expected that the Monarch brand overall would not realistically survive, given the ATOL press coverage and impact on consumer confidence[15].

To operate, Monarch Airlines held an Operating Licence and an Air Operators Certificate (AOC). An Operating Licence relates to the nature, ownership and financial health of an airline business. Operational safety is assessed under the AOC. An Operating Licence is contingent on holding a valid AOC. At the time the airline entered administration, the CAA suspended Monarch's AOC and Operating Licence, formally grounding it from a regulatory perspective. These were both later revoked in line with statutory decision-making processes that took several weeks to complete.

A number of linked and concurrent issues would have triggered the suspension of the AOC, which would need to be explored more closely with the CAA. For example, an AOC covers "the competence of the individuals who will be working for the operation", so by Monarch Airlines staff being made redundant immediately on going into administration, the airline would no longer be able to fulfil this AOC requirement. At the same time, the financial health of the airline

[13] https://www.ft.com/content/1b947168-a6b4-11e7-ab55-27219df83c97

[14] a £291m statutory loss was reported for the year to Oct 2016 https://www.ft.com/content/5648b990-a777-11e7-ab55-27219df83c97

[15] "Contagion" https://www.ft.com/content/1b947168-a6b4-11e7-ab55-27219df83c97

would at this point also not meet the CAA's requirements for an Operating Licence, or for the financing of its AOC.

Monarch's slots for the remainder of the summer season (through to end October 2017) would not have been immediately affected by the above. The slots for the upcoming winter season (W17) were allocated earlier in the year and would also not have been immediately affected. The slots for the following summer season (S18) were allocated in October 2018 – the administrators claimed these on behalf of Monarch Airlines and were awarded them after a decision by the Court of Appeal. In the Court of Appeal's view, Monarch Airlines remained an "air carrier" (as defined in the Slots Regulation, the Air Services Regulation and precursors) and was entitled to the slots it claimed through the coordination process. This was partly an accident of timing in two ways:

- The slots are allocated on 26 October 2017, at which point the Operating Licence and AOC were suspended but not yet revoked through the CAA's process.
- By going into administration towards the end of the summer season, Monarch Airlines had already fulfilled the requirements of the "use-it-or-lose-it" rule in the Slots Regulation, so was able to retain its grandfathering rights.

The administrators then traded Monarch's slots on the secondary market for both the following winter and summer seasons.

Airports, ANSPs and other suppliers

1.44 An airline can only operate if its suppliers continue to provide essential services, including:

- access to airport slots (covered above) and airport facilities;
- air navigation services / air traffic control services;
- access to aviation fuel; and
- access to ground handling and maintenance services.

1.45 While airport slots are managed, at a coordinated airport, by the independent coordinator, airlines access airports under the terms of the airport's "Conditions of Use", which constitute a commercial contract between the airline and the airport. If the airline is unable to pay the relevant airport charges (typically aircraft landing and parking charges and passenger terminal charges), it will be in default of its contract. The airport is likely to deny the access to the airline's aircraft or, if the aircraft are already at the airport at the point of bankruptcy, may prevent the aircraft from departing until debts are paid.

1.46 Airlines are also obliged to pay the air navigation service providers (ANSPs) from the country it is flying from and for the countries it flies over en route. ANSPs can take actions to ensure that payments are made.

1.47 One possibility is that a lien may be placed on the aircraft until debts are paid. While entry into administration leads to a moratorium on legal actions against the airline, this only applies in England and Wales, although it is recognised within the EU and application may be made to a court in other EU countries to prevent such actions there. Note that two kinds of lien may be applicable: tail liens, which apply to particular aircraft, and fleet liens, which apply to any aircraft in the operator's fleet, including aircraft which are not themselves the cause of the payment default.

1.48 In addition to airports, both the CAA and Eurocontrol (the coordinator of en route ANSPs across Europe) are able to impose tail or fleet liens[16] in cases when their charges are not paid. Hence, the risk of an aircraft being detained when the operator is in default of a range of fees (in particular airport and air navigation charges) is significant. Clearly, such detention would prevent use of the aircraft for repatriation purposes. Furthermore, as aircraft lessors may be concerned about such potential detention, there is also a risk that they will prematurely terminate leases to avoid having their assets seized, precipitating the problem of non-availability of aircraft. To address this, like many other aspects will need a source of liquidity that can allow charges to be met in full and/or for any amended insolvency regime to put a stay on the ability of the CAA (in its role as ASNP) to exercise its lien.

1.49 Where there is no unpaid debt, airports may nevertheless refuse to allow access or departure, as relevant, unless fees are paid upfront, since they are likely to assume that new obligations will not be met by the bankrupt airline.

1.50 Similar considerations apply to other service providers. All airlines need to purchase fuel from aviation fuel suppliers and many airlines, particularly away from their main base airport(s), rely on third parties to undertake aircraft handling and maintenance checks. It is highly likely that the airline's supply contracts with these organisations include termination clauses triggered by insolvency (in a broad sense, not just on entering into formal legal processes). Therefore, such suppliers will be under no obligation to provide services on existing terms and can be expected to demand upfront payments for future supply of fuel, ground handling or maintenance services.

1.51 More generally, the prospect of an insolvency is likely to lead to an overall 'tightening' in the supply chain as suppliers become concerned about the payment risk around the airline. This may lead to demands for prepayment or worse, a refusal to supply. This places extra emphasis on the need for any liquidity/funding mechanism to be seen as a 'cast-iron' substitution of the airlines credit standing and effectively able to provide an unconditional and irrevocable obligation to pay on a full and timely basis. This credit substitution that is likely to be necessary to keep the supply chain operating smoothly through the repatriation.

Conclusions

1.52 The ability to deliver a repatriation in a timely and cost-effective manner, is dependent on the ability to maintain supplier contracts and minimise creditor action and ransom payments after the point of insolvency. We discuss some potential interventions to address these issues in part 1b, particularly in respect of how a Special Administration Regime might provide a temporary stay on creditor action. Moreover, in order to continue operating, an insolvent airline will need to have access to sufficient liquidity to pay suppliers during any period of continuing operation (and potentially also to clear any existing unpaid debts to such suppliers). This liquidity may need to be on the basis of paying for services upfront, potentially without the benefits of any previously negotiated discounts (whose contractual basis may have disappeared with the automatic termination of previous supply contracts). Provision of such liquidity and the credit standing of its source is therefore a pre-requisite for an insolvent airline to undertake a repatriation exercise. This is addressed in detail in Part 2 of this report.

[16] DLA Piper advice to Airline Insolvency Review, 13 December 2018

Insurances

1.53 Airlines are required to hold insurance in order to operate, and Operating Licences are specifically dependent on holding the requisite level of insurance. The requirements are set out in CAP 1301 ORS1 and are based on requirements in the Licensing Regulation (1008/2008) and, more specifically, in Regulation (EC) 785/2004 "on insurance requirements for air carriers and aircraft operators". Minimum levels of cover are set out on the CAA website, with the key provisions being:

- Passenger cover of 250,000 SDRs[17] per passenger;
- Third party liability cover depends on aircraft type:
  - 300 million SDRs for narrowbody aircraft (A320, 737, etc.)
  - 500 million SDRs for widebody aircraft (777, 787, A330, A350, etc.)
  - 700 million SDRs for A380 superjumbo.

1.54 Some insurance contracts may be invalidated by insolvency but in most cases, it can be expected that insurance would continue to be available to an airline which has:

- a valid AOC (which relates to air safety);
- a valid Operating Licence (including a temporary Operating Licence issued after insolvency); and
- sufficient funds to continue to pay premiums.

Conclusions

1.55 We therefore consider that, if the other matters discussed above have been successfully managed, lack of insurance is unlikely to be the reason why an insolvent airline was unable to continue to operate, and in particular, to undertake a repatriation exercise.

Summary

1.56 Our review of the operating, regulatory and legal constraints to keeping the fleet of an insolvent airline flying indicates that there are two primary 'hair triggers' that effectively ground an insolvent airline:

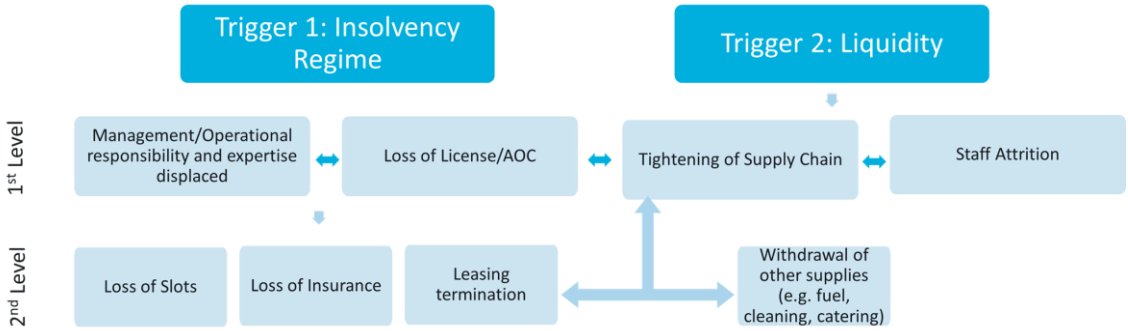
1. **Insolvency Regime:** The narrow 'creditor-in-possession' nature of the UK's insolvency regime significantly restricts the ability to continue flying beyond the point of insolvency. This is because a repatriation programme would act to incur further losses and potentially liabilities (particularly from a safety perspective) on the company and further expose creditors to a series of ongoing business risks that may increase 'loss-given-default'. This effectively displaces the airline's management from their operational responsibilities, and also prevents an Insolvency Practitioner from taking on a loss-making repatriation programme. It may also lead to a cascading withdrawal of various regulatory arrangements that are required to fly (e.g. licences)

[17] Special Drawing Rights – international currency unit defined by the International Monetary Fund, value at 4 October 2018 is 1 SDR = £1.07

2. **Liquidity:** An airline not able to meet its financial obligations will be unable to retain staff or serve its supply chain and therefore without additional financial support will see essential services withdrawn or key assets seized.

1.57 The flow diagram below provides an overview of how these triggers lead to consequential events that ultimately lead to the grounding of a fleet at the point of insolvency. The 1st level in the diagram are all direct consequences of either the specifics of the insolvency regime and/or a shortage of liquidity/cashflow in the airline. These 1st level consequences are also correlated with each other and create a series of 'knock-on' effects– e.g. if management is displaced then this will likely have an accelerating impact on staff attritions. At the second level, the supply chain of the airline and the airline's access to key markets (e.g. insurance, slots) start to become unavailable.

Figure 2 - Triggers to Grounding the Fleet



1.58 If interventions could be made prior to both (or either) triggers being pulled then there should be sufficient flexibility in the supply chain and regulatory framework to prevent knock-on effects and 'second-order' consequences such as a loss of licensing or a termination of leases from acting as a binding constraint.

1.59 This suggests that the focus of the review needs to be on putting in place a special regime for airline insolvency that provides at least the option for a legal stay before insolvency proceedings take place. During the stay, this would involve the administrator (with specialist skills) taking temporary charge of the airline to fly stranded passengers home. This is addressed in the following section in Part 1b. In turn, this would require a dedicated liquidity/funding mechanism to ensure this can be done safely and without incurring additional losses on creditors once the stay has ended. The funding mechanism will be analysed in Part 2 of this report.

Part 1b: Improving the current regime

Requirements for an improved regime

1.60 Part 1a of this report considered a number of different aspects of airline insolvency in the context of allowing for a repatriation of passengers stranded overseas using the insolvent airline's own resources. The issues considered included:

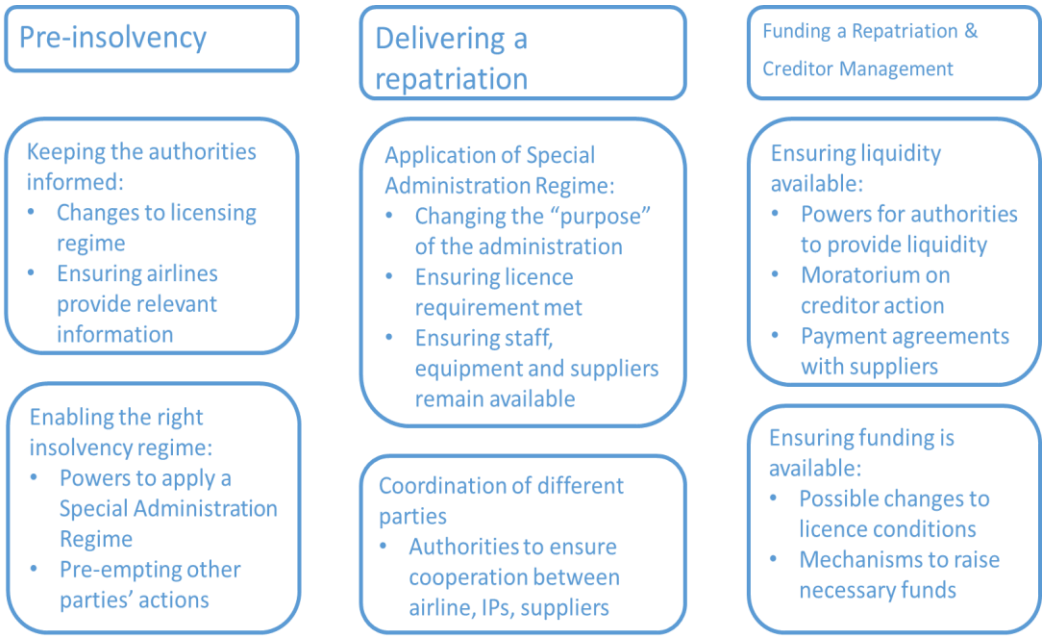
- the management of airline operations, whether by the directors or an administrator;
- airline staff, and in particular their retention during an insolvency;
- airline licensing (loss of the operating licence would prevent a repatriation exercise);
- aircraft leasing (whether leased aircraft might be repossessed);
- whether suppliers such as airports, ANSPs and other service providers would continue to support airline operations; and
- whether necessary insurance could still be put in place.

1.61 The conclusions from the Part 1a analysis indicates that all of these problems are solvable but require modifications to some aspects of the current regime. In the diagram below, these solutions are considered under three headings:

1. Pre-Insolvency - improving CAA's ability to enable an orderly wind-down;
2. Delivering a repatriation – improving the ability to keep the fleet flying in administration
3. Funding a repatriation, and creditor management.

1.62 Note that the financial aspects of the provision of liquidity and funding are dealt with in Part 2 of the study.

Figure 3: Keeping the fleet flying – potential solutions



1.63 These are discussed below.

Pre-insolvency

1.64 Prior to an airline becoming insolvent, but when it may be experiencing financial stress which could lead to insolvency, it is helpful for the authorities to be aware of the situation and to monitor the airline's financial health and other risk factors as appropriate. Through its licensing activities[18] CAA currently actively monitors the financial health of airlines on an ongoing basis and will increase its monitoring for individual airlines if they appear to be entering financial distress.

1.65 If necessary, the CAA can act to revoke the Operating Licence but as explained previously this protracted and very much a 'last resort' option. So, while the regime does allow for proactive monitoring and a gradual ramp up of information provision (including 'ad hoc requirements'), it does not provide the powers for CAA to flexibly and proportionately intervene when there are signs of material financial distress in a UK licenced airline. A more flexible licensing toolkit would allow CAA to better prevent or manage a failure more effectively. It would also bring the airline industry into alignment with other industries (e.g. financial services) that have introduced resolution and recovery planning as a key ongoing regulatory requirement (e.g. through the development of so-called 'living wills'). These are effectively a contingency plan to help prepare for an orderly wind-down and allow a new management team or repatriation co-ordinator to quickly get to grips with the operation.

