

# LIBOR Benchmark Replacement – “it’s time to get off the SOFR” – an overview of the impact of LIBOR transition on aircraft financing and leasing

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## Introduction

It’s time to face up to the fact that financial market participants will soon no longer be able to rely on LIBOR.

No one can claim that this comes as a surprise. In 2014, in response to concerns about the reliability and robustness of the interest rate benchmarks that are considered to play the most fundamental role in the global financial system, namely LIBOR, global authorities called for the development of alternative “risk free” interest rate benchmarks supported by liquid, observable markets. Notably, in July 2017, the Chief Executive of the UK Financial Conduct Authority (**FCA**), the authority which regulates LIBOR, made a seminal speech about the future of LIBOR, indicating that market participants should not rely on LIBOR remaining available after 2021. To emphasize the point in the United States, the President and Chief Executive Officer of the New York Federal Reserve famously quipped during a speech in 2019, “some say only two things in life are guaranteed: death and taxes. But I say there are actually three: death, taxes and the end of LIBOR.”

Even the enormous pressures heaped on market participants by COVID-19 have not changed the picture. As the impacts of COVID-19 continue to evolve, there is speculation as to whether the pandemic will delay the projected LIBOR cessation timeline. At the end of March 2020, the FCA confirmed that no such delay was forthcoming, remarking, “The central assumption that firms cannot rely on LIBOR being published after the end of 2021 has not changed and should remain the target date for all firms to meet.”

More recently, the Alternative Reference Rates Committee (**ARRC**), the working group convened by authorities in the United States, has announced a set of “best practices” for completing the transition from LIBOR. Of particular note is the ARRC’s recommendation that hard-wired fallbacks should be incorporated into loan documentation from as early as 30 June 2020, and the target date for ceasing to write new LIBOR deals should be 30 June 2021.

This article explores the steps already taken by the Loan Market Association (**LMA**), the ARRC and the International Swaps and Derivatives Association (**ISDA**), the likely impact of LIBOR benchmark replacement on loan and lease documentation and some of the uncertainties which still fall to be resolved.

## LIBOR

LIBOR (the London Inter-Bank Offered Rate) is a rate of interest, ostensibly used in lending between banks in the London interbank market. The LIBOR rate is calculated for various currencies and various terms. In the aviation financing market, 1-month or 3-month USD LIBOR is most commonly used. Note that these rates are forward-looking, are calculated based on repayment at the end of a specified term and represent a rate of interest for unsecured lending.

In aircraft transactions, LIBOR:

- can form part of the interest (and default interest) calculation in loan agreements;
- can represent the rate against which floating rate payments under interest rate swap agreements are calculated; and
- can form part of the default interest calculation in aircraft lease agreements (and, where lease rental calculations are made on a floating rate basis, the determination of rent).

## SOFR

A number of alternative benchmarks were considered as suitable replacements for USD LIBOR. The emerging winner, and the ARRC's recommended alternative, is the Secured Overnight Financing Rate (**SOFR**). SOFR is a broad measure of the cost of borrowing cash overnight collateralized by U.S. Treasury securities.

Unlike term LIBOR rates, SOFR is an overnight, secured rate.

Aircraft loan and interest rate swap repayments are not typically made on an overnight basis, so how would we apply an overnight rate to a loan which provides for accrued interest to be paid monthly or quarterly?

In time, it is anticipated that forward-looking term SOFR rates will emerge – this is the stated preference of the ARRC – but this has not happened yet and it is not certain that satisfactory term SOFR rates will be available ahead of LIBOR discontinuation.

Therefore, the ARRC does not recommend that financial market participants wait until forward-looking term SOFR rates exist to begin using SOFR in their loans. Instead, a simple average or compounded average of overnight SOFR rates for an interest period might be made to apply in lieu of a term rate.

A further complication with an overnight rate arises because, unlike term LIBOR rates, the amount of interest payable on a loan interest repayment date cannot be calculated until the last day of the applicable loan interest period. This makes loan administration (for banks) and payment processing (for borrowers) complicated. Various alternative calculation conventions remain under discussion. Selecting a final methodology is proving challenging in light of the lack of market convention and the operational challenges faced with making such a calculation.

