LIBOR AND OPERATING LEASES II

A year since our briefing "LIBOR and Operating Leases" and the aviation sector is still waiting for a clear contender to replace LIBOR as the common reference rate in aircraft financings, operating leases and related hedging arrangements. The FCA's December 2021 deadline for LIBOR discontinuation is approaching but the "legacy book" of aircraft loans and leases which use LIBOR for rental and other payment provisions continues to grow.

In the wake of the ECB's "Dear CEO" letter requiring board-level responses from regulated firms on preparedness for benchmark reform and Andrew Bailey of the FCA's latest speech at SIFMA, borrowers, lessors and lenders should consider taking precautionary action now in relation to their new transactions and any existing deals which will extend beyond 2021.

"The discontinuation of LIBOR should not be considered a remote probability 'black swan' event. Firms should treat it as something that will happen and which they must be prepared for."

Andrew Bailey, Chief Executive of the FCA, July 2018

WHERE ARE WE NOW?

As national regulators and benchmark reform working groups have developed their thinking, there appears little chance of a universally adopted alternative reference rate ("**ARR**") to LIBOR across different financial products. Some market participants have been hoping for an ARR which incorporates the principal features of LIBOR - namely its forward-looking, term rate and credit spread elements – to create a rate which "replaces" LIBOR with minimal adjustment to documents, economics or operations. While the FCA and the FSB have contemplated a potential (limited) "use case" for a term rate in the syndicated loans market, the direction of travel in the derivatives market and the preference of regulators points towards risk-free rates ("**RFRs**"). RFRs are intrinsically backward-looking and exclude term risk and credit risk. Compounded RFRs are a possible variant and one which the bond market has already tested with recent issuances.

It would be prudent for aviation parties to assume that there will be a divergence in ARRs utilised in loans (and leases), bonds and derivatives, including for instruments with different currencies and tenors.[1]

NEW DEALS

For banks, lessors and borrowers entering into new funding or leasing agreements, it is imperative to aim for maximum flexibility to enable the transaction to adopt the new world order, once it is known. Parties should no longer rely solely on documentary fall-back mechanisms originally drafted to mitigate against the temporary unavailability of LIBOR or other published reference rate in their agreements, including market disruption provisions.

The LMA (for English law loan agreements) and the LSTA (for NY law loan agreements) have both published model forms of replacement rate provisions

[1] For further comment, see our publication LIBOR Cross Product Review, October 2018

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expressly addressing LIBOR transition and, in the case of the LSTA, there is a "soft-wired amendment" approach and a "hard-wired" approach, with the latter involving the parties applying SOFR (or an alternate rate), according to a hierarchy of specified rates. For syndicated aircraft loans, the anticipation is that the lenders will and should require the relevant borrower to adopt one of these models; and that finance leases should include broadly equivalent provisions. In addition, given the prevalence of USD denominated loans in the aviation industry, parties may see a shift towards USD SOFR, probably on a compounded basis. Where SOFR or another RFR is selected as the relevant ARR, the lenders will expect a separate component to be included in the interest rate calculation to account for the credit spread which is intrinsic to LIBOR.

As discussed in our previous briefing, LIBOR is frequently the benchmark rate for calculation of floating rate rentals in operating leases (or, e.g., EURIBOR for euro-denominated rentals). For fixed rate operating leases, even if there is no express definition of or reference to LIBOR in the lease agreement, the lessor may utilise LIBOR (or other benchmark rate) in its underlying lease rate calculation. Lessors should have a strategy for agreeing replacement rate provisions with airlines, in respect of new lease agreements (including novated leases) and lease renewals or extensions. Any replacement rate would need to preserve the lessor's anticipated economic return from the leasing arrangement and to reflect the risks it has assumed.