1.66 This section identifies potential changes to the UK's airline licensing regime that could assist the CAA in managing airline failures and delivering a repatriation exercise. This is based upon discussions with the Airline Insolvency Review team, the CAA and other stakeholders, as well as elements of good practice seen in other sectors. Such a resolution and recovery planning system

[18] https://publicapps.caa.co.uk/docs/33/CAP1301ORS1JUL2008.pdf - See Annex 3, page 48

could include the following measures which would include a mixture of additional data provision, 'hard-wired' obligations on airlines and appropriate enforcement and step-in rights:

- **Certificate of Financial Fitness:** The objective would be to require the Board of each UK airline to provide the CAA with an annual certificate of financial fitness for the next 12 months, in accordance with the requirements of holding an AOL. This would need to be based upon the latest financial data, and would likely need to be produced within 90 days of the airline's end of financial year. The objective would be to concentrate minds in the airline's boardroom about financial performance and appropriate discipline on an annual basis and not only in relation to the initial application process for the AOL. This would be a similar approach taken by Ofgem in their 'Availability of Resources' test in Section 30 of their standard conditions applied to all electricity distributors (see case study below).

Case Study: Ofgem Section 30 Requirements

Ofgem requires that the licensees must at all times, not only have sufficient management, financial, and personnel resources, but also fixed and moveable assets, rights, licences, consents and facilities that enable them to properly and efficiently carry on the Distribution Business; and develop and maintain an efficient, co-ordinated, and economical system of electricity distribution.

The Regulator requires the licensees to provide a Certificate of Financial Resources - by 31 July each year - signed and approved by the Board of Directors, and confirming that after the payment of dividends, the Board have reasonable expectations that they will have sufficient financial resources to carry on Distribution Business for a period of 12 months from the date of the Certificate.

The Certificate of Financial Resources must be accompanied by the following:

1. A statement of the main factors that the Board have taken into account for assessing the sufficiency of the financial resources;
2. The main financial resources and financial facilities available to the licensee;
3. The most recent cash flow statement; and
4. The auditor's report confirming the financial resources or detailing any inconsistencies between the Certificate of Financial Resources and the statement submitted with it.

- **Additional Information -Power to demand booking data:** This would be a power to require a UK carrier to provide passenger booking data to the CAA, to a form and at a frequency specified by the CAA. This would give CAA greater visibility of the scale and shape of a possible failure, and also possibly provide a basis on which a communications campaign for passengers could be planned.

- **Development of a repatriation plan:** This would be a power to require a UK carrier to produce a repatriation plan, in a form acceptable to the CAA. The power could be invoked at any time but would be most likely used when a carrier was in financial difficulty (or say, when the industry is going through a systemic shock/downturn – e.g. spike in fuel prices). This would be usable in effect to gain the carrier's co-operation in preparing for its own

demise, and could be particularly valuable for communicating with passengers, and if the strategy were to keep the fleet flying. It would also have the benefit of involving the industry more closely in the provision of repatriation, which could be part of a broader programme seeking a cultural shift in the industry.

- **Ability to direct a UK carrier to mitigate future passenger risk:** This would be a power to direct a UK carrier to introduce measures that would mitigate the risk to passengers who had not yet travelled. This could include barring them from taking further bookings, or requiring some or all of the money from relevant[19] future bookings to be placed into a trust account, either for refund to the passenger or to contribute to the cost of a repatriation exercise. As shown in Annex 1 to this report, a 'waterfall' of interventions (with an ascending degree of intervention) could be designed to ensure that sufficient cash is being put aside to cover repatriation obligations

- **Power to sanction the Directors of UK carriers for non-compliance**: This would be the power to impose a sanction against the Directors of a UK carrier that failed to comply with any instruction given to them by the CAA in contingency planning against a potential failure, such as a failure to provide data or to produce a contingency plan. This is because the CAA's current powers to sanction in this context can only be made against the business holding the licence, whereas it is most important that the Directors follow the CAA's instructions when the business's existence is most threatened: In that scenario, the threat of sanctions against the business would have least effect. If the sanction were directed at the Directors personally they would be more dissuasive.

1.67 None of these interventions are currently at the disposal of CAA and would likely require a change in the licensing regime. This would also only apply to UK-licensed airlines, so would not be effective for monitoring problems at important foreign airlines. The licence requirements would also put a regulatory burden on UK airlines not borne by other airlines, so it would be necessary to consider whether this additional burden was justified by the mitigation of risk which it is designed to achieve.

1.68 Note that, assuming that EU regulations continue to apply, it needs to be considered whether such changes are consistent with the Licensing Regulation (EC 1008/2008), but it seems plausible that they could be allowed under Article 5, specifying the financial conditions needed for being granted a licence.

1.69 Assuming that an insolvency does occur, it is important that the appropriate form of administration is imposed. As noted in Part 1a, it is difficult to envisage that current standard administration under English law would be appropriate for keeping the fleet flying, particularly due to the "purpose" of the administration not including any support for a repatriation exercise, as well as liability risks for insolvency practitioners (IPs). Therefore, a Special Administration Regime (SAR) for airline bankruptcy needs to be developed. We discuss the relevant necessary features of such a regime in the next section, but the first step is to ensure that the SAR can be triggered when considered appropriate, given that normal administration procedures would still otherwise apply to a bankrupt airline.

[19] That is, presumably in respect of UK-originating passengers only.

1.70 In their consideration of potential changes to legislation, Reed Smith have suggested that there could be restrictions on placing an airline into an insolvency process, requiring petitioners to give the Secretary of State (SoS) and the CAA up to 14 days' notice of their intention. This would create a window to ensure the CAA has notice to prepare for a failure and avoid a sudden and unexpected collapse, while also providing an opportunity to introduce the special administration procedures. In addition, there could be restrictions for creditors on enforcing security on an airline's property during the same 14-day period. The SoS or CAA would have the options of proposing the Aviation Administrator (for an airline in the SAR), ensuring that he or she came from an approved list of IPs.

1.71 The SoS or CAA would also be given powers to prevent essential suppliers (including lessors, fuel suppliers, airport and ANSPs etc) from terminating contracts or demanding "ransom payments".

1.72 Note that these changes, while facilitating the use of a SAR for a bankrupt airline and hence allowing a repatriation exercise to take place, reduce the rights of an airline's creditors. This may have the effect of making it harder, or more expensive, for the airline to raise funding. However, it is important to note that the regime could be funded (as per the recommendations in Part 2 of our study to the Airline Insolvency Review) so as to ensure that creditors will not be left in a worse position as a result of the repatriation effort and moreover, any repatriation effort is likely to be very short term (maximum 2-3 weeks), after which a standard administration procedure would start.

Delivering a Repatriation

1.73 When an airline insolvency occurs, as noted above, a Special Administration Regime should be applied, with a specialist IP from an approved list taking the role of the Aviation Administrator. The use the SAR is designed to cure the problems with normal administration processes identified in Part 1a.

1.74 Firstly, the "purpose" of the SAR must be wider than that of a normal administration (where the duty of care is focussed on refunding creditors). In particular, it would be necessary to amend the purpose of an airline SAR to include the concept of repatriation of passengers left stranded by the failure. This will ensure that the IP appointed as the Aviation Administrator cannot be held liable for additional debts which are likely to occur from the repatriation exercise. The Aviation Administrator must be able to direct the operations of the airline to achieve the repatriation, including use of key staff and relevant aircraft and other resources.

1.75 Secondly, the Aviation Administrator should have the appropriate skills required to oversee the management of the repatriation exercise (which would be expected to be undertaken by airline management and staff).

1.76 Thirdly, the Aviation Administrator should be required to cooperate with a Coordinating Body (assumed to be the CAA) and which will help to coordinate the repatriation exercise.

1.77 Fourthly, liquidity needs to be provided. This is discussed in the next section.

Liquidity and funding issues

1.78 While the detail of how funds for repatriation exercises could be generated is discussed in Part 2, we consider here the different measures needed to ensure funds are available to support a repatriation.

1.79 The first requirement is to stop creditors from seizing airline assets, particularly aircraft, which would prevent a repatriation exercise. Pre-insolvency, this would be achieved by giving the SoS

the power to prevent the enforcement of security over the airline's property, as noted above. Therefore, a moratorium on creditor action is required during the 14-day period starting when a notification of an intention to serve a petition for administration is served. This moratorium would then be extended when the SAR came into force. Additionally, such a regime might include the following elements to provide additional comfort to lessors:

- The administrator must pay all fees relating to the operation of the aircraft during the administration period as an expense of the administration (see paragraph below)
- The administrator must be responsible for discharging or dismissing any liens asserted against the aircraft during the administration period (for example by foreign airports not under the jurisdiction of the UK courts and therefore not bound by the terms of the special administration). This is a subset of the first point, but it would clarify that this would be the case even where the fees in respect of which the lien is being asserted relate to the operation of the aircraft before the administration.
- The law should be clear that the moratorium under the SAR extends to statutory detention powers (e.g. by Eurocontrol) as well as lessors or banks terminating leases or enforcing security.
- The lessors or banks must be given the opportunity to terminate the leases or enforce security and move the aircraft somewhere safe before the administration ends (so as to prevent a fleet lien being exercised, as fleet liens only apply whilst the lessee is the operator of the aircraft).

1.80 Secondly, as noted in Part 1a, a key requirement to ensure that a repatriation exercise can go ahead is that liquidity is provided to ensure that payments can be made to airline staff, airports, ANSPs and key suppliers (such fuel suppliers and ground handlers). Regardless of the ultimate source of funding, it is essential that such liquidity can be provided swiftly. Reed Smith identified that the SAR legislation could include provisions for the SoS to provide a grant, loan or indemnity to the Aviation Administrator to support the repatriation exercise as seen in other SARs. However, this may be superseded by the recommendations in the Part 2 Report which proposes a funding and financing mechanism that puts the emphasis on the airline to fund their own repatriation obligations through a mixture of pledged security and a seat-levy fund. Reed Smith also identified that powers could be provided to allow airline client assets (such as forward payment of tickets) to be used to pay for the services of an alternative supplier, in the event that some or all of the repatriation uses another airline's services.

1.81 As noted, funding issues are discussed in more detail in Part 2.

Part 1c: Conclusions

The airlines insolvencies in the UK have led to immediate suspension of the operations of the insolvent airlines due to the withdrawal of operating licence by the CAA, because of which the insolvent airlines have been unable to continue operations to repatriate their passengers. Part 1 of the report discussed a number of reforms that would allow the insolvent airlines to continue operations until a certain time period to complete an efficient repatriation exercise by 'keeping their fleet flying'. The key conclusions of this part are:

1.82 A special administration regime, beyond the normal conditions of administration or liquidation, should be in place that allows the management of an insolvent airline to continue operations to repatriate passengers stranded abroad. The special administration regime should place the aircraft's fleet and other operations under the supervision of the management or specially qualified administrator for a limited time for completing repatriation exercise. For the administrator to oversee and efficiently complete the repatriation operations, there should be an immediate source of liquidity to meet operational costs (such as employees cost, lease payments etc.) during the repatriation exercise.

1.83 The special administration regime should allow the special administrator to retain the insolvent airline's staff and key suppliers to discharge its obligations of completing a repatriation exercise. As such, a funding source is required to ensure that salaries and fees are paid, and/or to bring in and pay additional staff to cover gaps created by staff attrition in the run up to the insolvency.

1.84 An authorised body (CAA) should be given power to intervene when there are signs of material financial distress in a UK airline (e.g. if financial resources of an airlines fall below a threshold level) and if necessary grant a temporary licence that allows for a time-limited repatriation to take place.

1.85 The clauses in aircraft lease agreements allow the lessors to seize the aircraft of an insolvent airline due to non-payment of lease instalments, resulting in the insolvent airline not being able to 'keep its fleet flying' to repatriate passengers. The adoption of the Cape Town Convention in the UK could facilitate the operation of an airline during insolvency for a short period. But, the lessor would still need to receive lease payments during any administration period, and as such an availability of liquidity would be needed to guarantee that the aircrafts would not be seized. They will also likely require assurances that a moratorium extends to statutory detention powers during the repatriation.

1.86 An insolvency of an airline could potentially lead to loss of slots at airports, posing difficulty for the insolvent airline to continue operations. The UK law has a provision whereby the slots are not immediately lost by the insolvent airline, but the grant of temporary operating license by the CAA would efficiently provide a mechanism to avoid slot losses in any event. As in the above points, an immediate source funding source is required to pay slot fees.

1.87 Finally, the ability to complete a repatriation in a timely and cost-effective manner is contingent upon the ability of an airline to continue making payments to suppliers, and ANSPs etc., which is dependent on an access to sufficient source of liquidity. This is also important for clearing off existing unpaid debt to such suppliers.

As such the provision of an immediate source of liquidity is therefore a pre-requisite for meeting objectives of all above points, and for an insolvent airline to undertake a repatriation exercise. The funding mechanism that can be enforced to meet cost of repatriation is discussed in detail in the following Chapter 2 of this report.

Part 2 Options to Finance and Fund Airline Insolvency Protection

1 Overview and Approach

Introduction

1.1 A key conclusion from the Part 1 analysis (undertaken by Steer), which considered the key constraints to keeping an airline's fleet flying during administration, was that a dedicated funding source was required to ensure that the insolvent airline had a comprehensive and clearly assigned source of liquidity to ensure it can meet its operational and supply chain obligations during a repatriation exercise. Likewise, the need to provide urgent liquidity is equally required for an organised charter or self-repatriation exercise. Furthermore, the collapse of the Monarch Airlines provides evidence that the current protection options and existing regulatory regime neither fully cover both repatriation and refund costs, nor is there a designated coordinating body to oversee a repatriation exercise[20]. As such Steer has worked closely with the Airline Insolvency Review team and its consultants; ICF and GAD to assess the range of options available to designing and implementing a dedicated funding mechanism to provide the necessary support to manage the impact of future airline insolvencies on passengers.

Approach

1.2 To assess the range of options available we undertook a step-wise approach and each chapter of the report addresses each of those steps as follows:

- In Chapters 2 and 3, we define the problem of the inadequate level of protection available to passengers under the existing regime. We do this by describing the regime in detail and outline some of its key drawbacks and outline why a new funding mechanism is required to improve upon the current situation;
- In Chapter 4, we outline the full universe of options available to develop a new funding mechanism – this considers the full spectrum of options that vary across which party pays/funds the mechanism and whether the mechanism is funded or unfunded. We filter these options by assessing which do not align with the Airline Insolvency Review's Terms of Reference so as to create a longlist of options to be analysed;
- In Chapter 5, we qualitatively appraise the longlist of options against the principles of the review to establish a set of shortlisted options;
- In Chapter 6, we appraise the shortlisted options quantitatively and qualitatively and outline the preferred standalone options to be tested with a range of key market stakeholders;
- In Chapter 7, we describe the market sounding exercise and the key findings/recommendations made by the market participants;
- In Chapter 8, we consider how the shortlisted structures that can be combined to optimise the level and cost of coverage to be provided by a new funding mechanism

[20] The Monarch Airlines collapse was an exceptional circumstance in which the Secretary of State for Transport mandated the CAA to co-ordinate the repatriation exercise under Section 16 of the Civil Aviation Act 1982.

- In Chapter 9, we summarise the findings and recommendations of this exercise

2 The Existing Protection Regime

2.1 In this section, we discuss the shortcomings of the existing insolvency protection regime for passengers; and in later sections outline the options for putting in place a more comprehensive mechanism that can support a more orderly and more efficient operation in the aftermath of an insolvency.

Outline of the Existing Protection Regime

2.2 In the existing regime, whether a passenger benefits from insolvency protection or not depends mainly on the method through which they buy their tickets. The current provision comes from a mix of statutory and non-statutory protection options.[21] These options are not universal and may overlap, meaning that some passengers may be protected in multiple ways, while others – intentionally or otherwise – may not have any protection at all and will carry the risk of an airline's insolvency themselves.

Current Statutory Protection Options

2.3 Under statutory protection arrangements, passengers who purchase packaged holidays which contain an airline ticket are protected by the Air Travel Organiser's Licence (ATOL) scheme.[22] ATOL is the Civil Aviation Authority's (CAA) scheme that provides funding and logistical support to ensure UK travellers can exercise their protection rights under the EU Package Travel Directive (2015/2302) [23], which requires firms selling packaged holidays containing a flight to protect their consumers by either arranging alternative flights or providing a full refund, should their booked airline fail in advance of a holiday. The firms should also make arrangements to repatriate their passengers who are already abroad and were booked on a return flight on the insolvent airline.