### Credit Adjustment Spreads

Because SOFR is an overnight, secured rate it does not include any term liquidity premium or any bank credit risk element, unlike a term LIBOR rate, where interest is paid at the end of a specified term and which represents an unsecured rate. As a result, SOFR prices lower than LIBOR.

Bankers therefore intend to apply a “credit adjustment spread” on top of SOFR, in order to account for the differences in which LIBOR and SOFR are determined, and in order to limit any transfer of economic value as a result of the transition between benchmark rates. The basis on which a credit adjustment spread is calculated is also the subject of continuing discussion. A further complicating factor for determining the spread adjustment is that the spread between LIBOR and SOFR fluctuates in rather meaningful ways over time. This fluctuation is, in part, due to the fact that Treasuries yields may be pushed down during times of crisis where there is a flight to quality.

### LMA and ARRC Slot-in Provisions dealing with LIBOR Transition

The LMA and ARRC have both been working on slot-in drafting for various financial instruments in anticipation of transitioning away from LIBOR.

On 21 December 2018, the LMA issued “The Recommended Revised Form of Replacement Screen Rate Clause and Users Guide”.

On 25 April 2019, the ARRC recommended two sets of fallback language, also for syndicated loan documentation – the “Amendment Approach” fallback language and the “Hardwired Approach” fallback language.

Note that the ARRC has also prepared recommended fallback language for floating rate notes and securitization transactions.

### *LMA and ARRC Amendment Approach – creating a framework for future agreement*

The LMA and ARRC Amendment Approaches (the **Amendment Approaches**) do not set out the replacement benchmark or credit adjustment spread which should apply, or set out the detailed basis on which interest should accrue or be calculated. Instead, a framework is set out in order to facilitate future agreement and related amendments to the loan documentation.

The LMA Amendment Approach does this by reducing the threshold for lender consent that might otherwise apply to relevant amendments.

The ARRC Amendment Approach provides that the borrower and the loan agent may identify a replacement rate (and spread adjustment), and the required lenders (typically 51%) have five days to object. If the required lenders reject the proposal, the loan goes to a prime-based rate until a successful amendment goes through.

### *ARRC Hardwired Approach*

The alternative, the ARRC “Hardwired Approach”, provides that, when LIBOR ceases, the benchmark rate converts to a specified version of SOFR plus a credit adjustment spread. Failing this, a rate agreed between the parties would apply. Unlike the ARRC Amendment Approach, the Hardwired Approach is also “future-proofed”, to cover further benchmark replacement to the extent this occurs.

The Hardwired Approach sets out a “waterfall” of replacement benchmarks which are to apply – firstly, a term SOFR rate or, failing which, the next available term SOFR rate; secondly, a compounded SOFR rate; and thirdly, an alternative rate selected by the loan agent and the borrower which has given due consideration to any selection or recommendation made by a “Relevant Governmental Body”, or market convention. The credit adjustment spread is added to the applicable replacement benchmark in each case.

The Hardwired Approach also sets out a waterfall of options to calculate the credit adjustment spread – firstly, the adjustment selected or recommended by a Relevant Governmental Body; secondly, the adjustment that would apply to the fallback rate for a derivative transaction referencing the ISDA Definitions to be effective upon an index cessation event with respect to USD LIBOR for a period equal to the relevant loan interest period; and thirdly, an adjustment agreed between the loan agent and the borrower giving due consideration to the factors which apply to determining a replacement rate of interest and set out above.

So, which approach is the aviation industry using? For the time being, we are seeing the Amendment Approaches (or negotiated variations of those approaches) applying, but as noted in the ARRC “best practices” recommendations, this is something which must develop quickly.

The ARRC noted that many respondents to their consultations who prefer the use of the ARRC Amendment Approach at the current time generally believe that eventually some version of the Hardwired Approach will be more appropriate. The Amendment Approaches set out a more streamlined procedure for LIBOR transition, but they leave many of the difficult questions unanswered and provide for additional amendments to be made further down the road. Banks and counterparties will need to consider whether it is feasible to amend thousands of loan documents in short order, and the related disruption this could cause.

### *ARRC Hedged Loan Approach*

Outside of the syndicated loan market, the ARRC recommends a third set of fallback language – the “Hedged Loan Approach”, to be considered for bilateral USD LIBOR loans which benefit from interest rate hedging.

