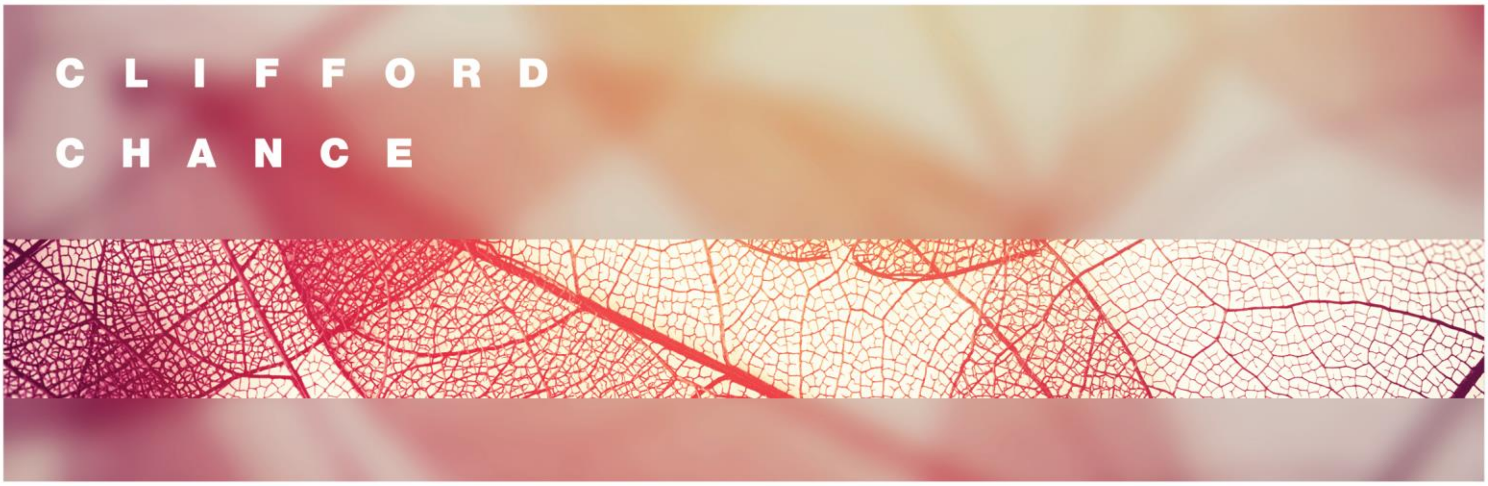

LIBOR TRANSITION AND AIRCRAFT LEASE FINANCINGS

This is the third in our series of briefings[1] examining the implications of LIBOR cessation for aviation transactions. Since summer 2020 and in the midst of the ongoing Coronavirus pandemic, there has been considerable and laudable progress by regulators, national working groups and institutions on LIBOR transition and broader global benchmark reform[2]. The ARRC's recommendation that USD LIBOR is replaced by SOFR brings some welcome clarity for the industry, given that most cross-border aircraft transactions are USD denominated. However, remaining uncertainties and divergence between products and markets mean that the work to ensure a smooth and balanced transition for commercial parties is only just beginning. This briefing summarises aspects which we consider crucial for industry participants to address in their internal planning, documentary due diligence and negotiations with counterparties.

Key issues

- End of a common benchmark rate for USD, GBP, Euro, CHF and JPY
- Global IBOR reform is progressing at different speeds across jurisdictions
- Product and market divergence
- Parties may elect different options for replacement rate triggers, RFR methodologies and documentary approaches
- Different SOFR forms and credit spread adjustment terms
- Loan and lease administration
- Hedging arrangements and operating lease financings
- Legacy transactions

Currency and product divergence

While the international consensus is that existing LIBOR rates should be replaced by risk-free rates ("**RFR**"s), independent working groups in the jurisdictions of the major currencies for which LIBOR is provided have taken responsibility for developing the replacement RFR for their domestic currency. This means there will no longer be a common benchmark rate for different currencies, as currently available through LIBOR for USD, GBP, Euro, CHF and JPY.

As airframes and aviation engines are USD valued assets, many aircraft leases and loans are USD denominated and use USD LIBOR as their benchmark rate (expressly, in the case of a floating rate loan or lease; or, for leases with fixed rentals, implicitly within the underlying lease rate calculation). We anticipate that specialist aviation financiers and operating lessors will follow the USD syndicated loans market in adopting SOFR. This undoubtedly simplifies LIBOR transition for the aviation market but lenders and lessors

1 July 2019 "LIBOR and Operating Leases II" and June 2018 "LIBOR and Operating Leases"

2 Our September 2020 briefing "LIBOR and the syndicated loans market – milestones and documentation" provides a helpful summary

should be sensitive to the likelihood that airlines with domestic currency ticket sales, debts and other non-USD denominated cashflows will still be formulating their entire LIBOR transition policy, including for currency hedging arrangements.