2.4 In case of the failure of a firm which is an ATOL holder, the CAA will protect consumers by drawing from centrally held ATOL funds to cover either refund or repatriation costs and any consequential losses for stranded passengers (additional hotel nights, surface transport costs etc.). The ATOL scheme predominantly covers package holidays, it does not automatically extend to 'ticket-only' flight purchases (not part of a package with hotel and car hire etc.), which

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[21] The key sources of protection are EU Package Travel Directive (Statutory), ATOL Regulations 2012 (Statutory), Consumer Credit Act 1974; S75 (Statutory), IATA's BSP (Non-Statutory), Travel Insurance ((Non-Statutory) and Debit Card Charge Back (Non-Statutory).

[22] ATOL is a UK financial protection scheme and it protects most air package holidays sold by travel businesses that are based in the UK. The scheme also covers some flight bookings, usually those where you book flights (including UK domestic flights) but do not receive your tickets immediately. ATOL is run by the CAA). It is funded by contributions from ATOL holders, which must pay £2.50 into the scheme's back up fund, the Air Travel Trust, for each person they book on a holiday. ATOL stops passengers losing money or becoming stranded abroad if the travel business you booked with collapses

[23] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32015L2302&from=EN

since the growth of low-cost carriers have become a growing source of airline ticket sales.[24] As such, the ATOL scheme only covers a minority of travellers, particularly on scheduled (rather than chartered) flights.

2.5 Other UK statutory protections include those made available through payment using a credit card. This means that the card company is jointly liable for the provision of the services under Section 75 of the Consumer Credit Act 1974. Passengers buying tickets through a credit card may claim from their card issuer (typically banks) for a refund (if failure occurs before travel) or to cover the cost of repatriation (if failure occurs during travel) and any reasonable consequential additional costs (e.g. hotel, surface transport etc.) incurred. The issuers are typically able to recover the refund or repatriation cost through charge-back arrangements with merchant acquirers. Airlines use the services of merchant acquirers to process and handle the payment interface with issuers. Acquirers thus provide an intermediation service which facilitates the payment from the issuer to the airline. If the airline fails before fulfilling the service to the passenger, then the acquirer must charge-back the amount to the issuer and so the acquirer thus de facto provides a line of credit to the airline which in turn protects the issuer from 'charge-back' losses. As such, the Consumer Credit Act provides a statutory source of coverage for passengers that is widely taken up – however, it is important to note that refund and repatriation costs are not settled immediately by issuers – there is a claims process, lasting days (or sometimes weeks) and so this is not a source of liquidity to the passenger to immediately defray costs.

Current Non-Statutory Protection Options

2.6 Non-statutory protection options may also provide limited protection against the insolvency of an airline. Under debit card charge-back schemes, passengers may claim 'personal loss' from their debit card issuers but cannot typically claim for consequential losses incurred due to an airline's insolvency. It is also important to note that the card rules and coverage can differ significantly by issuer and therefore there is not strict consistency between providers.

2.7 Passengers may also protect themselves against airline insolvency through travel insurance policies. Typical travel insurance policies are predominately focused upon healthcare coverage with some coverage for personal loss (e.g. lost baggage) or protection of special equipment (e.g. winter sports equipment). However, a number of policies do not, as yet, offer airline failure cover as standard and instead a policy-'add-on' or separate policy is required which covers 'end-supplier failure'. Such policies (or add-ons) are referred to as Scheduled Airline Failure Insurance (SAFI) and while supply and take-up of SAFI policies has increased in the aftermath of insolvency events such as Monarch Airlines, it is estimated that only between 40-50% of policies include SAFI cover. The protection provided by SAFI varies between the insurance providers and depends upon the type of policy taken out, which may simply cover the cost of original tickets purchased or any unused portion, or the additional cost of purchasing new flights, such as cost of new tickets for travelling back to the UK, when an airline is insolvent. However, we have not been able to develop a full picture about the claim experience of consumers who have had SAFI, the exclusion and the excess in this policy, and as such this is an area of further investigation.

[24] However, in some cases, when a consumer has not received a valid ticket immediately after booking a flight with an ATOL holder, but has received a ATOL Certificate after making payment, the flight only booking is protected if the ATOL holder fails. In such a situation, the ATOL holder is also obliged to provide protection should the airline the consumer is booked with becomes insolvent.

2.8 It is also important to note that most travel insurance policies have clauses which require that all other forms of cover should be exhausted before any payment is made from the policy. In this sense, travel insurance can be seen as an extension of other sources of coverage (e.g. ATOL, credit cards) rather than a primary source of coverage. This inevitably leads to a loss-adjustment process which will not provide immediate liquidity to passengers to provide them a refund or immediately defray repatriation costs. Likewise, all insurance policies require some degree of excess whereby the insured party (the passenger) meet the initial part of the cost and so in this sense, the passenger still must meet some of the costs of the failure.

2.9 Other non-statutory sources include the voluntary agreement in place amongst International Air Transport Association (IATA) member airlines in Europe whereby airlines offer affected passengers' access to discounted transport to return home, subject to available capacity. These 'rescue fares' are sold at a discounted rate and are made available for purchase up to a maximum of two weeks after the event to affected passengers flying to and from or within Europe who does not already possess insurance covering this eventuality. These rescue fares have been offered in a number of recent airline failures including for Monarch Airlines and Primera Air. However, such an approach only assists in the self-repatriation model and not in the organised charter or 'keep the fleet flying' modes of repatriation. Moreover, 'rescue fares' are more limited in use where an insolvent airline has failed on a route which it had hitherto monopolised and there are no alternative carriers/routes within easy reach of the stranded passenger without a long surface journey leg (e.g. taxi, public transport etc.) to access an alternative airport, route and carrier. In this sense, 'rescue fares' are a useful element of the repatriation options available to passengers but are not a comprehensive situation in all circumstances.

2.10 The IATA settlement service between airlines and travel agents (known as the BSP, or Billing and Settlement Plan) is the central point through which funds flows between travel agents and airlines. It has a provision to reimburse travel agents for monies submitted to the airline, depending on the national bankruptcy legislation and the specifics of the airline's participation with IATA. But, there isn't any available evidence that this has been used to refund money to passengers. Furthermore, the lengthy refunds payment cycle provides very limited – if any - refund protection to passengers, as the refund claims submitted by the travel agents are processed in 28 days.[25]

Weaknesses of the Existing Protection Regime

Limited Coverage for Repatriation

2.11 The above sources of statutory and non-statutory protection generally provide coverage for refunds[26] after a claim/loss adjustment period has been worked through, except for ATOL which covers both refund and repatriation costs, and plays a proactive and coordinating role to repatriate passengers in the event of an airline's failure as required by the Secretary of State for Transport. However, as discussed, ATOL only covers package holidays and does not comprehensively cover all seats sold by airlines, thus there are a large number of passengers

[25] https://www.iata.org/policy/consumer-pax-rights/consumer-protection/Documents/airline-bankruptcy-position-paper.pdf

[26] Evidence presented by ICF suggests that a large proportion of refund obligations (approximately 82% of unflown revenue) and many consequential losses (such as additional hotel nights) caused by an airline failure are already covered by the existing protection options (i.e. ATOL, Consumer Credit Act 1974 and travel insurance).

who do not have protection which provides assistance and immediate access to liquidity for repatriation. As such, there is a demonstrable gap in covering the costs of repatriation, which by their nature need to be covered quickly and so many passengers face high out-of-pocket costs that must be met while any loss-adjustment process is worked through on existing mechanisms (e.g. credit cards, travel insurance). Moreover, the existing protection options do not provide protection against recovery of full costs. In principle, credit cards wouldn't cover the full cost of the new flight in case of self-repatriation, but only the refund of the portion of the unused fare of the insolvent airline. This situation is particularly pronounced where there are few alternative carriers or seats available to provide repatriation and an organised operation is required to repatriate passengers.

Lack of Immediate Source of Liquidity

2.12 The existing protection regime does not provide an immediate source of liquidity that can quickly defray the cost of repatriation to 'keep an insolvent fleet flying', arrange an organised charter operation or provide immediate funds for an assisted or self-repatriation. As such, in the existing situation, the government becomes the 'organiser and funder of last resort', where the financial and political risk of repatriating a citizen abroad is implicitly assumed to be taken up the government. This indicates that a dedicated funding source is required to ensure that an insolvent airline has a comprehensive and clearly assigned source of liquidity to ensure that operational and supply chain obligations can be met during a repatriation exercise.

Lack of a Coordinating Body

2.13 In the existing regime (with the exception of ATOL coverage), there isn't a dedicated coordinating body that enforces, manages and centralises the proceeds from the various funding mechanisms to ensure that a repatriation operation is carried out efficiently and effectively. In this sense, the proceeds of many of the existing sources of protection are assignable only to individual passengers when in many cases it would be more practical and efficient for them to be assigned to a coordinating body which will have to meet the organisational challenge created by a repatriation. Without a coordinating body for such situations, an orderly repatriation of stranded passengers is much more difficult, particularly in the case of a large airline where there are few alternative carrier options or IATA rescue fares available.

Simplicity for Passengers

2.14 The existing protection regime is undoubtedly complex with a 'patchwork' of different sources of protections all offering different and sometimes overlapping levels of coverage. This is undoubtedly difficult for passengers to navigate and this results in both under-coverage of passengers and uncertainty of how to access funds in the event of an insolvency. This complex patchwork of protections increases the risk of an inefficient and disruptive repatriation operation.

Government as Funder of Last Resort of Repatriation

2.15 Because the existing protection regime does not provide full coverage and is not comprehensive, particularly in terms of repatriation, although not legally mandated, an implicit obligation to provide support to uncovered passengers currently falls on government when a medium-to-large size airline collapse. Such a liability for government is not currently recognised or accounted for. This represents a risk which the government currently has relatively little control over, and therefore cannot develop a risk management strategy or funding mechanism

to support that strategy. However, in any case, the government cannot recover full cost incurred to support repatriation exercise of an insolvent airline. This was witnessed in the Monarch Airlines collapse where the UK government, with considerable support from the CAA had to arrange and fund an urgent organised charter operation to repatriate stranded passengers back to the UK, but could not recover the full repatriation cost incurred Furthermore, a situation - without any funding mechanism in place to meet the cost of repatriation could also be argued to create moral hazard for both passengers and airlines who may assume government will step in where there is no formal protection.

The Challenge of Expanding ATOL

2.16 There could be a potential option to withdraw the airlines exemption from ATOL regulations, whereby airlines would be required to hold an ATOL and pay the APC when selling tickets to consumers. [27] The benefits of such an approach are that: it is an established and recognised scheme, it would require minor changes through primary legislation, it could be consistently applied to all airlines, and it would be welcomed by tour operators as it would be 'level playing field' approach.

2.17 However, –without considerable reform to the ATOL scheme reforms - would not only bring refunds within the scope of the Airline Insolvency Review, which is a risk covered sufficiently by the market as indicated by the market sounding exercise, but also potentially increase the government's exposure as the Air Travel Trust Fund (ATT) is on the government's accounts. Applying the flat rate APC (currently set at £2.50) to all airlines without discriminating based on the risk of insolvency would also lead to strong opposition from airlines. Furthermore, it is also not clear whether the UK would be bound by the EC1008[28] in future due to uncertainly around Brexit, and as such comprehensive legal analysis would be required to evaluate the implementation of this approach. Due to these reasons this approach was not considered further for the purposes of this report.

Summary

2.18 The existing protection regime suffers from a number of weaknesses that should be addressed by any new mechanism – in summary, these are:

- Repatriation costs are not always adequately covered
- The sources of funding and finance within the existing regime do not provide the urgent liquidity needed to meet the short-term logistical and financial challenge of any repatriation exercise
- There is not a single entity in place which can coordinate the complex task of organising and overseeing an orderly repatriation and discharging funding
- The existing provisions are complex and overlapping in nature, resulting in confusion for passengers on what protection is available and the related limitations of any protection
- The weaknesses of the existing regime leave the government as the *de facto* funder of last resort when medium-to-large airlines collapse

[27] Details on airlines exemption from ATOL can be found at Regulation 10 to the 2012 ATOL Regulations, amended in 2018.

[28] EC 1008 requires that member states should not require airlines to hold additional licences or permits beyond the requirements of EC 1008.

2.19 All the above will need to be addressed in the design of a new funding mechanism and are key to the approach taken to appraising different options for a new mechanism as outlined in the following chapters.

3 Developing a New Funding Mechanism - Approach

Introduction

3.1 We have so far outlined how the existing regime for travel protection works and the observed weaknesses in that regime. This has shown that the existing regime, while catering relatively well for refunding passengers who have not yet flown on an insolvent airline, does not have the architecture to adequately support an orderly repatriation of passengers, particularly for medium-to-large sized airlines. As such, it is necessary to consider what options exist to put in place a new regime that can provide the necessary funding and/or finance to ensure an orderly repatriation and improve the level of consumer protection offered. Refunds are therefore not envisaged to be covered in this funding mechanism, although it should be noted that the provision of clearer information to passengers on their rights and the protection offered by different products could be improved as part of a package of interventions (but this is not covered in this report explicitly).

3.2 In the section below, we outline the approach that has been taken to identify, appraise and develop the options for a new funding mechanism.

Approach

3.3 The following approach was undertaken to assessing the options for a new funding mechanism:

Step 1: Definition and Sifting of Macro Options

3.4 A range of macro options have been identified, which could potentially fund the passenger liabilities that arise due to airline insolvencies. These macro options represent the full spectrum of potential interventions and have been sifted against the following 'pass/fail' criteria that underpin the Airline Insolvency Review's Terms of Reference:

- ***Increase commercialisation of protection:*** The recommended funding options should be deliverable on a more commercial basis so that the burden of the cost of airline failures is minimised or not borne by taxpayers.
- ***Minimise government intervention:*** The funding mechanisms and the regulatory regime should allow airlines to wind-down in an orderly fashion so that they are able to conduct the repatriation exercise with no or minimum Government intervention.

3.5 The macro options that do not meet these 'pass/fail' criteria are deselected and not further analysed. The remaining macro-options are longlisted and appraised in Step 2.

Step 2: Appraisal of Longlisted Options

The longlisted macro options have been appraised and scored against a qualitative multi-criteria assessment framework to shortlist the options that are taken forward for further design and

analysis as delivery options. The multi-criteria assessment framework includes the following principles identified in the Interim Report of the Airline Insolvency Review

- The beneficiary pays for protection;
- Efficient allocation of risk;
- Minimisation of market distortions;
- Simplicity for passengers; and
- Deliverability of options – this is an additional criterion that was not included in the Interim Report and assesses the compatibility of the option with the important task of assigning liquidity quickly to repatriate passengers of an insolvent airline. The level of transaction and administrative costs of the option are also considered.

The two options that rank highest are shortlisted and appraised in Step 3. Those that do not meet the scoring threshold are deselected and not analysed any further.

Step 3: Definition and Appraisal of Shortlisted Options

Each short-listed option is developed further and quantitatively and qualitatively assessed against a set of micro criteria. Firstly, each option was assessed qualitatively based on the following criteria:

- ability to finance the estimated amount of protection for all passengers,
- applicability of the approach to all airlines,
- implementation of the approach with minimum legal risk, and
- managed transition from the current situation to a future scheme.

This analysis was supported by a quantitative actuarial assessment of each of the short-listed options carried out by the Government's Actuary Department (GAD). GAD used forecasts of repatriated passengers and costs from the consultancy firm, ICF. ICF were hired by the Airline Insolvency Review to develop a dataset that could estimate the exposure and cost of insolvency by a range of airlines.

