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USD LIBOR CESSATION – COUNTDOWN FOR AIRCRAFT LEASE FINANCINGS.

This is the fourth in our series of sector briefings[1] examining the implications of LIBOR cessation for aviation transactions. The remaining USD LIBOR tenors will cease to be published in their current forms on 30 June 2023. This briefing considers where the aviation leasing and financing market is in terms of USD LIBOR transition and the key issues which parties should address before the countdown ends[2].

Key issues

- 30 June 2023 deadline date
- Scope of transition due diligence
- Compounded SOFR vs. Term SOFR
- Hedging arrangements
- Synthetic USD LIBOR?

Which deals to transition?

Parties are advised to review all their USD denominated aircraft loans and leases and related sale and purchase documentation, including sale and lease-back arrangements, which use LIBOR as the benchmark rate for calculation of future rental amounts and/or interest accruals or which otherwise refer to LIBOR. For some time, most aviation banks and other financial institutions have been amending their existing loans and, for new facilities, either including "rate switch" provisions (with specific contractual triggers) or applying RFR terms from day one, in accordance with their regulatory requirements and internal policies.

Similarly, operating lessors have been dealing with their own financing arrangements, as borrowers, as well as seeking to amend their leases with airlines. The transition of any aircraft leases with related financings, particularly limited recourse deals, needs to be managed carefully to avoid structural mismatches.

Parties should pay particular attention to the fact that, in addition to using LIBOR to calculate scheduled floating rate interest and rental payments, deals may reference LIBOR in other aspects, including as the benchmark rate for default interest on late payments, the basis for interest accrual on cash deposits and/or the discount rate for calculating a make-whole payment or a prepayment fee. Furthermore, many fixed rate loans and, in certain cases, fixed rate operating leases will expressly refer to or otherwise incorporate a LIBOR linked swap rate in order to determine the initial fixed rate of interest or rent amount, but also to determine any close-out payments due on early termination of the financing or lease – such arrangements require close attention.

1 January 2021 "LIBOR Transition and Aircraft Lease Financings", July 2019 "LIBOR and Operating Leases II" and June 2018 "LIBOR and Operating Leases"

2 This briefing assumes a level of knowledge and familiarity with general LIBOR transition matters. Please refer to the IBOR Transition and Risk-Free Rates Topic Guide on our website for introductory materials and other relevant client publications

In conducting their transition due diligence, parties should cross-check the scheduled expiry or maturity dates of their existing LIBOR transactions against the 30 June 2023 deadline, taking into account any extension or purchase options and addressing any deals where the relevant agreement has been executed but the scheduled delivery date of the aircraft being financed or leased, or the effective date of the transaction, e.g. an aircraft sale or lease novation, falls after such date.

Which form of SOFR?

LIBOR provides a single interest rate for the relevant period, ascertainable in advance, with credit risk and term risk reflected. The challenge for many market participants in adopting SOFR (or any RFR) is that it is a daily rate calculated based on the cost of borrowing cash overnight, in the case of SOFR, as collateralised by US Treasury securities in the repurchase market; and is therefore only available in arrears.

While compounded SOFR provides for a rate over a period, this involves applying individual rates for each day of the relevant period and many parties do not have the internal systems to run such calculations across their lending exposures. Equally, whilst the market has developed conventions (in particular, the use of a lookback period) to allow for a compounded SOFR rate to be calculated in advance of the relevant interest payment date, the borrower would still ordinarily only receive relatively short notice (e.g., often 5 business days) of the actual interest amount due. In contrast, Term SOFR provides a rate that is available in advance for the whole of the relevant period (1, 3, 6 and 12-month published tenors for CME Term SOFR), by estimating the compounded average of SOFR over that time (using SOFR futures data and other inputs). Therefore, whilst a Term SOFR loan is economically based on the same principles as other SOFR-based loans, from an operational perspective it is more comparable to a LIBOR-based loan.

Since the announcement in July 2021, when the ARRC formally recommended (CME) Term SOFR for business loans, including multi lender facilities and trade finance, the aviation leasing and financing industry has followed the USD domestic lending market and other offshore USD funding products in preferring Term SOFR as the replacement reference rate for USD denominated transactions. This choice has been supported by aircraft borrowers and operators who require the certainty of payments at the start of the relevant interest period and/or rental period. Mid-interest period calculations (e.g., prepayments or early termination amounts) are also more complex if compounded SOFR is utilised.

Notwithstanding this, use of Term SOFR as the replacement rate is not universal across the aircraft financing market. In certain cases, aviation parties are selecting compounded SOFR (or another form, such as daily simple SOFR or SOFR index) for regulatory or administrative reasons. The calculation methodology for such compounded SOFR differs depending on the individual deal. Non-bank financiers will also have different funding sources and return requirements.

Commercial terms

Once the form of SOFR has been settled, parties still need to agree various commercial issues. These include (i) whether it is appropriate to include a credit adjustment spread ("CAS") or equivalent adjustment to the margin in the lender's SOFR-based interest rate (or in the lessor's rental calculations) to reflect the fact that SOFR-based rates (unlike LIBOR) do not include a premium for either credit risk or term risk, and if so, the amount of such CAS or margin adjustment; and (ii) primarily in a loan context, the application of break costs and market disruption provisions, and the hierarchy of fallback rates if SOFR is not available either on a temporary basis or following permanent discontinuation during the transaction term.