The position may be further complicated where their domestic currency is pegged to the US dollar but the timing of any IBOR reform in that jurisdiction is not aligned with USD LIBOR transition. In other cases, the relevant benchmark rate for a currency may be continuing, as is the case with EURIBOR (as distinguished from Euro-LIBOR) which is frequently used for Euro-denominated loans and other products.

The derivatives, loans and bonds[3] markets have also diverged in their approaches to calculating replacement RFRs and to setting the timing and mechanics for such replacement, with differing optionality within the relevant documentation. We focus below on selected examples of this fundamental variance in the context of USD LIBOR lending products and linked hedging.

Milestone dates include

- 1 October 2020 – re. inclusion of conversion terms for new GBP LIBOR loans; and use of updated hardwired fallbacks for new USD LIBOR syndicated business loans
- 25 January 2021 - ISDA IBOR Fallbacks Supplement and Protocol effective date
- 30 June 2021 – new issuances of loans and derivatives to cease using USD LIBOR
- 31 December 2021 – target end date for conversion of LIBOR referenced loans
- 30 June 2023 – proposed extension for USD LIBOR publication by IBA

Calculation conventions and market documentation

The derivatives market, as represented by ISDA, is the most progressed and offers the least optionality, with ISDA's IBOR Fallbacks Supplement and Protocol[4] taking effect on 25 January 2021. The Supplement revises the 2006 Definitions with a suite of replacement rate (fallback) provisions and prescribed RFRs for specified IBORs. Any new transaction incorporating the 2006 Definitions entered into from 25 January will automatically implement the Supplement terms, unless expressly "switched off" by the parties. The Protocol allows parties to adhere to the fallback terms for a broad range of existing transactions, from that date.

The Sterling Risk-Free Reference Rates Working Group (the "**Sterling WG**") for SONIA loans (SONIA being the recommended replacement rate for GBP LIBOR) has recommended that, from 1 October 2020, any new and re-financed LIBOR referencing loans include "*clear contractual arrangements…to facilitate conversion…through pre-agreed conversion terms or an agreed process for renegotiation*". Accordingly, the LMA has published exposure draft "Rate Switch Agreements", which reflect the conventions for SONIA loans recommended by the Sterling WG. Although the Rate Switch Agreements set out provisions for all currencies in a multicurrency facility to reference RFRs based on the conventions recommended by the Sterling WG, the LMA notes that market participants will need to decide whether this is the correct approach for currencies other than sterling.

The Rate Switch Agreements may be used for any IBOR referenced loans and provide for an agreed conversion of the loan interest reference rate from an initial term rate to a compounded RFR, following a relevant trigger event. There is an in-built backstop date for the rate switch which parties may specify and for LIBOR, this should not be past 31 December 2021, in light of the FCA's position.

Individual market participants operating in the European syndicated loans market may choose to adopt these terms (and whether to amend them), including the conventions, in their lending documentation. As an alternative,

[3] This briefing does not consider LIBOR reform in the bonds market. Refer to the IBOR Transition and Risk-Free Rates Topic Guide on our website for further client publications

[4] Refer to our October 2020 briefing "ISDA IBOR Benchmark Fallbacks Supplement and Protocol: key considerations" for details

lenders may elect to use the LMA's replacement of screen rate clause for facility agreements, which may be supplemented by a set of terms outlining the parties' commercial agreement on the replacement RFR(s)[5]. This spectrum of approaches reflects the Sterling WG's above recommendation.

In August 2020, the ARRC published updated "hardwired" fallback provisions for use with business loans. The ARRC has recommended using these provisions for new *syndicated* business loans after 30 September 2020 and for new *bilateral* business loans after 31 October 2020. The ARRC is further recommending that, from 30 June 2021, US banks enter into new syndicated loans referencing SOFR at the outset. The LSTA has produced Concept Credit Agreements reflecting the ARRC recommendations.