Step 4: Market Sounding of Delivery Options

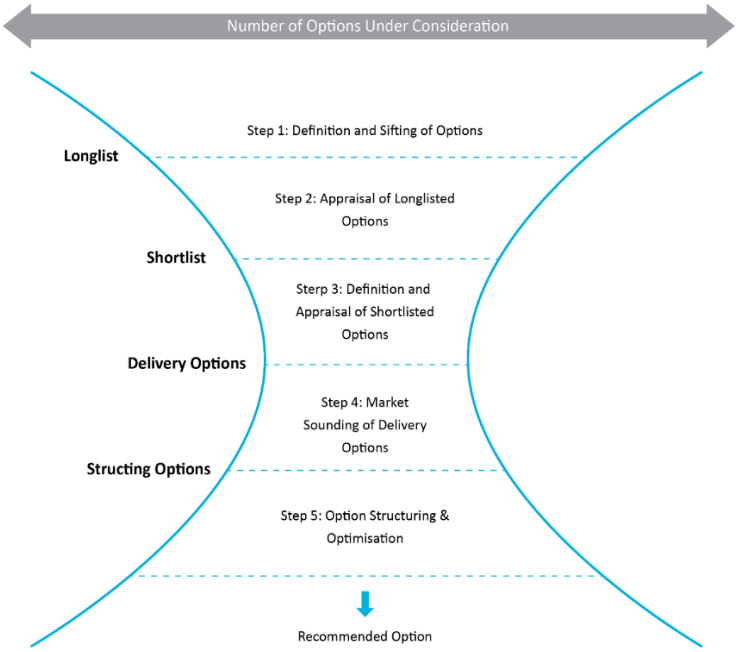
Together with GAD and the Airline Insolvency Review team, a market sounding exercise was undertaken with key market participants (e.g. insurers, reinsurers, payment card providers and acquirers) to assess market capacity and appetite to deliver the shortlisted options (or any of the deselected options). The market sounding exercise is outlined in detail in the 'Market Sounding 'section.

Step 5: Option Structuring and Optimisation

The short-listed options were further refined based on the feedback in the market sounding exercise in Step 4 to create a range of structured options which can be combined to provide an efficient and comprehensive solution. This forms the basis for a set of recommendations was developed for a proposed funding mechanism detailed in 'Option Structuring and Optimisation' section.

3.6 The figure below provides an overview of the Option Analysis Approach from Steps 1-5.

Figure 4: Option Appraisal Framework



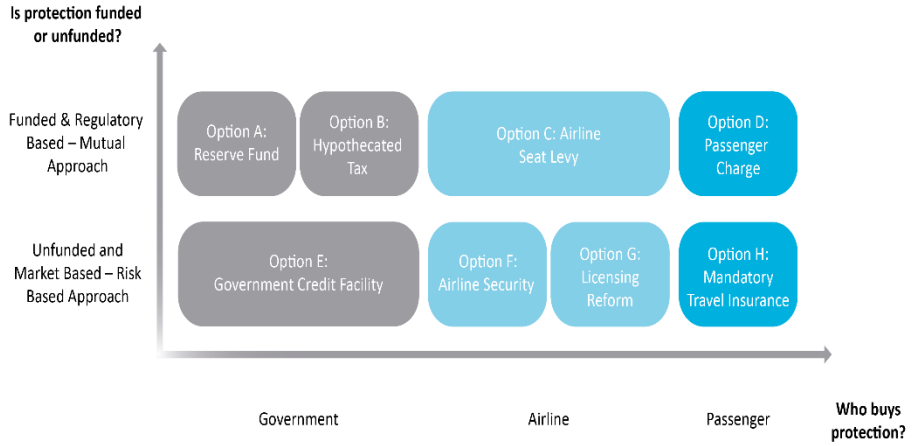
4 Definition and Longlisting of Macro Options

Universe of Options

4.1 Figure 6 below shows a range of macro options representing the full spectrum of potential funding and financing mechanisms that can be considered. These options are plotted across two key dimensions:

- Which party is responsible for paying in/contributing to the funding option to meet the cost of repatriation i.e. taxpayers, airlines or passengers; and
- Whether the option is funded (i.e. enough cash or equivalent is reserved as collateral to match expected liabilities) or unfunded (i.e. a lower level of collateral is held to meet expected liabilities – by leveraging the financial strength of the entity providing coverage).

Figure 5: Option Design Framework



Option Design Principles

4.2 All of the options presented below are based on the following key design principles:

- **Scope – Repatriation Only:** Given that market failure is predominately concentrated around the lack of effective protection for repatriation (rather than refunds), the options are all designed to fund the repatriation of UK-originating passengers only[29].
- **Mandatory –** All options are assumed to be mandatory so as to prevent any 'free-riding' amongst airlines or passengers and to ensure the risk is equitably spread and a standard for protection of all consumers is created with regard to repatriation.

[29] Any scheme should only cover those passengers who need its protection, so those who originate in other countries and are returning from the UK, those who are protected by ATOL and domestic passengers would not be covered.

- **CAA as coordinating body:** Following the Airline Insolvency Review's Call for Evidence, Interim Report and thorough consultation with industry and stakeholders, there was broad consensus that the CAA, due to its unmatched expertise (gained through management of ATOL scheme) in overseeing repatriation operations, would be the entity best placed to fulfil the role of a 'coordinating body'. Its mandate to protect consumers and ensure safety aligns with the core task of repatriating UK originating stranded passengers with a return ticket to the UK with the insolvent airline. Moreover, under Section 16 of the Civil Aviation Act[30], the CAA can be mandated to provide support to the Secretary of State as needed. As the industry's regulator, the CAA would also have the principal levers by which participation in any funding mechanism could be enforced.

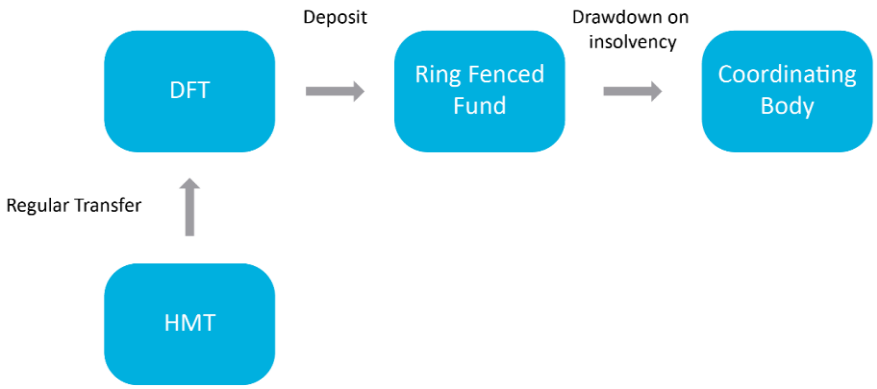
4.3 In the sections below we describe each of these macro options in more detail.

Option A: Reserve Fund

4.4 Under this option, the government would be responsible for building a budgetary reserve to provide a source of 'on-demand' liquidity to fund a repatriation exercise. This would likely have to be committed as part of central government budgets (e.g. earmarked as part of the DfT annual settlement from HMT) [31].

4.5 The reserving policy for such a fund would be based on an assessment of the forecast exposure and cost of repatriating passengers of an insolvent airline. The reserving amount (i.e. the maximum balance of the fund) could be reset periodically based on the balance of the fund and on updated forecasts of likely insolvencies (e.g. if there is a major spike in oil prices). The figure below shows how such a mechanism may operate.

Figure 6: Reserve Fund Structure



4.6 Such an option would likely be simple for passengers and the proceeds from the fund easily assignable to an insolvent airline, but repatriation risks would be entirely absorbed by non-users

[30] Civil Aviation Act, 1982, s16, para 1: *Subject to subsection (3) below, it shall be the duty of the CAA to provide such assistance and advice as the Secretary of State may require it to provide for him or any other person in connection with any of the Secretary of State's functions relating to civil aviation.*

[31] The structure would be similar to police financial reserves, police and crime commissioners (PCCS) can keep part of their funding in financial reserves to help manage financial risk and to fund major future costs such as change programmes aimed at improving services to the public. Usable financial reserves are split into resource and capital. resource reserves are categorised into a general fund to cover unforeseen pressures and earmarked reserves which are each held for a specific purpose. Capital reserves are ring-fenced for capital investment. As at March 2017, PCCS held over £1.6bn in usable resource reserves.

(i.e. taxpayers), and as such, this option has a potential of creating 'free riding' by airlines as the entire cost of protection would neither be borne by insolvent airlines nor passengers. Due to the same reasons, this option would potentially distort the existing market for traveller protection, thereby leading to crowding out and a moral hazard from passengers. Furthermore, government may not have the execution capacity to run the scheme efficiently and appraise risks. There is also uncertainty whether HM Treasury would allow such high reserving/ring-fencing of public funds given strong preference for fungibility of public funds.

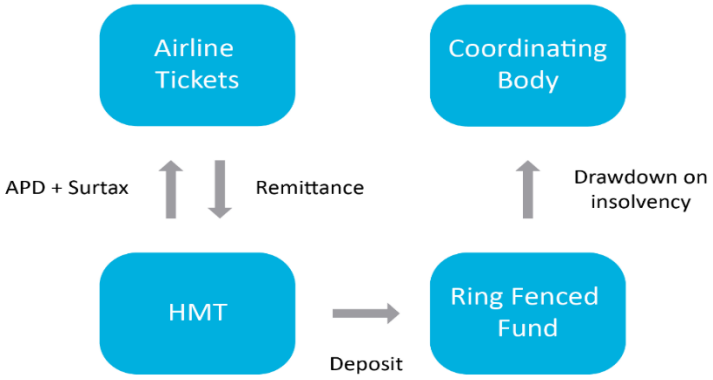
4.7 Overall, this option would result in government managing a risk it has little control over. Furthermore, a government fund acts as an obstacle to both passengers and airlines from paying and meeting their own obligations to mutually protect themselves and therefore does not promote *commercialisation*. Such a scheme would provide the necessary liquidity quickly and would be easy for passengers to understand but requires a high degree of *government intervention* and does not result in an equitable allocation of risk and could create a moral hazard. **As such, this option is assessed to fail both the pass/fail criteria and is deselected at this stage.**

Option B: Hypothecated Tax

4.8 Under this option, government would add a surtax on its existing taxation of the airline industry and then would hypothecate (i.e. ring-fence) the proceeds of the surtax to fund future repatriation obligations.

4.9 The surtax would most likely take the form of an additional amount added to the Air Passenger Duty (APD) which is an excise duty already applied to all air journeys on aircraft with more than 20 seats. The amount of duty charged can vary from £13 to £450 per passenger depending on flight distance and class of travel. Airlines collect this duty through the airline ticketing process and then remit the payment to Treasury. The surtax would likely be a very small proportion of the APD amount and would only be applicable to international departing flights (not transferring passengers or domestic passengers). Figure 8 below summarises how this could work in practice.

Figure 7: Hypothecated Tax Structure



4.10 As with Option A, such an approach would likely be simple for passengers and the proceeds from the fund easily assignable to an insolvent airline, however, there is uncertainty whether HM Treasury would allow such high reserving/ring-fencing of public funds given strong preference for fungibility of public funds. Applying the surtax may also have transaction costs given that the tax bases would be different. Moreover, the liabilities of the scheme would be entirely treated as 'on-balance-sheet' and so would add to the government's overall financial exposure.

4.11 Overall, as with Option A, this option would result in government managing a risk it has little control over. It does not provide adequate incentives because it acts as an obstacle to both passengers and airlines from paying and meeting their own obligations to mutually protect themselves and therefore does not promote *commercialisation*. By its nature this option requires a high degree of *government intervention* and does not result in an equitable allocation of risk and could create a moral hazard. **As such, this option is assessed to fail both the pass/fail criteria and is deselected at this stage.**

Option C: Airline Seat Levy

4.12 Under this option, all airlines would be levied on a per seat basis for UK originating passengers only. It would be up to the airlines to pass the cost to all or only relevant passengers by appropriately revising the cost structure of the tickets. The proceeds of the levy would be held in an escrow account, the balance which would continue to grow over time. The structure of this option is similar to the ATOL protection scheme. [32]

4.13 A key issue to assess is whether such a levy would be treated as a tax and therefore the full responsibility of the government. For a payment/charge to be classified as a tax, it should meet the qualification criteria that it is compulsory or unrequited (disproportionate to the service which is provided). If the charge is not compulsory or requited, it would be unlikely to be considered as a tax. [33]

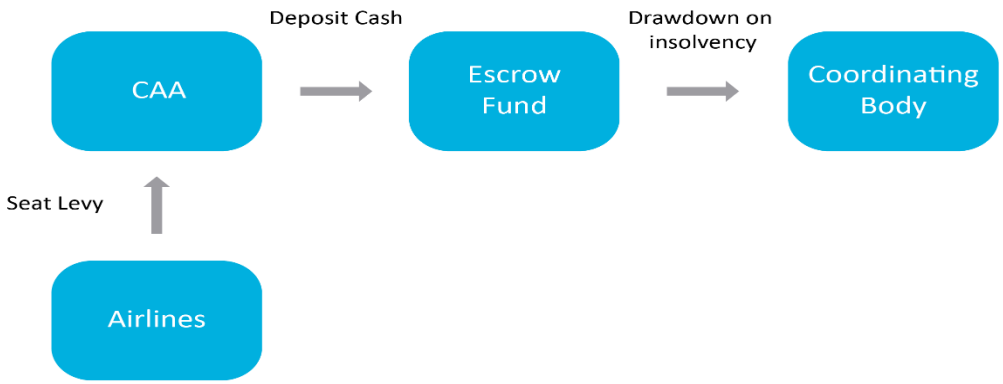
4.14 The reserving policy for building such a fund would be based on an assessment of the forecast exposure and cost of repatriating passengers of an insolvent airline. The reserving amount could be reset periodically based on the ending balance of the fund at the end of each period and on updated forecasts of likely insolvencies. It would be at the discretion of the individual airlines whether they pass this levy onto passengers.

4.15 The levy could be flat or risk-based discriminating on the credit risk of individual airlines (i.e. for a risk based levy, the amount charged could go up or down depending on the default risk of individual airlines.) or could vary in some other way, Figure 9 below shows how such a mechanism may operate.

[32] ATOL is a UK financial protection scheme and it protects most air package holidays sold by travel businesses that are based in the UK. The scheme also covers some flight bookings, usually those where you book flights (including UK domestic flights) but do not receive your tickets immediately. ATOL is run by the CAA). It is funded by contributions from ATOL holders, which must pay £2.50 into the scheme's back up fund, the Air Travel Trust, for each person they book on a holiday. ATOL stops passengers losing money or becoming stranded abroad if the travel business you booked with collapses

33 The Office for National Statistics (ONS) classifies APC as tax. The APC is compulsory to pay under legislation and is also unrequited. Therefore in their view, even though the travel firm pays the charge and pass it on to their passengers, it is the firm who pays the charge and receive nothing back in return. They view that benefits are delivered to consumer, when companies fail. They are also not convinced that the ATOL holder receives a regulatory service in exchange for the £2.50 APC paid, or even if the regulatory services are considered benefits, they believe the cost of these services is disproportionate, particularly for large firms who contribute more to the fund than smaller firms.

