LIBOR's days are numbered: are your lease contracts ready?

Aircraft lessors must ensure that lease contracts maturing beyond 2021 incorporate fallback provisions in case LIBOR is unavailable, enabling their platforms to transition to an alternative reference rate. The volume of contracts to review is daunting!

With the anticipated end of the London Interbank Offered Rate (LIBOR) fast approaching, the global aviation finance and aircraft leasing sectors are gearing up to revisit loans, leases, bonds, hedging, sales and purchases, and other agreements worth trillions of dollars annually that use LIBOR in their interest rate calculations. LIBOR, whose likely end became apparent in 2017, still has no global replacement that can be plugged into aircraft leasing or finance documents as a direct interest rate substitute.

The World's Most Important Number

With the 'world's most important number' soon to become non-existent, the transition to alternative rates poses an enormous challenge for lessors. According to the Bank for International Settlements, the central banks' bank, a 'one-size-fits-all' benchmark alternative is undesirable.

LIBOR is likely to be replaced by a number of 'risk-free rates' (RFRs). Each currency for which LIBOR is currently quoted will have its own RFR based on the rates charged in overnight lending in that currency in the previous 24 hours among banks and other institutions in the principal financial centre for that currency, and regulated by the central banking or other financial regulatory authorities in the country of that currency.

Three of the key RFRs are:

- US Dollars – SOFR (the Secured Overnight Financing Rate), which is a (secured) repo rate administered by the Federal Reserve Bank of New York;
- Euro – ESTER/€STR (Euro Short-term Rate), an unsecured rate that the European Central Bank will administer (the ESTER rate will replace EONIA in October 2019); and
- Sterling – SONIA (the Sterling Overnight Index Average), an unsecured rate administered by the Bank of England.

> *"Now is the time to begin the process of lease document modification, which can take significant time and effort to execute."*
>
> **Joey Johnsen**, Principal, Zeevo Group

Aviation financiers and aircraft lessors must consider whether their current or future transaction documents, which use LIBOR and run beyond 2021, contain robust language that provides a fallback interest calculation method – or are equipped with an efficient process for replacing any LIBOR-based interest rate calculation, or fallback interest rate calculation, which can only work in the short-term.

Zeevo Group Principal Joey Johnsen says that "the price of the alternative, or pre-replacement rate may not match LIBOR, and therefore impact the economics and commercial value of leases".

Today, LIBOR incorporates credit risk, is highly liquid and has a long history. Potential alternatives do not have the same credit risk, and, in many instances, are risk-free. Also, they may not be as liquid and their tenor is still to be established. Given these limitations, lessors should expect that the new benchmark rate will be different from LIBOR. This difference will impact the economics of existing commercial contracts.

Johnsen adds that "lessors will need to work to identify this potential commercial valuation exposure and its impact. To put a valuation on this difference will be a complex matter. With these differences in value, the impact on accounting for existing contracts will be considerable, especially if lessors have adopted hedge accounting. It is advisable now to start reviewing potential accounting impact of change from LIBOR."

An efficient process in a free-standing aircraft lease might involve, for example, the lessor and the lessee agreeing to negotiate in good faith for a set period to find a replacement for LIBOR in their lease. Failing such agreement, the interest rate might be based on the lessor's cost of funds from whatever source it reasonably selected; or by adopting a fixed rate (and entering into related hedging agreements).

A Complex Task

The clock is ticking, and the volume of the contracts to be reviewed and revised is staggering. Millions of documents will need to be reworked, and lessors are facing extensive and costly administrative work associated with changing the contracts, updating accounting systems, and communicating the transition to their airline customers.

"Now is the time to begin the process of lease document modification, which can take significant time and effort to execute," says Johnsen.

The transition away from LIBOR consists of three key phases:

- **Identify exposures; create a lease inventory**
  The first step is to assess the impact of LIBOR on existing contracts, segregating leases that reference LIBOR from those that do not.
- **Pre-replacement rate actions**
  Lessors must start now to incorporate interim amendments, incorporating a fallback interest calculation method. Lessors can also start to develop contingencies.
- **Post-replacement rate actions**
  Lessors must amend leases and other contracts, as well as update systems and business processes to procure and test data feeds for the new rate. Staff must be trained to address the needs of the new rate and desktop procedures may need to be updated.

Now is the Time to Begin

Zeevo Group is ready to assist aircraft lessors and financiers assess existing leases and other contracts; make necessary changes for a smooth transition to alternative reference rates; calculate exposures; and ensure maximum return on investments.

"The transition from LIBOR to an alternative rate will not be easy. Lessors must start now to manage the financial and legal risk associated with the LIBOR transition and turn a challenge into an opportunity. The Zeevo team has both the expertise and the experience in facilitating such transitions for lessors," concludes Johnsen.