No impact on lessor credit from UK court ruling

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The UK High Court ruling in favour of aircraft lessors under war risk insurance policies for assets stranded in Russia establishes a precedent that could expose insurers and reinsurers to several billion dollars in cumulative liabilities. However, the judgment favouring the six lessors will have no direct impact on their credit profiles, Morningstar indicates.

For those lessors with still active claims under their war risk contingent insurance policies, the judgment "may provide confidence in the potential future outcome" of their cases, despite some being filed in other jurisdictions, it adds.

Nevertheless, any collection, timing, and amount of any further judgments involving the lessors is uncertain.

“While the defendants have been granted leave to appeal, the initial judgment sends strong signals to the insurance market regarding the broad interpretation of war risk clauses and the insurability of politically driven asset seizures. This introduces significant uncertainty in loss projections, legal strategies, and future policy wording for aviation insurers and Lloyd's syndicates,” says Morningstar.

The ruling also confirmed that the losses caused by the seizure of aircraft and engines in Russia following the invasion of Ukraine must be covered under war risk policies rather than under all risks policies.

Morningstar indicates that earnings in the second quarter will benefit from the recoveries obtained under the judgment, given that receipt of the proceeds is expected by no later than 2 July.

However, since the onset of the Ukraine conflict, it has treated the financial impacts of this event as nonrecurring items and thus excluded them when calculating lessors' core earnings.

The firm excluded more than $8 billion of write-offs incurred in 2022 that were associated with aircraft and engines that remained in Russia and Ukraine. It also excluded more than $3 billion in recoveries that lessors have realised from insurance-related settlements related to these specific assets.

“In our view, disciplined risk management has always been a pillar of those lessors with stronger credit profiles. This legal judgement supports our view that lessors have been thoughtful in addressing the various potential risks faced when leasing assets across the globe to largely non-investment-grade customers operating in a wide range of jurisdictions with varying strengths in legal rights for lessors,” it adds.

A "key component of risk management" has been lessors’ use of contingent insurance to cover potential gaps in their airline customers' insurance policies.

While lessors typically require airlines to contract primary insurance policies with certain specific coverages, lessors will also purchase separate contingent policies, which can be triggered if the coverage under the primary policy is insufficient or the latter has been rendered invalid.

Higher prices?

The UK court judgement compels war risk and all risks insurers to "reassess and likely increase" technical provisions. Entities with high exposure but insufficient reserving buffers—particularly some Lloyd's syndicates—could experience pressure on solvency ratios.

The case also highlights the importance of clarity in policy language. Insurers that adopted aggressive denial postures or failed to engage in good faith negotiations may face reputational damage. As a result, future underwriting relationships with aviation lessors and financiers could be impaired.

As such, insurers will "likely tighten definitions and exclusions" related to political and sovereign risks.

"We expect more limited contingent coverage or higher premiums for war-related endorsements. Some insurers may withdraw from offering contingent war risk coverage for leased aircraft or limit geographic exposure. This could lead to capacity constraints and increased pricing in the aviation insurance and reinsurance sectors," it adds.

Although this is an English court decision, the ruling is likely to influence courts and tribunals globally, particularly in jurisdictions that apply common law principles.

Aircraft lessors operating in other jurisdictions may gain leverage in ongoing disputes.

Shareholder returns

With year-end 2024 balance sheet leverage already at the "lowest level in the last five years", partially due to reduced funding requirements given new aircraft delivery issues at the original equipment manufacturers (OEMs), Morningstar expects that many of the larger lessors will use the proceeds from the judgements to return capital to shareholders and owners rather than for the repayment of debt.

For those lessors without order books with the OEMs, it believes proceeds from potential future insurance-related judgements and/or settlements will be used to acquire aircraft in the secondary market to support incremental growth.

The court has granted war risk insurers leave to appeal the decision. A successful appeal could narrow or reverse certain aspects of the liability findings, particularly regarding the interpretation of policy exclusions.

However, absent a strong overturn on appeal, the ruling's broader legal and financial implications will persist.

“We expect most affected insurers to announce updated loss guidance and reserving decisions over the coming quarters. Meanwhile, reinsurers may experience secondary impacts through direct participation and retro layers. With the Court's ruling favouring the lessors, the legal and financial implications of the Russia-related aircraft insurance saga have been reshaped by confirming a broad interpretation of war risk perils and affirming the enforceability of lessor policies against insurers.”

Morningstar will continue to monitor the developments, including potential appeal proceedings and upcoming trials related to operator policies, to assess the longer-term consequences for the insurance and aircraft leasing industries.