Figure 8: Airline Seat Levy Structure



4.16 This option ensures that airlines and passengers are funding their own protection and so the taxpayer's exposure is likely to be significantly reduced. As such, this option passes the *minimisation of government intervention* test. The ability to combine this option with potential participation of insurers (through reinsurance) also allows this option to pass the *commercialisation* test. **As such, this option is assessed to pass both the pass/fail criteria and is assessed in more detail in the section below.**

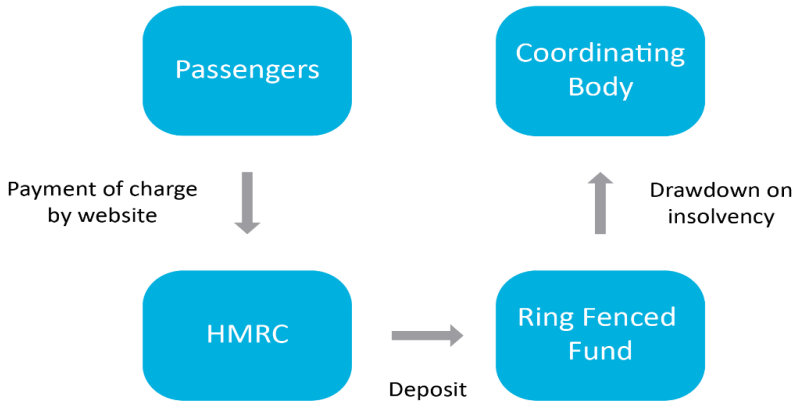
Option D: Passenger Charge

4.17 This option is similar to the 'Airline Seat Levy (Option C)'. However, under this option, all UK originating passengers would be directly levied on each flight departing the UK rather than the charge being paid by the airline. The proceeds of such a charge would flow back into an escrow fund. The reserving policy for such the fund would be based on an assessment of the forecast of cost of repatriation of an insolvent airline. The reserving amount could be reset periodically (e.g. per quarter) based on the ending balance of the fund at the end of the period and on updated forecasts of likely insolvencies (e.g. if there is a major spike in oil prices).

4.18 Practically, this option could work in three ways: (1) passengers directly interacting with the government (or other agency) through a website to make the payment and gain pre-authorisation before being able to have a ticket issued. This would be akin to how an electronic visa waiver works[34] whereby certain foreign nationals can make a direct prepayment to enter the UK without a visa, (2) the charge collected at the airport from all UK departing passengers with a return ticket. This can be collected by airlines and then transferred into the escrow account, or (3) the charge levied through airlines at the point of sale and at some point, checked by airline staff before departure. Each of these options have complex implementation structures with high transaction costs, with no additional benefits beyond airline seat levy option.

[34] https://www.gov.UK/get-electronic-visa-waiver

Figure 9: Passenger Charge Structure



4.19 Despite the likely higher transaction costs and initial set up costs, this option still ensures that passengers are directly funding their own protection and so the taxpayer's exposure is likely to be significantly reduced. As such, this option passes the *minimisation of government intervention* test. The ability to combine this option with potential reinsurance also allows this option to pass the *commercialisation* test. **As such, this option is assessed to pass both the pass/fail criteria and is assessed in more detail in the section below.**

Option E: Government Credit Facility

4.20 Under this option, the government would provide a financial guarantee to airlines to obtain a line of credit from a financial institution to cover repatriation obligations in the event of an insolvency. The guarantee would be provided at a commercial fee/premium. This would effectively be a contingent liability for government with the government unilaterally managing the risk but receiving a corresponding reward (through a guarantee fee). The UK Guarantee Scheme (UKGS)[35] is an example of a government initiative that provides contingent support to the private sector (in the case of UKGS, it provides guarantees to banks and bondholders investing in large infrastructure projects).

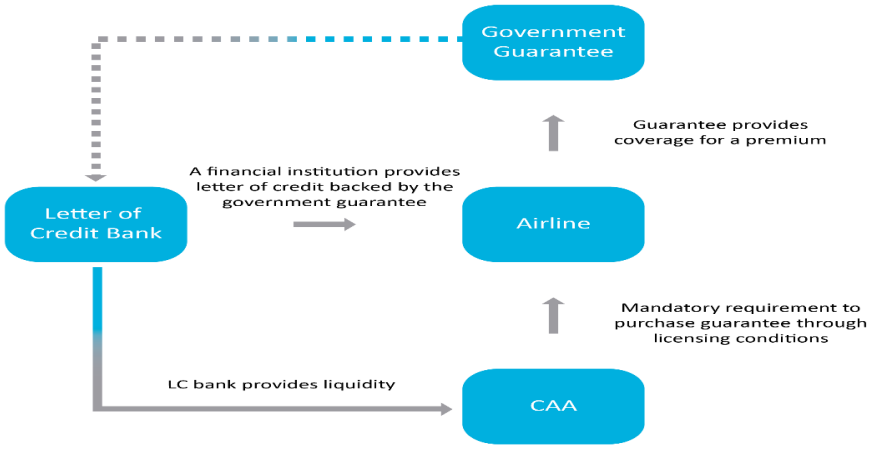
4.21 In order to ensure sufficient liquidity is injected quickly into a repatriation operation, a financial institution (e.g. a commercial bank) could provide a letter of credit to airlines against the government guarantee. If the guarantee is called, the credit provided could be converted into a loan that would be settled in the administration process – this could allow government to recover some of its costs from covering a failure.

4.22 For such an option to be effective, it would likely have to be a mandatory requirement for airlines to purchase the guarantee and for this to be underpinned in licensing arrangements.

4.23 The figure below shows how such a mechanism may operate.

[35] https://www.gov.UK/guidance/UK-guarantees-scheme#how-the-scheme-works

Figure 10: Government Credit Facility Structure



4.24 Overall, as with Options A and B, this option would result in government managing a risk it has little control over, although it does at least, under this option receive financial reward for doing so under a fee structure that will be reflective of relative risk and so does pass the *commercialisation* test. However, by its nature, this option still requires a high degree of *government intervention* and does not result in an equitable allocation of risk. **As such, this option is assessed to fail one of the pass/fail criteria and is therefore deselected at this stage.**

Option F: Airline Security

4.25 Under this option, airlines are required to provide an acceptable form of security that can be called on in the event of an insolvency. In effect this is each airline taking individual responsibility for insuring itself against failure so that its passengers are protected. This is a different approach from Options A-E whereby the risk is effectively pooled and spread across the industry rather than on an individual airline basis. The adopted security would need to provide the necessary liquidity without a lengthy claims or loss adjustment period. As per the insolvency protection options permitted for non-flight packages under the UK Package Travel and Linked Travel Arrangements Regulations 2018, the following forms of security could be provided:

- **An 'on-demand' performance bond** - Bonds are irrevocable undertakings from third party banks or insurance companies (bond obligors) provided to the coordinating body. If an airline is unable to meet its obligations to its consumers, the coordinating body will demand the proceeds of the bond from the obligor. It is important to note that there is normally a 'wait-period' associated with demanding a bond due to invoicing and payment terms so the coordinating body might need to have access to a short-term financing facility (e.g. overdraft or standby facility) to cover the likely working capital requirement associated with claiming the bond. This is one of the reasons why the ATOL includes a short-term revolving borrowing facility from a commercial bank
- **Trust account -** where money paid by consumers for bookings is held in trust and can be used following the failure of an airline. **Insurance –** where airlines provide insurance policies covering passengers. The insurance companies must agree to indemnify passengers in the event of airlines insolvencies by covering the cost of repatriation as well as accommodation costs prior to the repatriation. Although not currently accepted by the CAA for ATOL – the following forms of security could also be considered (if they could provide sufficient comprehensive and complete coverage of the airline's obligations):

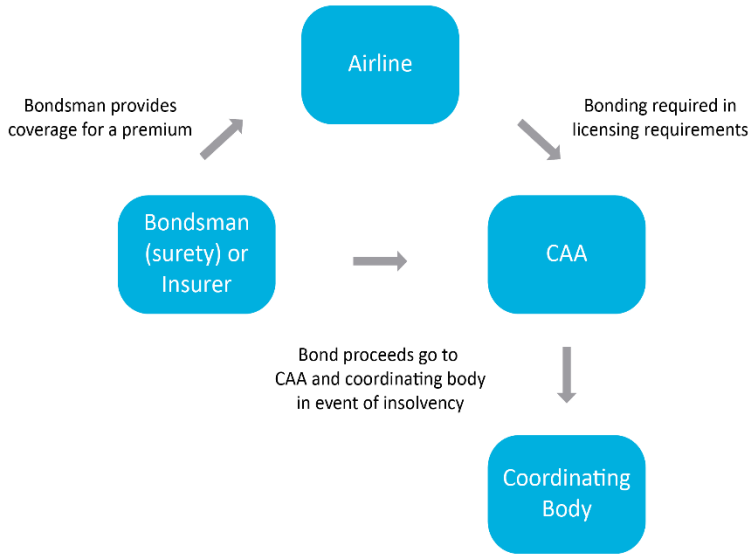
- **A letter of credit (from a well-rated financial institution)** - A letter of credit is a document from a bank that guarantees payment.; and
- **A parent company guarantee (from a well-rated parent group)** - A parent company guarantee is a guarantee given by a parent company for the performance by its subsidiary.

4.26 In all cases, a coordinating body (e.g. CAA) would need to hold a first-charge over whichever form of security is put forward by the airline (i.e. the proceeds of the security are easily assignable to the CAA so that it has near immediate access to the required liquidity to mount an effective repatriation operation).

4.27 Such a mechanism would only likely be effective if the obligation to provide this security is hard-wired into an airline's legal and/or regulatory obligations so as to provide a 'hard' enforcement mechanism. A voluntary scheme has not been considered further given the risk that security, particularly that provided by a third party (e.g. insurance, bond provider) could be withdrawn at very short notice.

4.28 The figure below provides an overview how this option could be structured.

Figure 11: Airline Security Structure



4.29 This option ensures that airlines are protecting passengers from their potential failure and are doing so using risk-products available in the market without significant recourse to the government. As such, this option passes both the *commercialisation* and *minimisation of government intervention* test. **As such, this option is assessed to pass both the pass/fail criteria and is assessed in more detail in the section below.**

Option G: Licensing Reform

4.30 Under this option, an airline would provide security through its obligations under a series of regulatory provisions and covenants that would be attached to the airline operating licence regime in the UK. It is important to note that this would require reform of the existing licensing regime. Such an approach is already adopted through the ATOL regime but as mentioned

previously, this applies to package-based travel and does not always apply to all 'ticket-only' travel.

4.31 If enacted, these regulatory provisions would grant the regulator (i.e. CAA) the right to regular monitoring of the financial health of regulated airlines and would assess whether any covenants, in the form of key financial ratios have been breached. These ratios would be a series of 'cover ratios' that will assess the amount of cash (and cash equivalents) in the business over and above the estimated cost of a repatriation operation for the airline. These cover ratios will provide an ongoing indication of the ability of the airline to cover its own repatriation costs. If the covenants have been breached, then the regulator will be able to exercise a range of subsequent rights to ensure that the airline is putting aside (i.e. locking-up) cash to cover potential repatriation obligations rather than paying out cash in the form of dividends or inter-company transfers. Any cash that is locked-up would be reserved in an escrow account. If the ratios recover above breach levels, then the cash would be gradually released back to the airline and therefore any reserve would be temporary.

4.32 At the core of any such regime is the potential trade-off between ensuring that there is enough cash available to ensure an orderly repatriation is carried out and potentially exacerbating the financial problems faced by the airline by locking up scarce financial resources (i.e. over-regulation versus under-regulation). As such, the regime would have to be very carefully calibrated to balance these two factors.

4.33 This option ensures that airlines are incentivised through regulatory levers to protect passengers from their potential failure and are doing so without significant recourse to the government. **As such, this option passes both the *commercialisation* and *minimisation of government intervention* test.**

Option H: Mandatory Travel Insurance

4.34 Under this option, the government would mandate and regulate that all travel insurance policies must include airline failure cover and that all passengers must subsequently carry a travel policy that at a minimum covers insolvency and repatriation costs. This would mandate a policy akin to the minimum insurance threshold imposed on motorists which is to cover third party losses from a road traffic accident. This will require a significant investment in a validation mechanism that would check that valid insurance is in place at the time of sale or departure. This is because it would be impractical to check insurance at the airport individually and potentially add further processing time at check-in or boarding which could increase passenger dissatisfaction. As such, an approach similar to the Motor Insurers' Bureau's Motor Insurance Database (MID)[36] may be required. This option would therefore require the largest set-up costs of all of the macro options and the most challenging implementation as it would de facto create an 'insured-flyer' scheme.

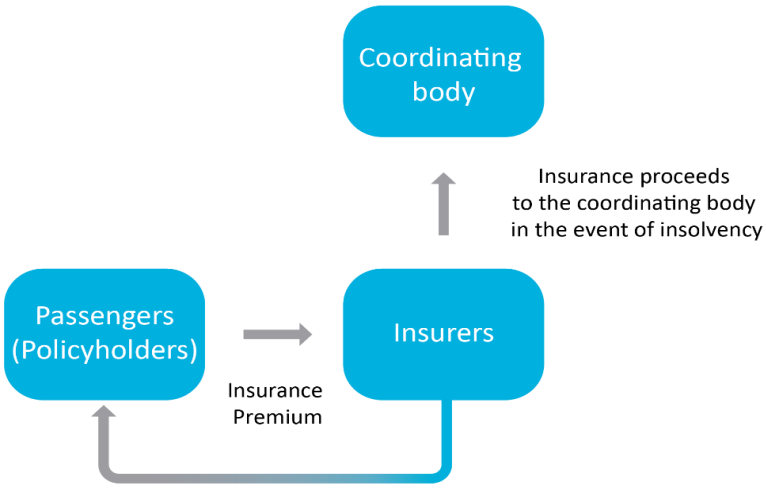
4.35 A further complication is that passengers of riskier airlines may not be able to receive cover if the insurer is unprepared to take the credit risk on the airline. This could act as a trigger to insolvency if it became apparent to the airline's other creditors that they were uninsurable from a credit perspective.

4.36 Likewise, there would be challenges in assigning the proceeds of this insurance to a coordinating body in the event of a failure. Whereas in the example of an airline security package, there is

[36] https://www.mib.org.UK/managing-insurance-data/the-motor-insurance-database-mid/

effectively a one-to-one relationship between the airline and the third party providing the security, in this example there are multiple insured parties and assigning the proceeds of each of these separate policies could be time-consuming and complex and may not provide the liquidity required in the time required. The figure shows the potential structure of this option.

Figure 12: Mandatory Travel Insurance Structure



4.37 This option has significant delivery challenges but it relies predominately on commercial delivery and minimises the recourse to government intervention and so it is assessed to pass both the commercialisation and minimisation of government intervention test. Furthermore, the market sounding exercise of the option indicated that the Financial Conduct Authority may prohibit mandatory passenger insurance. As such, this option is assessed to pass both the pass/fail criteria and is assessed in more detail in the section below.

Summary: Longlisting of Options

4.38 The table below summarises the results of the longlisting exercise.

Table 2 - Longlisting of Macro Options

Criteria Met	Commercialisation of Protection	Minimum or No Government Intervention	Option Taken Forward
Option A: Reserve Fund	×	×	No
Option B: Hypothecated Tax	×	×	No
Option C: Airline Seat Levy	✓	✓	Yes
Option D: Passenger Charge	✓	✓	Yes
Option E: Government Credit Facility	✓	×	No
Option F: Airline Security	✓	✓	Yes
Option G: Licensing Reform	✓	✓	Yes
Option H: Mandatory Travel Insurance	✓	✓	Yes

4.39 As can be seen, Options A, B and E are all deselected at this stage on the grounds of not passing the tests of commercialising protection or minimising government intervention in protection. The remaining options are appraised in the following chapter.

5 Appraisal and Shortlisting of Longlisted Options

Approach

5.1 The longlisted options carried forward from the previous section are assessed against the qualitative multi-criteria assessment framework described in the table below. The framework uses a relative scoring system to show which option ranks best to worst against each criterion. The four criteria adopted match those used in the Airline Insolvency Review's Interim Report. Furthermore, we have also adopted an additional criterion that assesses the deliverability of an option. This is focused on the compatibility of an option with the task of assigning liquidity to a repatriation exercise and the associated transaction and administrative costs of the option.

5.2 The two top-ranked options are shortlisted following this exercise. The scoring methodology is outlined in the table below.