Hedging considerations

If applicable[3], the ISDA IBOR fallbacks provide for existing USD LIBOR-based hedging arrangements to transition to (i) a term-adjusted risk-free rate (i.e., SOFR for USD interest rate swaps) which is compounded in arrears for the period corresponding to the designated maturity of the original rate (i.e., USD LIBOR), and (ii) a fixed credit adjustment spread (set as at 5 March 2021) published by Bloomberg[4]. If, therefore, the parties elect for an aircraft loan to transition to use of Term SOFR as the benchmark rate for interest payments (from USD LIBOR), whilst continuing to apply the standard ISDA IBOR fallbacks for transition of any related hedging to a daily SOFR-based rate, lenders will need to consider the mismatch between the swap arrangements and the loan interest rate terms.

In the context of new transactions, it is also noteworthy that the absence of an inter-bank market for Term SOFR-based hedging[5] means that hedge providers are generally reluctant to offer such hedging (whether by means of third party ISDA-based arrangements, or under notional swap provisions in the loan or other transaction documents) to borrowers; as a result, we understand that pricing for such transactions is often higher than that for equivalent hedging based on daily SOFR. The same considerations discussed above around mismatches between the swap arrangements and loan interest rate terms may therefore apply to new transactions.

Further, if the relevant loan or lease relies on a published swap rate, market participants should bear in mind that the USD LIBOR ICE Swap Rate will cease to be published from 30 June 2023[6]. Since November 2021, the administrator, IBA, has published a USD SOFR ICE Swap Rate which is available for the same tenors and at the same time as the USD LIBOR ICE Swap Rate.[7] However, this published SOFR swap rate uses a compounded SOFR for the floating rate element of the swap.

"Tough legacy contract" legislation

Where a lessor or lender has not been able to engage with its lessee, borrower or other counterparty in relation to USD LIBOR transition of any existing lease, loan or other agreement, or there have been other obstacles to amendment, they may be able to avail themselves of the "tough legacy contract" legislation introduced in the UK (for English law governed agreements) or in the US (for NY or other US law governed agreements). The legislation broadly provides for a replacement rate to apply by operation of

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3 Where expressly incorporated into the agreement or for swaps entered into after 25 January 2021 using the 2006 ISDA Definitions, as amended by the IBOR Fallbacks Supplement (or for legacy swaps, if the parties have adhered to the IBOR Fallbacks Protocol, with effect from 25 January 2021)

4 https://assets.bbhub.io/professional/sites/10/IBOR-Fallbacks-LIBOR-Cessation_Announcement_20210305.pdf

5 https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2021/ARRC-Scope-of-Use-FAQ.pdf

6 https://www.ice.com/publicdocs/ISR_USD_LIBOR_cessation_feedback_statement.pdf

7 https://www.theice.com/iba/ice-swap-rate page has details of (i) the currently published USD SOFR ICE Swap Rate and (ii) a "beta version" USD SOFR *Spread-Adjusted* ICE Swap Rate. In March 2023, IBA announced it hopes to publish the spread-adjusted version for use by licensees from July 2023.

law, subject to conditions, and allows the contract to continue in the absence of adequate fallbacks. The UK legislation applies synthetic LIBOR and the US legislation (which only covers USD LIBOR) applies various forms of SOFR, as the replacement rate. Whether an agreement is within scope of the relevant legislation will depend on its specific terms, including if any contractual fallbacks apply[8].

In relation to synthetic USD LIBOR, the FCA announced in November 2022 that it is proposing to publish synthetic 1, 3 and 6-month USD LIBOR for a limited time after the cessation date, until the end of September 2024[9], subject to consultation. Synthetic USD LIBOR would be calculated based on CME Term SOFR and the Bloomberg fixed CAS for the relevant settings. However, at time of writing, the FCA has not published its response to the consultation.

While there may be certain cases where parties could agree not to amend their existing LIBOR loans (or other agreements) to adopt SOFR, and instead choose to use synthetic LIBOR as the benchmark rate, for example, if the transaction is scheduled to end well within the publication period, this should only be considered on an exceptional basis. The FCA has the power to restrict use for those institutions it regulates; and there may be commercial disadvantages to locking into the synthetic rate.

8 Refer to our client briefings "Synthetic LIBOR and the UK Critical Benchmarks (References and Administrators' Liability) Act 2021: 10 things that you need to know", December 2021, and "Federal Reserve Board Proposes Regulations Implementing The US LIBOR Act", August 2022

9 https://www.fca.org.uk/publications/consultation-papers/cp22-21-synthetic-us-dollar-libor

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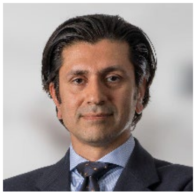

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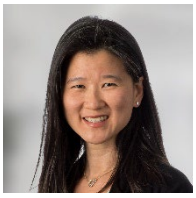

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