The “Hedged Loan Approach” is the alternative approach for those who want to ensure that the fallback language in their loan agreement is consistent with the fallback language in any corresponding hedge they enter into with respect to their credit facilities. There is no reason that the language cannot be amended to accommodate syndicated loan transactions.

Interest rate swaps are commonly used in aircraft lessor financings in order to mitigate basis risk between operating lease payments (typically calculated on a fixed rate basis) and scheduled interest rate payments under the related loan agreement (typically calculated on a floating-rate basis).

The Hedged Loan Approach aligns the trigger events, replacement rate, and any spread adjustments under a subject loan with those as determined in accordance with the soon-to-be finalized revisions to the ISDA Definitions.

### *Trigger Events for LIBOR Transition*

There is some variation between the trigger events for LIBOR transition between the LMA and ARRC approaches. As you would expect, both cover events relating to an immediate or upcoming LIBOR cessation. Both also include an early opt-in election which may be made by the parties. The ARRC Hedged Loan Approach trigger events are tied to those that will apply under any relevant ISDA documentation.

The LMA has also included a “material change” event, such that a trigger event can apply if the methodology, formula or other means of determining the LIBOR screen rate has materially changed. The LMA offers both objective and subjective language (in the opinion of the Majority Lenders and, where selected, the Obligors) for making the material change determination.

The ARRC includes as an additional event an announcement from the supervisor of a benchmark administrator that the applicable benchmark is no longer representative. This is intended to reflect the requirements of, and the procedures which apply under, the EU Benchmarks Regulation (the **BMR**). Where such a determination is made, it is possible that the loan parties would want to accelerate LIBOR transition, and EU-supervised entities could be prohibited from referencing LIBOR in new derivatives and securities. U.K. and U.S. authorities have also stated that it might be prudent for market participants to include this pre-cessation

trigger in their loan documentation.

The early election triggers that apply under the ARRC Amendment and Hardwired Approaches are also drafted differently. Note that a term SOFR rate only can apply if an early election trigger applies under the Hardwired Approach.

## ISDA Benchmarks Supplement

ISDA published its Benchmarks Supplement in 2018 primarily to facilitate compliance with the requirements of Article 28(2) of the BMR, but it has been drafted so that market participants can use it to incorporate fallbacks for reference rates into derivative transactions, whether or not they or the transactions are subject to BMR. The Supplement includes a number of trigger events relating to benchmarks and fallbacks which apply upon the occurrence of one of those triggers. Currently, ISDA has provided for benchmark replacement in two scenarios: (i) a permanent cessation of the then applicable benchmark; or (ii) if applying an applicable benchmark would breach applicable law. These broadly align with the corresponding trigger events in the ARRC documentation, but there are some important variations, discussed below.

Ultimately, ISDA intends to update the ISDA Definitions to include fallbacks to selected alternative interest rate benchmarks, and work on this is ongoing, but in the meantime incorporation of the Supplement into transactions referencing LIBOR could form part of a wider strategy for the transition away from LIBOR, even if it is not required by BMR.

## Tensions between the Loan and Derivatives Markets?

As described above, aircraft lessor financings will very often be hedged pursuant to an ISDA Agreement in order to avoid basis risk.

But what if the approach taken by loan markets in relation to the timing for LIBOR transition and the calculation of floating rate interest differs from the approach taken by derivatives markets under swap agreements? Payments are no longer fully hedged and basis risk is re-introduced.

The major issue goes to the rate itself – the ARRC is hoping for term SOFR rates to emerge which will be used to calculate floating rate loan interest payments, but it is almost certain that ISDA will not apply term SOFR rates to floating rate payments under derivatives transactions and a version of compounded SOFR will instead apply.

Trigger events for benchmark replacement also vary between the two markets, but work is ongoing to converge differing approaches.

Under the ISDA Benchmarks Supplement, no early opt-in election applies. This would tend to make it less likely that early opt-in elections for hedged loans would in fact be exercised.

Note also that no pre-cessation trigger event currently applies under the Supplement – so “material changes” to the benchmark calculation (as contemplated by the LMA Amendment Approach), and the non-representativeness test included in the ARRC provisions, are not included as trigger events, albeit that ISDA has consulted on the latter and an amendment to the Supplement to include the non-representativeness test is expected to be published in July.