Table 3 - Appraisal Framework - Shortlisting

Criteria	Description	Ranking = 5th	Ranking = 4th	Ranking = 3rd	Ranking 2nd	Ranking = 1st
Beneficiary Pays for Protection	Assesses careful balancing of the level of risk covered and the affordability of protection. The corollary of this principle is that the taxpayer's exposure should be minimised or removed.	Lowest		Mid-Ranked		Highest
Efficient allocation of risk	Assesses that the risks for passengers should be allocated to those best placed to manage and control them, whilst avoiding duplication where possible.	Lowest		Mid-Ranked		Highest
Minimisation of market distortions	Assesses constraints on the competitiveness and size of the UK aviation market that should be minimised. It also assesses that the UK registered airlines should not be put at a competitive disadvantage vis-à-vis international competitors.	Lowest		Mid-Ranked		Highest
Simplicity for Passengers	Assesses the extent to which passengers understand the protection available and be able to identify which risks are covered, and to what level. In addition, passengers should be compensated in a timely and efficient manner: being brought home and compensated quickly.	Lowest		Mid-Ranked		Highest
Deliverability of Option	Assesses the compatibility of the option with the important task of assigning liquidity quickly to the task of a	Lowest		Mid-Ranked		Highest

	repatriation exercise. This also considers whether the options are practically implementable. The level of transaction and administrative costs of the option are also considered.					

Option Appraisal Results

5.3 The appraisal of each longlisted option against the criteria is shown in the sub-sections below.

Option C: Airline Seat Levy

5.4 The appraisal of Option C is outlined in the table below:

Table 4 - Airline Seat Levy - Pros and Cons Analysis

	Pros	Cons	Ranking
Beneficiary Pays for Protection	Indirectly the cost may be passed through to the passenger through ticket prices, so the beneficiary could ultimately be paying.	Passenger not directly accessing market for protection and paying directly	3rd
Efficient allocation of risk	A levy imposed on airlines places the cost on airline management who are best placed to manage the risk of insolvency, as it is management who know the financial situation of the company and are able to take action to strengthen it. However, a flat seat levy (and the fund it would create) is a pooled protection mechanism which mutualizes the risk and inevitably means that financial stronger airlines are subsidizing weaker airlines. The levy could be differentiated by risk with riskier airlines proportionally contributing more to the levy fund and thus reducing cross-subsidisation and the potential moral hazard of the option. Levy could be scaled back, or rebates provided if the fund balance reaches a sufficient level (i.e. automatic stabilisers could prevent over-reserving).	Directly imposes additional obligations on airlines, which would be particularly difficult for financially weaker airlines and struggling to compete already on price. A financially weaker airline may struggle to make contributions to the fund, thus leading to the fund shortfall. Healthy airlines may object to subsidising less financial stable airlines if there is not sufficient risk discrimination in setting the levy. Risks are fully cash collateralised which leads to a significant 'cost-of-carry' when compared to an unfunded solution.	3rd

	The option could also be combined with commercial insurance through insurers reinsuring the levy fund to provide additional coverage beyond the fund balance. This can promote risk sharing between the passenger/airline and a 3rd party insurer		
Minimisation of market distortions	Risk is effectively pooled across airline industry and so overall level of levy is likely to be low when compared to other options	This option could have negative competitive effects, particularly if the levy is passed on to passengers for smaller airlines (or lower yielding airlines such as Low Cost Carriers - LCCs). May distort existing take-up of passenger insurance products if passengers are misinformed that this is displacing the need for existing products to cover refund and consequential losses. Limitations of such a scheme would have to be clear that this covers only the operational costs of repatriation.	1st
Simplicity for Passengers	Very simple for passengers provided that they knew which risks are covered.	Could be some confusion vis-à-vis other sources of protection-	3rd
Deliverability	Very straightforward to assign proceeds to the coordinating body as the fund will be dedicated and ring fenced.	Higher transaction costs associated with collecting the levy, administering the fund and paying escrow banks etc.	1st
Overall Ranking			**1st**

Option D: Passenger Charge

5.5 The appraisal of Option D is outlined in the table below:

Table 5 - Passenger Charge - Pros and Cons Analysis

	Pros	Cons	Ranking
Beneficiary Pays for Protection	The cost would be directly applied to passengers without any intermediation from airlines and so the passenger is fully responsible for making payment and protecting themselves.		1st
Efficient allocation of risk	A passenger charge allocates the cost to passengers. The risk can potentially be managed by passengers to the extent that they have information to be able to understand risk and make decisions accordingly (e.g. fly with another provider) but this is not as efficient as imposing the cost on airlines. To improve efficiency, the charge could be differentiated by risk with passengers of riskier airlines proportionally paying more to the levy fund and thus reducing cross-subsidisation and the potential moral hazard of the option. The charge could be scaled back, or rebates provided if the fund balance reaches a sufficient level (i.e. automatic stabilisers could prevent over-reserving).	Risks are fully cash collateralised which leads to a significant 'cost-of-carry' when compared to an unfunded solution and so is generally not as efficient.	5th

	The option could also be combined with commercial insurance through insurers reinsuring the charge fund to provide additional coverage beyond the fund balance. This can promote risk sharing between the passenger/airline and a 3rd party insurer		
Minimisation of market distortions	Risk is effectively pooled across airline industry and so overall level of charge is likely to be low when compared to other options	This option could have negative competitive effects, particularly if the levy is passed on to passengers for smaller airlines (or lower yielding airlines such as Low Cost Carriers - LCCs). May distort existing take-up of passenger insurance products if passengers are misinformed that this is displacing the need for existing products to cover refund and consequential losses. Limitations of such a scheme would have to be clear that this covers only the operational costs of repatriation.	2nd
Simplicity for Passengers		It can potentially be complex for passengers depending on the payment mechanism as the enforceability structure to pay the charge can be complex.	5th
Deliverability	Very straightforward to assign proceeds to the coordinating body as the fund will be dedicated and ring fenced.	There would be very high transaction costs of this option relative to the likely size of the charge, so the option is unlikely to be cost-effective.	2nd
Overall Ranking			**3rd**

Option F: Airline Security

5.6 The appraisal of Option F is outlined in the table below:

Table 6 - Airline Security: Pros and Cons Analysis

	Pros	Cons	Ranking
Beneficiary Pays for Protection	Indirectly the cost is likely to be passed through to passenger through ticket prices.	Passengers still not directly paying or accessing market for protection. Given the likely difficulties faced by the commercial market to cover weaker airlines there is still the potential for government or levy to have to take the residual risk.	4th
Efficient allocation of risk	This option places the obligation fully on airline management who are best positioned to manage their own risk. Moreover, this option is financially more efficient as it uses a risk-based/unfunded approach is significantly more efficient than levying which inevitably ties up cash. Cost of security will be risk-based so does not require cross-subsidy from healthy airlines to failing airlines. Risk-based/unfunded approach is significantly more efficient than levying.	Security from a third party (e.g. insurer or bond provider) can be withdrawn with relatively little notice and this could introduce some uncertainty and instability in providing coverage if airlines suffer short-term performance issues or there is an external shock (e.g. large spike in fuel prices).	2nd
Minimisation of market distortions	Performance bonds and airline insurance are an established product	May act as a barrier to entry for smaller lower/unrated airlines – thus driving up fares (see below) and potentially crystallizing the risk of insolvency of weaker airlines.	3rd

		May distort existing take-up of passenger insurance products if passengers are misinformed that this is displacing the need for existing products to cover refund and consequential losses. Limitations of such a scheme would have to be clear that this covers only the operational costs of repatriation.	
Simplicity for Passengers	Straightforward for passengers as they will not directly pay for coverage.	Enforcement and set-up costs are likely to be high.	2nd
Deliverability		More difficult to assign proceeds and get liquidity to repatriation operation compared to a levy-type option (note: this is a key reason why ABTA and ATOL whilst using insurance in their product still rely on a levy based-fund to provide the initial liquidity while a claims process on insurance is worked through).	3rd
Overall Ranking			**2nd**

Option G: Licensing Reform

5.7 The appraisal of Option G is outlined in the table below:

Table 7 - Licensing Reform: Pros and Cons Analysis

	Pros	Cons	Ranking
Beneficiary Pays for Protection		Passengers not directly paying or accessing market for protection.	5th
Efficient allocation of risk	Incentivises effective risk management by the airlines themselves who are best positioned to manage the risk of insolvency		1st
Minimisation of market distortions		Regime may act as a large barrier to entry for smaller lower/unrated airlines – thus driving up fares (see below) and reducing competition. Could be difficult for market to manage this risk for smaller or lower/unrated airlines without some credit enhancement. May distort existing take-up of passenger insurance products if passengers are misinformed that this is displacing the need for existing products to cover refund and consequential losses. Limitations of such a scheme would have to be clear that this covers only the operational costs of repatriation.	5th
Simplicity for Passengers	Straightforward for passengers as they will not directly pay for coverage.		1st

Deliverability		Is likely to result in high regulatory costs, particularly around monitoring and enforcement. Also, potential push back from such a high degree of regulation on airlines	4th
Overall Ranking			**4th**

Option H: Mandatory Travel Insurance

5.8 The appraisal of Option H is outlined in the table below:

Table 8 - Mandatory Travel Insurance - Pros and Cons Analysis

	Pros	Cons	Ranking
Beneficiary Pays for Protection	Passenger pays directly and market provides cover		2nd
Efficient allocation of risk	Options allocates the cost to passengers. The risk can potentially be managed by passengers to the extent that they have information to be able to understand risk and make decisions accordingly (e.g. fly with another provider) but this is not as efficient as imposing the cost on airlines. However, risk-based/unfunded approach is significantly more efficient than levying (i.e. funded sources).	Insurers may struggle to manage the risk for smaller unrated airlines and may need credit enhancement to manage certain risks. Enforcement and set-up costs are likely to be very high.	4th
Minimisation of market distortions		Very difficult for market to manage this risk for smaller or lower/unrated airlines (or lower yielding airlines such as Low Cost Carriers - LCCs), so could have competition effects as	4th

		passenger premiums will be high and may act as barrier to entry.	
Simplicity for Passengers	Supports take up of existing products and might bring new products to market. If passengers know they are covered then they may be more incentivised to arrange self-repatriation and thus take pressure off an organised charter/keep the fleet flying operation	Customers will have to navigate insurance market and choose between existing provision and this scheme which could overlap.	4th
Deliverability		Assignment likely to be difficult without it being supported by an initial source of liquidity. Financial Conduct Authority (FCA) would effectively forbid the mandating of travel insurance under their regulatory rules.	5th
Overall Ranking			**5th**

Appraisal Results Summary

The table below summarises the results of the appraisal exercise:

Table 9 - Options Appraisal Results

Criteria	Score for Beneficiary Pays for Protection Ranking)	Score for Efficient allocation of risk (Ranking)	Score of Minimisation of market distortions (Ranking)	Score for Simplicity for Passengers (Ranking)	Score for Additional Criteria: Deliverability of Option (Ranking)	Overall Ranking (Based on Total Score))	Option Taken Forward
Option C: Airline Seat Levy	3	3	1	3	1	**1st (11)**	**Yes**
Option D: Passenger Charge	1	5	2	5	2	**3rd (15)**	**No**
Option F: Airline Security	4	2	3	2	3	**2nd (14)**	**Yes**
Option G: Licensing Requirements	5	1	5	1	4	**4th (16)**	**No**
Option H: Mandatory Travel Insurance	2	4	4	4	5	**5th (19)**	**No**

Deselected Options

5.9 The following options were deselected:

- **Passenger Charge (Option D)** places the obligation on the end-beneficiary (i.e. the passenger) but such an option is likely to be difficult and costly to implement as it would represent a new and separate transaction for passengers which may further confuse passengers in what is already a complex protection landscape. Moreover, such an option largely exonerates airlines from managing risk for which they are best positioned to manage.

- **Licensing reform (Option G)** would incentivise airlines to set aside internal resources for their obligations to repatriate their own passengers and so the option ranks highly on 'efficient allocation of risk' as the airline is entirely managing a risk that it is best positioned to manage. Likewise, such an option is straightforward for passengers as they are effectively absolved from having to cover themselves off this risk. However, this option still presents several potential challenges including:

  – Calibrating the framework so that the timing and scale of reserving of funds does not act as a trigger for insolvency and disproportionally impact an airline that is still solvent
  – The regulatory and administrative costs for both government and the airline of managing such a regime
  – The negative competition effects of such a regime given that it would likely be only possible to impose these requirements on UK-licenced airlines

  Because of the difficulty in creating an optimal set of licensing requirements – it would not be prudent to rely on this mechanism as the only source of protection. However, elements of licencing reform could be used alongside other options to increase risk management (similar to how these risks, which are currently recognised in the ATOL scheme).

- **Mandating travel insurance (Option H)** places the obligation firmly on the end-beneficiary (i.e. the passenger) but will be difficult to set up and costly to implement: By mandating passengers to cover themselves to a minimum level to allow for their repatriation costs to be met means passengers are paying for the benefit they would receive during insolvency and so reduces moral hazard. A passenger insurance solution is also financially efficient when compared to levy solutions and airline security because there is not the 'cost-of-carry' of fully collateralising the risk of a levy and there is a more diversified portfolio of parties to insure when compared to insuring just a small number of airlines (i.e. benefits of a portfolio). However, enforcing all passengers to carry insurance will require the creation of a new validation mechanism that will be costly and complex, and this results in the option scoring poorly on 'deliverability' and 'simplicity for passengers'. It would also significantly increase the administrative cost of the insurers to credit assess each airline for trip based policy and allocate premiums to passengers for every UK departing flight. There is also a question on the appetite of insurers to cover passengers flying on poorly or unrated airlines and whether a lengthy claims process could affect getting liquidity quickly to a coordinating body which further affects the ranking on the deliverability criteria.

Shortlisted Options

5.10 The following two options have ranked the highest on average across the appraisal criteria:

- **Airline Seat Levy (Option C)** is simple to deliver and ensures that those who benefit from protection (airlines and passengers) pay for it. It is the simplest mechanism to pass the risk to airlines which would likely in turn pass the cost to passengers through ticket prices. As such it ranks well on the 'beneficiary pays' and 'allocation of risk' criteria. This mechanism also ranks reasonably well on 'simplicity for passengers' because it would be simple to deliver as airlines would deposit the levy in an escrow account managed by the coordinating body, which would have immediate access to the fund to defray repatriation cost of an insolvent airline. However, this option is not financially efficient in isolation as it does not use the leveraging capacity of 3rd party insurers and a very large levy fund would be required to defray all risk were it to be adopted alone.

Airline Security (Option F) would ensure each airline covers its own failure risk on behalf of its passengers. This option ranks consistently across most criteria because it transfers risk away from government, brings the financial efficiency of an insurance (rather than levy) solution but has less of the deliverability and set-up challenges of a mandatory passenger insurance scheme. However, there is also a question on the appetite of insurers to cover poorly or unrated airlines and whether a lengthy claims process could affect getting liquidity quickly to a coordinating body which further affects the ranking on the deliverability criteria. If this option is only enforced on UK licence airlines, this could have negative competition impacts on them vis-à-vis their non-UK counterparts flying to/from the UK. But, legal advice obtained by the Airline Insolvency Review suggested that this option could be enforced on both UK and foreign airlines, in which case this option wouldn't have negative competition impact on the UK airlines.

5.11 These two shortlisted options represent the options that best address the principles that underpin the Review, but as can be seen, these options contain imperfections. In the next chapter we outline different delivery options for each of these shortlisted options and appraise each further to assess which option represents the most efficient and effective model for improving protection.

6 Appraisal of Shortlisted Options

Overview

6.1 In the previous chapter, a shortlist of two macro options was developed for a potential new mechanism to cover the cost of repatriating passengers stranded by insolvent airlines. These shortlisted macro options were as follows:

- Option C: Airline Seat Levy
- Option F: Airline Security

6.2 In this chapter, these shortlisted options are appraised (using a simple Red, Amber and Green (RAG) rating) against the Review's delivery objectives:

- Delivering an affordable solution to finance the right amount of protection for all passengers (quantitative).
- Applicability of such an approach to all airlines (qualitative)
- Implementation of such an approach with least legal risk (qualitative)
- Developing a managed transition from the current situation to a future scheme (qualitative)

6.3 The aim of this appraisal is to present a balanced scorecard of the different delivery options to inform the feedback requested from the market sounding exercise and the subsequent refining and structuring of options.

6.4 Prior to undertaking the appraisal, the options are further described and in the case of Option C; further disaggregated into sub-options to reflect the different potential charging models for an airline seat levy. The choice of different charging models leads to a different set of trade-offs and should therefore be considered separately.