For leases with related financings, including any hedging arrangements, operating lessors must be mindful of avoiding mismatches between the lease cashflows and their loan and swap payments. This may arise from different ARRs applying under different financial instruments within the same commercial transaction. Further, different documents may not have the same triggers for the application of an ARR in place of LIBOR (for example, market standard documentation for interest rate swaps may not have corresponding provisions to those set out in a bespoke loan or lease agreement). In such cases, parties may wish to build in termination or re-financing rights, including the ability to enter into additional or replacement hedging arrangements to guard against any mismatches.

LIBOR may also be relevant to other loan, lease and other contractual payment provisions, including as the default rate applicable to late payments. In this limited context, parties might wish to consider selecting an identified ARR which is not subject to ongoing consultation, such as the USD prime rate (which is based on the rate set by the United States Federal Reserve and which is outside of the global benchmark reform process), in their documents going forward.

LEGACY DEALS

Parties would be well-advised to review their existing portfolios to determine which leases and loans are scheduled to expire after 2021 (including where there is an option to extend the lease and/or financing term) and whether the relevant transaction documentation includes any fall-back provisions in relation to the unavailability of LIBOR or other reference rate.

CONTRACTUAL CONTINUITY AND UNINTENDED CONSEQUENCES

The contractual continuity challenges considered in our previous briefing remain relevant to both legacy deals and any new deals not carefully

> “Fall back language to support contract continuity or enable conversion of contracts if LIBOR ceases is an essential safety net – a 'seat belt' in case of a crash when LIBOR reaches the end of the road…The wise driver steers a course to avoid a crash rather than relying on a seatbelt. That means moving to contracts which do not rely on LIBOR and will not switch reference rates at an unpredictable time."
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> **Andrew Bailey, Chief Executive of the FCA, July 2018**

documented. As time progresses, an English court may not interpret favourably a lease agreement entered into by the parties since the financial markets have begun developing a response to the pending cessation of LIBOR, where the lease incorporates an unamended definition of LIBOR without any appropriate fall-back mechanisms whatsoever. In such case, there is a risk that the court may hold that the parties intended to use only LIBOR (as it currently exists) for calculation of rental and any other payments. The parties find themselves locked in to a so-called "synthetic LIBOR" or "zombie LIBOR" (if such a rate exists), even if it is no longer commercially attractive, not reflective of the lessor's actual financing costs and at odds with other elements of the capital structure (e.g. hedging arrangements). For lenders subject to the EU Benchmarks Regulation, there is no certainty that their regulator will assess such "zombie LIBOR" as satisfying the "representativeness test" required under the legislation.

Where LIBOR is no longer published in any form, there is no certainty that the court would be satisfied that any particular ARR should apply to the specific lease agreement, with potentially detrimental effects on the ability to calculate future rentals and other payments.

Even where fall-back language exists, it may give rise to unintended consequences, depending on its drafting and the precise circumstance of LIBOR discontinuation. In many loan and other financing agreements, the fall-back mechanisms will provide that, where the parties cannot agree on an acceptable replacement rate, the individual lender may revert to its cost of funds. This option may not be appropriate in structured aviation transactions, for example, in relation to a lender who is not a bank or other financial institution or in relation to a leasing company which is unlikely to readily disclose its internal cost of funding.

Switching the relevant loan, lease or hedging rate during the term of the transaction may impact the tax and accounting treatment of the relevant cashflows (and may have a material impact on the balloon risk or other fundamental economic metrics); this analysis will be driven by the individual fact pattern and specific advice should be sought on a case-by-case basis[2].

"Transition is not just about new business but about converting outstanding – or legacy – LIBOR contracts."

"I urge you not to have misplaced confidence that LIBOR as it exists today will survive."

Andrew Bailey, Chief Executive of the FCA, July 2019

[2] Clifford Chance has an in-depth Topic Guide "IBOR Transition and new risk-free rates" in our Financial Markets Toolkit which is available to registered client users – you can request full access to the Toolkit by emailing FMToolkit@cliffordchance.com. Please contact any of the authors of this briefing or your usual CC contact if you would like details of the firm's capabilities to support financial institutions and corporates in reviewing their legacy book in respect of IBOR transition and preparedness.

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