Each organisation presents SOFR and any credit spread adjustment differently. For example:

- ISDA calculates a term adjusted rate, by compounding daily SOFR in arrears over an accrual period that matches the relevant LIBOR tenor. A "lookback" of 2 business days applies to the calculation period.
- The ARRC provides a hierarchy of rate options for syndicated business loans, starting with Term SOFR (which is not yet available[6]), then daily simple SOFR and finally, an alternative rate selected by the borrower and agent. The ARRC recognises that, instead of daily simple SOFR, parties may wish to use a compounded form and it allows for different methodologies (daily compounded in arrears or alternatively, using SOFR averages to calculate a compounded in advance rate).
- The LMA Rate Switch Agreements, following the Sterling WG recommendations, transpose the SONIA methodology for USD loans converting to SOFR, with SOFR compounded in arrears[7]. Drilling down, this is drafted as a non-cumulative compounded rate, whilst the ARRC starting point is to compound the balance[8]. The Sterling WG recommends a 5 business day lookback period, compared to ISDA's 2 business days. As mentioned, the over-arching principle is that market participants should decide if the SONIA methodology should be used for USD loans.
- The ARRC has recommended syndicated business loans follow ISDA's credit spread adjustment for USD LIBOR switching to SOFR, which is the historic median difference between the relevant USD LIBOR tenor and SOFR over a 5 year lookback period. The Sterling WG approach is to defer to individual parties' commercial agreement on the methodology and also on the timing of fixing of any credit spread adjustment and whether the spread is applied a single time or for each interest period.

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5 The LMA issued its Revised Replacement of Screen Rate Clause in August 2020 and the RFR Terms in November 2020

6 Term SOFR will depend on sufficient liquidity in the SOFR derivatives market developing, as well as the appointment of an administrator and IOSCO certification.

7 There are 2 separate Rate Switch Agreements with differing rate calculation methodologies: Lookback *without* Observation Shift and Lookback *with* Observation Shift. On 28 January 2021, the LMA published exposure draft documentation for multi-currency compounded rate /term rate loan facilities which contemplate that *from the outset*, compounded RFRs will be used for USD, GBP and CHF interest amounts (using the Sterling WG Conventions) and EURIBOR will be used for Euro interest amounts, with an option to allow the automatic replacement by compounded €STR.

8 For daily compounded SOFR in arrears, the LSTA has published a Concept Credit Agreement with "compound the balance" terms and latterly, a separate Concept Credit Agreement with "compound the rate" terms.

Finally, the APLMA has published two discussion draft USD SOFR facility agreements for Asia-Pacific market participants to consider: while the drafting style is more akin to the LMA facility documentation and the conventions are based on the Sterling WG's recommendations, the prevalence of USD loans in the region means that the respective drafts contemplate daily simple SOFR and compounded daily SOFR, reflecting the ARRC approach.

Parties should carefully consider which SOFR methodology they wish to follow and, ideally, seek to align their selection across the relevant transaction documents. For aviation banks, which terms to use may be influenced by whether the specific lending transaction involves an offshore USD syndicated loan involving European, Asia-Pacific or Middle Eastern lending institutions, as distinguished from, for example, a domestic USD loan provided by and primarily sold to US banks. Typically, parties have used LSTA forms for NY law governed aircraft loans and LMA forms for English law loans but they may need to be flexible on the replacement rate provisions, including the conventions to adopt.

Operating lessors may have more flexibility, as they will be able to formulate their own contractual fallback provisions for leases, including the SOFR or other RFR calculation methodology, to be negotiated with their airline customers. However, it is paramount that they review any linked financing agreements, including any hedging documents, to mitigate against any mismatches between replacement rate definitions, triggers and other payment related provisions, such as business days. They should also be mindful of the tradability of their leases, especially where potential buyers are subject to financing requirements.

Other commercial matters

In addition to fundamental replacement rate methodology and mechanics, parties will need to negotiate commercial matters, such as the application of any break funding concept and market disruption terms in relation to the RFR, once activated for the relevant loan or lease.

Loan and lease administration

Interest payment calculations for individual loans will invariably require more administration by the agent or lender(s) than LIBOR referenced loans, e.g. as calculating compounded SOFR involves daily computations and there will be no equivalent screen rate for the relevant interest period. Notably, the ARRC acknowledges that certain conventions may not be administratively feasible for institutions to apply. Aviation financiers and operating lessors will need to ensure they have sufficient operational capabilities for RFR calculations and related payments, including early termination payments and other unscheduled amounts.

Timing and hedging considerations

Market participants will be aware that on 30 November 2020, the LIBOR administrator, IBA, announced its intention to continue publication of USD LIBOR (for overnight and 1, 3, 6 and 12 month settings) until 30 June 2023, subject to consultation. This extension should allow many legacy USD LIBOR loans to mature, although aircraft loans and other asset financings with, for example, 10-12 year tenors may not benefit from this. Regulatory support of the proposal is predicated on the market continuing to transition away from

LIBOR ahead of end-2021 by entering new loans referencing an alternative rate or with clear contractual fallbacks.