Further Development of Shortlisted Options

Option C: Airline Seat Levy

6.5 An airline seat levy could take various forms and could vary according to the degree of price discrimination that is applied. The following levy models have been considered:

- **Option C1 – Flat Levy:** This would be a flat charge applied to all airlines and would be an equivalent model to ATOL (which currently charges a flat fee to tour operators on a per passenger basis). This option is the most simple and transparent model and would have the lowest administrative (ongoing monitoring costs) due to its simplicity. However, the major drawback of a flat fee basis is that it makes no assessment of the relative risk of the airline being covered by the scheme and would effectively lead to the cross-subsidisation of financially healthy airlines to weaker ones which would represent a sub-optimal allocation of risk. In isolation, a flat levy does not provide any discretion to airlines which may prefer to provide security to cover their repatriation obligations and so is the most regulatory inflexible approach. Moreover, the levying of a flat charge could be assessed as a tax and

therefore could affect the accounting of the liability of the levy fund with the scheme being treated as 'on-balance sheet' and thus imposing a contingent liability on government.

- **Option C2 – Risk-Based Levy:** This would be a levy charged based on the relative risk of the airline – i.e. healthier airlines would pay less than financially riskier airlines. Such an approach would mitigate the risk of cross-subsidisation between airlines. However, a risk-based levy would entail a more complex set of charging arrangements that would need to be underpinned by ongoing creditworthiness monitoring of the airlines. Calibration of such a charge would need to be done carefully and regularly so as to not unduly create a competitive barrier to entry and competitive disadvantage to smaller airlines.

6.6 Each of these sub-options are appraised against the Review's delivery objectives in the following section and further tested in the market sounding exercise.

Option F: Airline Security Package

6.7 Mandating airlines to pledge security is an efficient option to ensure that the airline is covering the risk of repatriation on behalf of its passengers. However, there are challenges and limitations that need to be specifically addressed in further detail below:

- **Appraising risk of individual airlines versus risk pooling**: Many airlines would seek to provide security in the form of a bond (from a surety provider) or insurance against their failure (from a commercial insurer) or by way of alternative means (i.e. a letter of credit). However, undoubtedly, certain airlines because of their existing financial situation, their track record or just their scale may not be able to access coverage at a reasonable price or not access it at all, particularly if the individual insurer would be excessively exposed to such an airline in their portfolio. As such, although this would be an optimal allocation of risk, it is likely to distort the market between incumbent carriers and might act as a barrier to entry to the sector. As such, a pooling approach to bonding or insuring a group of airlines may need to be arranged. Rather than allowing the risks of each airline to be treated individually (e.g. each airline gets its own bond or insurance or trust account from a different commercial provider), a pooled solution would be that all airlines would purchase this from one designated insurer / bond provider or a panel of providers. An insurance pool is a commonly used risk management approach in the insurance/surety industry whereby there is a gathering of insurance companies for a specific business endeavour, usually when a financial risk is too high for a single company to take on and can only be addressed through shared resources (i.e. there is joint liability). This is an approach already adopted in high-risk insurance markets where insurance on an individual-customer basis is too risky to work on a commercial basis and so insurers have come together to pool resources (sometimes with government reinsurance whereby the government takes a share or specific element of the loss profile) to provide coverage that was hitherto not available in the market.
- In Chapter 8, the structuring around a pooled scheme and its application to airline insolvency is discussed further.

- **Enforcement challenges:** Obligating the provision of security is assessed to be feasible within the operating licence regime that the CAA uses to regulate carriers[37]. As discussed above, the legal advice suggested that this option could be enforced on both UK and foreign airlines, thus balancing competition issues and maintaining a level playing field for all airlines.
- **Monitoring architecture:** The pledging of security and its validity will need regular monitoring and it is important to note that this will create an additional administrative cost on both the regulator (CAA) and regulated (airlines). This is a clear drawback versus levy options (particularly the flat levy).

Appraisal (RAG Analysis) of Shortlisted Options

6.8 The shortlisted options described above have all been appraised below against the Review delivery objectives and the results are presented in the table below.

[37] The Airline Insolvency Review has commissioned DLA Piper to assess the legality of imposing extra licensing conditions on carriers under the current licensing regime. DLA has come to the view that is that there is latitude under EC 1008 for the DfT to create new domestic legislation which:

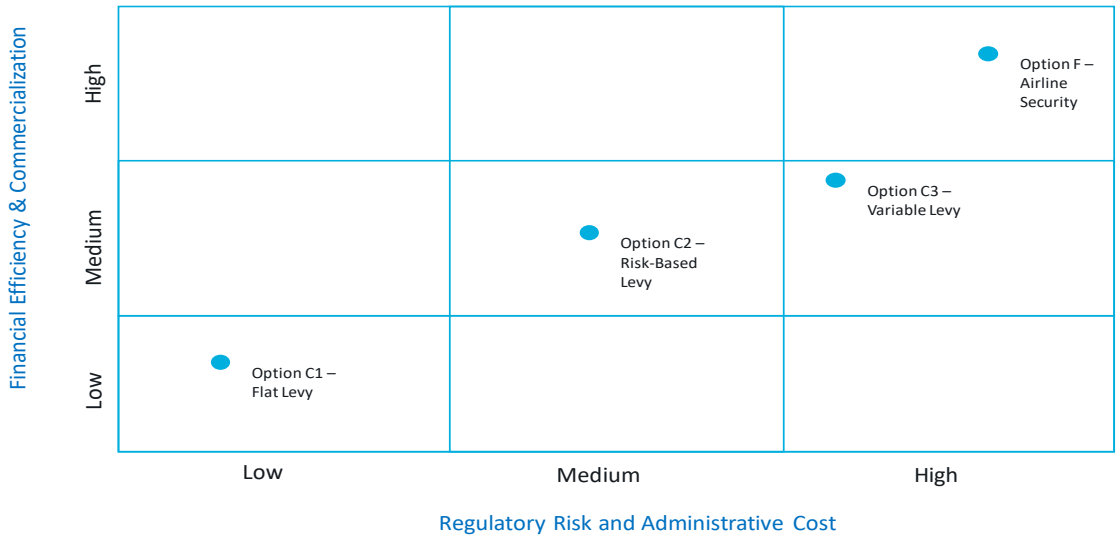
- sets out minimum financial requirements for all UK carriers to satisfy; and / or
- requires carriers to provide the CAA with a repatriation plan, as part of the ongoing assessment criteria to hold a valid operating licence; and / or
- defines financial obligations applicable to air carriers licences in the United Kingdom in such a way so as to provide the CAA with more expansive means by which it can have forward visibility of an air carrier's financial position and provide the requisite protection which might be necessary to implement any repatriation plan.

Table 10 - Appraisal (RAG Analysis) of Shortlisted Options

Option	Applicability to All Airlines	Legal Risk	Transition from current situation to future scheme	Overall RAG Rating and Commentary
Option C1 – Flat Levy	Levy could be applied to any airline operating from the UK	Could be treated as a tax and therefore could be treated as on-balance sheet and expose public accounts to the liability	Levy would need to be consulted upon and a reserving policy agreed. Reinsurance of levy fund would need to be established	Option has minimal regulatory risk and low administrative cost but the solution has only a limited commercial basis (through reinsurance) and liability may be treated as on on-balance sheet. However, like all levy solutions there is financial inefficiency associated with holding high levels of cash.
Option C2 – Risk Based Levy	Levy could be applied to any airline operating from the UK	Limited legal risks but challenges in calibrating the scheme and the costs and challenges of monitoring it on an ongoing basis	Levy would need to be consulted upon and a reserving policy agreed. Reinsurance of levy fund would need to be established	More commercial than the flat levy if accounting treatment can treat as off-balance sheet. Regulatory and administrative costs will be higher because there will be a need to maintain a credit rating system to assess relative risk of airlines and an appropriate levy structure . However, like all levy solutions there is financial inefficiency associated with holding high levels of cash.
Option F – Airline Security	Legal advice received by the Review indicates that security requirements could be imposed on both foreign and domestic airlines	Limited or no legal implementation risk – security products are generally well established in the UK	Amount of security required would need to carefully regulated and a fit-for-purpose monitoring regime set up which will have a significant lead time	Maximises the use of market products and so increases financial efficiency and commercialisation. Will also need a robust monitoring system to be established

6.9 As can be seen from the appraisal table above, the choice of which option best meets the Review's objectives is not deterministic. At this stage, there are essentially many trade-offs between the shortlisted options for which market input is sought (see Chapter 7) and for which ultimately a balanced value judgement will need to be made. The key trade-off is between financial efficiency/commercialisation against and deliverability/low regulatory costs. The figure below maps out these trade-offs.

Figure 13: Option Trade-Offs



6.10 In addition to the trade-offs demonstrated in the figure presented above, the detailed appraisal of these options also indicates that no single option provides a comprehensive solution to covering insolvency risk and all have their individual limitations including:

- **Market capacity and appetite –** a market-based option (i.e. Option F) is going to be limited by the market's appetite and capacity for risk. Very risky airlines may not be insurable and while arrangements like pooling can potentially offset some of these challenges, it is likely that some of the exposure needs management through another party (e.g. a levy fund) taking a share of the risk. This was a view that was tested thoroughly in the market sounding exercise (Chapter 7) and informs the development of the structured options (Chapter 8)
- **Transition** - A further consideration (particularly for levy options) is the availability of funds/finance to cover major losses or to cover losses when the fund balance is building up early in its existence. Reserving/protecting against all possible outcomes (i.e. always being fully funded for any eventuality) is unlikely to be affordable (given the large amount of levy charge needed) nor efficient (given the high cost of carry of holding large amounts of cash-in-hand and foregoing other higher yields). As such, the reserving policy of the fund will likely focus on providing coverage to meet a loss profile that is realistic but not infinite and so if an event occurred that generated losses more than the coverage provided then another party would need to pick up any of that residual risk.[38]If insurers (or commercial

[38] . Under the ATOL scheme, any losses in excess of the balance of the levy fund (the Air Travel Trust)) are picked up by commercial insurers which effectively reinsure the fund and a commercial bank liquidity facility which provides standby financing for when the balance on the fund is low (i.e. the commercial bank is effectively lending against the future cashflow generated by the levy).

banks) cannot cover the entirety of the residual risk then potentially government can also reinsure but would have to do so under the framework set out by HM Treasury on managing contingent liabilities[39]. This framework stresses the need for balance between risk and reward to the government and so will likely require commercial pricing of the risk. Any reinsurance (provided by commercial insurers or government) and a commercial bank facility will therefore incur a cost and this will need to be added on to the levy charge. The need for coverage of residual risk is discussed further in Chapter 7 and Chapter 8.

- **Affordability –** there are likely to be affordability challenges for any standalone option because covering the full envelope of risk is likely to lead to high pricing. This is particularly the case for any levy option which at a minimum will likely require some reinsurance (from either commercial insurers or government) and/or a supporting liquidity facility
- **Regulatory coverage -** some options are only realistically enforceable through regulations but the CAA will only have jurisdiction over UK licenced airlines and so to cover the whole industry, will likely require a combination of options

6.11 The trade-offs and limitations of the options identified above were all tested as in the market sounding exercise which is outlined in the next chapter.

[39]https://assets.publishing.service.gov.UK/government/uploads/system/uploads/attachment_data/file/635939/contingent_liability_approval_framework_guidance.pdf

7 Market Sounding

Overview of Market Sounding Exercise

7.1 Together with GAD and the Airline Insolvency Review team, a market sounding exercise was undertaken with key market participants to assess the current market coverage in the existing regime and test market appetite to cover the cost of repatriation under different funding options. The following market participants participated in the market sounding exercise:

- Towergate Insurance;
- WorldPay;
- Direct Line Insurance;
- Willlis Towers Watson;
- UK Finance;
- Lloyds (acquirer and issuer); and,
- Barclays.

7.2 The feedback from the market participants is outlined in sub-sections below:

Feedback from Market Sounding

Focus on Repatriation

7.3 The consensus from market participants suggested that the refund risk of insolvencies could be (and is) covered through credit card issuers and travel insurance so on the whole validated the approach of the Review to focus on repatriation risk. This incentivises credit card issuers to actively manage their risk, which in turn can be 'priced-in' through to airlines and can incentivise airlines to strengthen their balance sheets. In this sense the commercial market is already undertaking risk management. However, a number of participants did indicate that there are currently significant 'headwinds' in the market – including lower economic growth and a weaker currency which might put significant stress on airlines in the near future. In this situation, issuers will be stretched in their risk management activities and might require more security with ultimately the last resort being to stop the receipt of payments

7.4 In the current regime, 'merchant acquirers' have difficulty in assessing the risk posed by airlines but can manage the risk by mechanisms such as withholding customer payments from airlines and charging more for provision of services. Due to the difficulty in assigning a value to the claim of potential future refunds, acquirers indicated that more comprehensive credit card cover for refunds would be difficult to implement, and as such would create problems for airlines which would find it expensive to get a merchant acquirer.

7.5 There is also a risk that due to the introduction of new payment methods without charge back protections (for example through Payment Initiation Service Providers, such as PayPal) , the level of refund protection may decline going forward with increased fragmentation in the payment market. Increases in the proportion of payment transactions via such methods means

that the percentage of passengers with refund protection will also decline in future. There is, therefore, a need to assess how refund protection develops in future.

Capacity and Appetite in the Insurance Market to Cover Repatriation Cost

7.6 Market respondents indicated that the analytical approach adopted by GAD to calculating and quantifying insolvency risk was robust and indicated that they would use similar methods in appraising credit risk in the sector.

7.7 The respondents indicated that there is limited capacity in the insurance market to cover repatriation cost of insolvent airlines as the insurers are reluctant to cover both large (financially healthy) and smaller (less financial healthy) airlines due to over-exposure risk and high default risk respectively. Furthermore, the traditional types of insurance will not deliver effective cover as the traditional policies give the third-party insurer the right to cancel insurance at any time without any notice, thereby leaving a potential gap in protection.

7.8 A funding mechanism based solely on a flat levy would also be difficult to implement as healthy airlines might object to subsidising less financially healthy airlines, if sufficient risk discrimination mechanisms were not put in place.

7.9 Therefore, a number of market participants indicated that a hybrid funding mechanism is required such that a fund is built from a risk-based levy to meet the 'first loss' (or excess), while the 'second loss' is taken up by insurance products. However, the entire 'second loss' risk cannot be covered by any individual insurance provider as the whole risk is localised in one industry (aviation), and any individual insurance provider does not have appetite to cover it, even if the exposure is fairly evenly spread among airlines.

7.10 As such, for any hybrid option to be commercially successful and fully cover 'second loss' risk, it should be spread and covered by a pool of insurance providers, such that each insurance provider in the pool covers part of the 'second loss' exposure.

7.11 The market also indicated a preference for any mechanism to be accompanied by the kind of licensing requirements that are already in place under the ATOL scheme whereby the CAA can step in to reserve cash and to manage potential repatriation exposure. This was seen as an important risk management tool that can enhance any mechanism rather than a mutually exclusive option, but respondents did recognise that the reach of such requirements is likely to be limited to UK-licenced airlines only.

7.12 The market sounding exercise also confirmed that the Financial Conduct Authority (FCA) would effectively forbid the mandating of travel insurance under their regulatory rules. Likewise, there was general consensus that individual passenger insurance does not provide an immediate source of liquidity to meet the cost for a repatriation exercise due to its slow claim process because insurers only validate that consumers are eligible for cover at the point of need. Furthermore, travel insurance is only available to UK residents who have been resident in the UK for six or more months and have bought return ticket at the time of departure. This validated the deselection of this option during the shortlisting exercise.