Since the FCA has already announced the expected procedures that would apply if it were to make a determination that LIBOR was no longer representative and how such a determination would be communicated to the markets, it seems that the ARRC approach towards trigger events would be the preferred approach for hedged loan documentation.

It is also possible that the basis on which credit adjustment spreads are calculated will vary between the two markets but, on this point, it has been the ARRC’s turn to re-consult on the proposal made by ISDA; i.e. that the same spread adjustment value is used across all of the different fallback rates. It is hoped that a consistent credit adjustment spread can be made to apply between loan and derivative markets, although given that there is a range of methodologies for calculating pre-cessation credit adjustment spreads that could apply in loan markets, this might be more difficult to achieve where an early opt-in election is exercised and might make the actual exercise of early opt-in elections less likely for hedged loans.

## Where Does That Leave Us?

Thus far, most borrowers/lessees within the aviation finance market have favoured some version of the LMA or ARRC “Amendment Approach” fallback language in their loan or lease documentation – the advantage being that it does offer flexibility.

Parties have entered into a number of variants but the underlying principle behind the Amendment Approaches appears to be adhered to – it serves as a placeholder to the issue and aims to bring the commercial parties back to the table once the loan market has broadly accepted a replacement standard for LIBOR.

Key reasons for this are the absence of a term SOFR rate and an absence of consensus as to the basis on which alternative SOFR rates and credit adjustment spreads might be calculated. People are not yet ready to commit to SOFR or a Hardwired Approach since at the moment no one knows exactly what they might be getting.

Notwithstanding the above, the “Hedged Loan Approach” should not be discounted for bilateral (or syndicated) aircraft lessor financings which are hedged by way of an interest rate swap.

Lenders/borrowers that are concerned with “basis risk” upon LIBOR cessation may prefer this approach since it is designed to eliminate any basis risk between the loan and the related hedge. However, it remains to be seen whether loan markets will be able to accommodate a departure from whatever becomes settled loan markets convention, commercially and operationally.

If the floating rate under the swap and the floating rate under the loan are aligned, then the change from LIBOR to a different benchmark should theoretically be cost neutral for that borrower, except where a swap premium is payable as a result of transition to a replacement benchmark rate. The requirement to pay a swap premium may be considered more likely if a swap is required to pay a floating rate that reflects a term SOFR rate or another loan market convention where the same is at odds with the default position in the derivatives market. Commercial parties will follow this issue with particular interest.

Note also that on 6 March 2020, the ARRC released a proposal for New York State Legislation for USD LIBOR contracts, which would operate to replace LIBOR by the recommended alternative benchmark included in the legislation and other related matters.

## Operating Leases

Lessors and lessees will need to consider how LIBOR transition is achieved under their operating leases.

Most operating leases do not make provision for LIBOR transition, nor do they provide for a fallback rate in the event of LIBOR cessation beyond requesting reference bank rates (which is not itself an effective fallback, since a shrinking number of reference banks are prepared to quote a rate even now).

At this stage, where LIBOR is referenced in operating leases, it would be prudent for leasing companies to take a similar approach in their operating leases to that taken in the Amendment Approaches referred to above. This will ensure that LIBOR transition triggers are broadly consistent between operating leases and any related financing and hedging arrangements; it will also ensure that appropriate interest calculation methodologies and market approaches can be introduced into operating leases by amendment at the appropriate time.

Where fixed rate operating lease rentals are payable, the parties might also consider an alternative basis on which to calculate default interest under the lease which avoids SOFR and credit adjustment spreads altogether, but this would require careful thought, particularly regarding the way in which this interacts with any upstream financing.

Leasing parties will need to consider an appropriate costs allocation for amendments of existing leases.

Another point to note is that fixed rate operating lease rental calculations are usually constructed from a swap screen rate for an agreed term (taken an agreed number of business days ahead of the rent calculation date), and lease rentals cannot be adjusted after the event.

The swap screen rate will itself have been constructed from an interest rate exchange which assumed that 1-month LIBOR rates would remain available for the duration of the swap period, which means that such correlation as previously existed for leasing companies between outgoings (funding costs) and income (lease rental) is lost. Whether this creates a windfall or a loss for leasing companies will depend on what happens to SOFR rates in the future.

So, some real food for thought and some important decisions lie ahead. Discussions should start now and action should be taken soon in order to ensure an orderly transition.

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