In particular, US bank regulators have indicated that entering into new contracts referencing USD LIBOR after 31 December 2021 would create safety and soundness risks.[9] Regulators recognise that there may be circumstances when it might be appropriate for a bank to enter into new USD LIBOR contracts after such time, however, these are limited, for example, novations of USD LIBOR transactions executed before 1 January 2022 or transactions that reduce or hedge the bank's or its client's USD LIBOR exposure on contracts entered into before 1 January 2022. Regulators have also acknowledged that US banks may select a replacement reference rate other than SOFR, if appropriate to their specific circumstances.

While the proposed extension offers valuable breathing space for lenders and borrowers, parties should consider the potential consequences. For example, a lessor may (through an SPV entity) enter into a USD LIBOR interest rate swap with a bank on 1 February 2021 which implements the ISDA IBOR Fallbacks Supplement, as part of its fixed rate funding arrangements for the acquisition of a portfolio of operating leases. Under the Supplement, the swap floating rate will switch to the defined SOFR fallback rate upon actual cessation of USD LIBOR or, if earlier, when the USD LIBOR rate becomes unrepresentative (pre-cessation event). However, the credit spread adjustment will be fixed when that cessation event or pre-cessation event is announced, which will likely occur earlier. Individual parties may be reluctant to lock in to value transfer terms over 2 years ahead of any actual rate switch, during which time interest rates may move to either party's detriment. On the other hand, from an operational viewpoint, if the spread adjustment is fixed sometime in, e.g. mid 2021, this would assist institutions in their calculations and provide certainty to the USD loans market.

The lessor, as borrower, should ensure that its loan replacement rate provisions are drafted consistently with the swap or agree close-out rights with the swap bank to protect itself (and/or the structure) from significant payment mismatches. Negotiations are likely to be more complicated in respect of the underlying operating leases, if airlines do not feel compelled to link the lease rate terms to any related financing obtained by the lessor. Lessors with structured asset-backed portfolio financings and their financiers are advised to review those portfolio covenants which assume a specific funding rate or which may otherwise be affected by a rate switch in any of the transaction documents, including collateral valuation provisions.

Legacy transactions

We have concentrated on addressing LIBOR transition issues for new transactions, however, legacy leases and loans should not be disregarded, particularly where the lease or financing term (including any renewals and extensions) will extend beyond December 2021 (or possibly June 2023 for such agreements referencing USD LIBOR). Although legislative or regulatory solutions for tough legacy contracts, including publication of a "synthetic LIBOR", are being considered, the prudent course of action is for commercial parties not to rely on these being available for their existing agreements. Instead, in the current distressed environment of multiple deferrals and re-

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[9] For this purpose, "new contracts" would include new USD LIBOR lending; new USD LIBOR debt, preferred equity or securitisation issuance; and new USD LIBOR derivatives transactions

schedulings for airlines and other borrowers, aviation lenders and lessors may have the opportunity to incorporate robust contractual LIBOR fallbacks into their amendment agreements.

Conclusion

The documentary, administrative and commercial challenges involved in adopting any replacement rate for new deals and amending any legacy leases and loans to address the loss of LIBOR should not be underestimated. Time is short: notwithstanding the outstanding uncertainties discussed in this briefing and the continuation of Coronavirus-related restrictions on businesses, operations and individuals, the FCA and other regulators will be urging regulated credit institutions to continue to work on the premise that LIBOR in its current form will no longer exist by the end of 2021. The aviation industry cannot afford to be left behind.

Proposed timeline for USD LIBOR transition

- 31 December 2020 - new issuances of FRNs to cease using USD LIBOR
- First half of 2021 - IBA likely to announce the date(s) on which it intends to cease publication for LIBOR tenors (which would result in fixing of credit spread adjustments for purposes of ISDA fallback language and the ARRC equivalent)
- 30 June 2021 - new issuances of loans and derivatives to cease using USD LIBOR
- 31 December 2021 - US regulated banks should cease all new uses of USD LIBOR
- 1 January 2022 to 30 June 2023 - to the extent possible, legacy USD LIBOR contracts should be refinanced into an alternative rate or be amended to include robust fallback language
- 30 June 2023 - IBA has proposed to cease publishing overnight, one-month, three-month, six-month and twelve-month USD LIBOR (which would trigger a "LIBOR cessation" rate replacement for all tenors of LIBOR under fallback language developed by ISDA and the ARRC)

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