Key Conclusions

7.13 The key conclusions from the market sounding exercise are as follows:

- Refund risk is generally well covered by the existing protection regime but could come under pressure due to economic and airline industry uncertainty and due to the growing use of alternative payment risks. As such the design of any new funding mechanism, while

focusing initially on repatriation risk may need to be future-proof to evolve into also covering refund risk

- The market warned against a flat-based levy as this will likely face opposition due to the potential cross-subsidisation from healthy airlines to financially weaker airlines
- The insurers consulted are interested in continuing to support the market but there are capacity and appetite concerns due to over-exposure of larger dominant airlines and default risk of smaller weaker airlines. As such, there was general consensus that only a pooled insurance approach could realistically systematically provide high level of risk coverage and this would likely have to be backed up by a levy fund or government reinsurance (i.e. a structured solution)
- Any structured solution should be combined, if possible with licensing requirements, akin to that available under the ATOL scheme but it is recognised that these are only likely to be enforceable on UK-licenced airlines

7.14 In the following chapter, this feedback informs the development of a range of structured options that could be taken forward to increase the level of protection for repatriation risk.

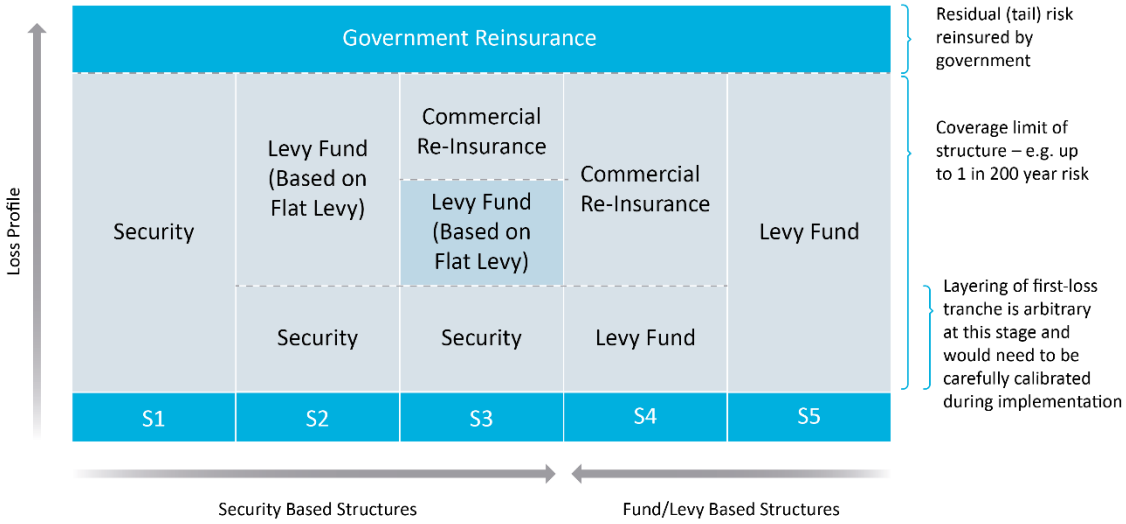
8 Option Structuring and Optimisation

Proposed Structures

8.1 The options appraisal and market sounding exercises indicated that any single option is unlikely to provide an optimal and affordable amount of coverage of repatriation risk. As such, a combined (or hybrid) approach is likely required whereby risks are shared across different parties so as to ensure that market providers of protection are 'crowded-in' to the mechanism and therefore increase the commercialization of the mechanism and minimises government intervention.

8.2 In the figure below, a range of illustrative structures is outlined. These structures differ on whether the first-loss of any structure is taken by either a levy (as per Options C1-C3) or through an airline security (Option F).

Figure 14: Structuring Options



8.3 The table below describes each of the structures in further detail.

Table 11 - Description of Structuring Options

Structure	Description	Example
S1 – Full Security + Government reinusrance	Standalone option where airline has to provide security up to the required level of coverage to protect against its own failure. If losses exceed coverage of the security then government reinsurance meets losses	UK Rail Franchise Performance Bonds[40]
S2 – Security + Levy Fund + Government reinsurance	Airline must provide security to a specified level to partially meet required level of coverage. If losses exceed the pledged security then a levy fund is then called. If losses exceed coverage of the mechanism then government reinsurance meets losses	ABTA[41]
S3 – Security + Levy Fund + Commercial Reinsurance + Government reinsurance	Airline must provide security to a specified level to partially meet required level of coverage. If losses exceed the pledged security then a levy fund is then called (on the second-loss). The levy fund is also reinsured to provide third-loss cover and reduce the level of levy required. If losses exceed coverage of the mechanism then government reinsurance meets losses	PoolRe
S4 – Levy Fund + Commercial Reinsurance + Government reinsurance	Airlines pay into levy. Levy covers first losses and is reinsured by commercial insurers to provide second-loss. If losses exceed coverage of the mechanism then government reinsurance meets losses	ATOL
S5 –Levy Fund + Government reinsurance	Standalone option where levy fund provides full coverage. If losses exceed coverage of the security then government reinsurance meets losses	Financial Service Compensation Scheme (FSCS)[42]

8.4 The following are additional points and assumptions to consider on the definition of the structured options:

[40] The current franchising system includes a number of safeguards to ensure that the train operator will remain solvent and cannot walk away from the contract without a monetary penalty. As part of these contracts, owning groups may be required to give 'parental guarantees' to Government that they will stand behind losses incurred by the operator to a predetermined level. They must also provide performance bonds and subordinated loan facilities that are used to cover the Department's costs should the operator terminate the agreement and need to step in to rescue the franchise

[41] The association of British Travel Agents (ABTA) provides traveler protection for member travel agents of the scheme. members must pay membership dues which help fund a reserve account to fund losses from travel agent failure but alongside the membership dues – the member travel agent must pledge security to ABTA in the form of either: cash; underlying bond (i.e. bond backed by a property interest); or on-demand bond. Unless the prospective member can provide this security, they are not able to join the scheme and therefore benefit from being part of a standard-setting trade body that has a 'halo-effect' for holiday-makers

[42] The FSCS is the UK's compensation fund of last resort for customers of authorized financial services firms. It pays compensation if a firm is unable, or likely to be unable, to pay claims against it. This is usually because it has stopped trading or has been declared bankrupt. The FSCS is funded by levying financial services firms operating across eight different classes of services (e.g. deposits, insurance, pensions etc.). The Prudential Regulation Authority (PRA) sets funding envelopes for each class and then firms contribute proportionally based on units sold.

- In the summary results of the GAD analysis (presented below), it was assumed that insurance (or bonding) in any of the structures would be provided on an individual (one-to-one basis). However, when structuring and implementing any of these structures in detail, the insurance market would be solicited to assess whether it would be more efficient to provide coverage on a pooled basis as described in Chapters 6 and 7;
- . Licensing reforms (Option H) were deselected as a standalone funding/financing option but some elements could be part of the risk-management framework of any of the above structures to help reinforce and protect the mechanism and ensure airlines are in a position to provide the necessary cash required to cover repatriation.

Quantitative Analysis of Structuring Options

8.5 GAD has undertaken a quantitative assessment of the structures outlined above. The approach taken and assumptions applied are provided in detail in their Report – *Airline Insolvency Review – Risk Analysis – Phase 2*.

8.6 The table below summarises the results of GAD's quantitative analysis.

Table 12 - Quantitative Analysis of Structuring Options

Option	Cost (£) per passenger								
S1 Security	**Average**			**Min**			**Max**		
Total Cost	0.54			<0.01			11.04		
Cap on security payout as proportion of average monthly cost exposure	50%			60%			70%		
S2 & S3 – Security Fund & Reinsurance	Average	Min	Max	Average	Min	Max	Average	Min	Max
Security cost	0.27	0.01	5.53	0.32	<0.01	6.51	0.36	0.01	7.51
Levy cost	0.03	0.03	0.03	0.03	0.03	0.03	0.02	0.02	0.02
Reinsurance cost	0.03	0.03	0.03	0.03	0.03	0.03	0.02	0.02	0.02
Total cost	0.33	0.07	5.59	0.38	0.06	6.57	0.40	0.05	7.55
Fund size return period	1/50			1/90			1/200		
S4 & S5 – Levy Fund & Reinsurance	Average			Average			Average		
Levy cost	0.06			0.07			0.07		
Reinsurance	0.10			0.07			0.02		
Total cost	0.16			0.14			0.09		

8.7 The key findings from the GAD quantitative analysis can be summarised as follows:

Levy Based Options

- A levy fund protected by reinsurance (S4 and S5) from either government and/or a commercial provider would provide the lowest cost structure – costing between 9 pence and 16 pence per passenger.

- The higher the coverage (or return period) provided by the levy fund (i.e. the greater the size of the levy fund), the lower the overall cost because less reinsurance (which is assumed to be priced at market rates) is required
- However, it is important to note that the cost of holding cash in the fund (rather than investing it elsewhere) has not been calculated by GAD and so the 'true cost' of the levy options is higher due to the inefficiencies created by this 'cost of carry'

Security Based Options

- Placing the obligation entirely on airlines to provide security (S1) is the most expensive option with an average cost per passenger of circa 54.
- This cost is based on airlines seeking coverage on an individual basis (rather than pooled basis). If a pooled approach was pursued, GAD has estimated that this cost could be reduced significantly
- Using a levy fund to provide a second-loss (S2 and S3) will significantly reduce the overall cost as this will allow the exposure of third-party providers (e.g. insurers/bond providers) to cap their losses. This can reduce the average cost to around 33 pence per passenger
- The higher the cap on losses (i.e. the % of losses to be covered by security vis-à-vis the levy fund), the higher the annual cost. For example, if airline security is capped at 70% of losses then the average cost per passenger is 40 pence per passenger compared to 33 pence per passenger if airline security is capped at 50% of losses. This is to be expected given the higher cost of capital of security providers.

9 Recommendations

Overview and Recommendations

9.1 We developed an initial universe of options for mechanisms to pay for passenger protection alongside consideration of what the scheme should cover and how. As highlighted previously, all possible options were considered, including those seemingly ruled out by the Review's Terms of Reference and then adopted a filtering process to narrow them to the most appropriate ones.

9.2 This filtering was a five-step process that involved testing the options qualitatively against the Review's Terms of Reference; then against the Principles set out in the Call for Evidence and Interim Report; quantitative assessment; testing them with market participants; then deciding on how to structure the ideal model to achieve the right amount of protection at the most efficient price.

9.3 The options were narrowed to a final two using this approach:

- **Airline seat levy:** Airlines would be levied on a per seat basis for seats sold departing the UK and would be responsible for remitting the levy into a fund, built up to a certain amount. The fund could be used to finance bank facilities or insurance to pay for repatriation operations. The levy could be flat, risk-based, or varied in some other way.
- **Airline security:** Airlines are required to provide an acceptable form of security that can be called on in the event of their insolvency and can provide the necessary liquidity to manage some or all of their failure costs without a lengthy claims or loss adjustment period. A range of different forms of security (e.g. bonding, trust account or insurance) could be acceptable to the coordinating body.

9.4 There are several different ways either of the options could be imposed and/or structured which would vary the cost, protection level and administration costs. The two could also be combined to balance their differing benefits. We considered how to best structure the mechanism by market testing each option.

9.5 Engaging with market participants indicated that a hybrid funding mechanism could be developed that would see security provision combined with a fund built up from an airline seat levy taking either first or second loses. This was seen by market participants as the best way to crowd-in commercial sources of protection (and thus minimizing government intervention) but within the constraints, in terms of appetite and scale, of the commercial market for airline insolvency risk.

9.6 Of the structures analysed, Option S3 was considered best able to achieve the objectives of the Airline Insolvency Review of increasing the *commercialisation* and *minimizing government intervention* of insolvency protection. The structure was considered most effective in crowding-in market participation and allocating risks to those parties best positioned to manage them, while simultaneously offering a largely affordable and comprehensive level of protection against repatriation risk that provides a step-change from the status quo. Moreover, the risk retained

by government would be provided on a commercial basis. In summary, the S3 would achieve the following:

- Airlines have the choice whether to access the commercial market for protection or to pay a flat levy to provide the necessary collateral for the mechanism – this allows them to exploit any competitive advantage associated with their relative financial strength
- Structure can crowd in financial institutions through a potential pooling arrangement for the provision of security
- Airline security and the flat levy would be enforced on UK and foreign airlines
- Government is called as last resort and is rewarded for the risk it takes on commercial terms.

9.7 The figure below details this structure:

Table 13 - Preferred Structure - S3

Third loss	Re-insurance • either commercial, or if market capacity was unavailable, provided by government at commercial rates
Second loss	Fund capitalised by a flat seat levy • Airlines would pay a flat levy to build a fund up to a specific amount fund would be used to finance insurance products (third loss), meeting ongoing premiums and any excess payments as well as providing protection up to a specified loss level
First loss	Individual airline security • the Coordinating Body would publish a list of acceptable security products, and determine the appropriate level of security to be provided by airlines

Additional Considerations

Licensing Reforms

9.8 The kind of Licensing Reforms that were considered under Option F should not be mutually exclusive to the proposed structure (S3). Instead, as we described in Part 1 of this report, some of these interventions could be part of a wider reform effort to ensure airlines are much more proactive in managing their own failure risk in advance of an insolvency event thus further reducing the risk of a disorderly wind-down and in turn preventing unnecessary calls on the proposed structures. Such an approach is in line with the kind of recovery and resolution planning which have become more commonplace in strategically important industries (e.g. banking, large government outsource contracts) where an insolvency can have a very material impact on customers and where at least a temporary continuation of service is required. ATOL has long used similar licence levers to reduce the probability and impact of an airline failure and

to reduce the risk of ATOL being called and it would seem reasonable to do the same for this proposed mechanism.

Organisational and Governance Structure

9.9 Although beyond the scope of this study, a key question for further consideration would be how the proposed mechanism would be governed and managed in practice. A range of different organizational structures would need to be analysed in detail but at a macro level, there are perhaps three broad choices to consider:

4. Integrating structure into the existing governance arrangements provided by ATOL
5. Setting up a separate trust and parallel scheme to ATOL to be managed by CAA
6. Setting up a new entirely arms-length company to manage the mechanism (e.g. such as FloodRe)

9.10 As already mentioned, the integration of the proposed structure into ATOL would likely be problematic in the short-term as ATOL's coverage is broader in that it provides coverage for refunds and is the de jure scheme that ensures that the UK follows the EU's Package Travel Directive. The mechanism considered here is much more focused on the narrower task of repatriation. However, in the longer-term, such an approach could be considered, especially if there is appetite from government and the market to extend coverage to refunds which would create greater symmetry between the two mechanisms.

9.11 Setting up a separate trust (to oversee the levy fund) would likely be the most expeditious option given the legal and governance framework provided by ATOL is largely in place alongside the extensive delivery and management experience of the CAA. However, a key issue remains the accounting treatment of ATOL which the ONS in 2012 classified as a government entity and thus its liabilities are added to the government's accounts and is viewed as 'on-balance sheet' for a range of reasons including the treatment of the APC (i.e. the levy element of ATOL) as a tax and the government's (particularly the Secretary of State) predominant role in the governance structure. As such, if the government wished to commercialize this mechanism from inception then a number of amendments would need to be made to the governance structure and these would need to be further tested with the ONS.

9.12 Setting up an arms-length company, whether it be classified as a public corporation or as a private company (such as FloodRe) would potentially move the proposed mechanism away from the government's accounts. However, by necessity, this will need government representation in the governance structure to be minimal (and likely not controlling) and this reduction in control may not be acceptable for government for what is covering a direct duty of care of the government to repatriate a stranded citizen. Moreover, it may not be practical in that unlike arrangements such as PoolRe and FloodRe where the core transactions are business-to-business (B2B) – i.e. commercial insurers buying off a specialist reinsurer, the transaction here is more complex with the airline (effectively on behalf of its passengers) buying protection directly and doing so on a likely legally mandated basis. The company would also potentially have to itself be commercially viable if it was to be treated as off-balance sheet, particularly around providing the capital to establish and pre-fund itself and this in turn would depend upon market appetite.

9.13 In all cases, a detailed market solicitation exercise would have to be undertaken to understand the appetite and capacity for a market based organizational structure. And, in parallel a wider analysis of the determinants and impact of the accounting treatment of different structures would need to be carried out.

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