Frequently Asked Questions for Non-Sovereign Guaranteed Borrowers
Disclaimer

The purpose of this document is to inform you of recent and upcoming developments related to the transition of interest rate benchmarks. This guide is not intended to be, and should not be relied upon as legal, financial, tax, accounting, or other advice. You should consult your advisors for advice on the risks and challenges related to the reform of interest rate benchmarks. This FAQ is not intended to address all the financial and other risks that may arise regarding the interest rate benchmark transition. This document will be regularly updated with the latest market developments. Always refer to the latest update date indicated in the document.
Overview

The African Development Bank (AfDB) provides loans and hedging products to its clients at floating interest rates based on LIBOR\(^1\), EURIBOR\(^2\) or JIBAR\(^3\); commonly known as IBORs\(^4\). These benchmarks are currently undergoing a global reform with some ceasing by the end of 2021 and being replaced by newly recommended Risk-Free Rates (RFRs):

- USD LIBOR will be replaced by SOFR\(^5\)
- JPY LIBOR will be replaced by TONA\(^6\)
- EURIBOR could be replaced by €STR\(^7\)
- JIBAR could be replaced by ZASFR\(^8\)/ZARONIA\(^9\)

This process of transition covers the move from IBORs to RFRs in both legacy loans and new loans. AfDB also uses IBORs as reference rates in its borrowing and treasury investment activities. Therefore, replacing IBORs with RFRs will affect different areas including legal documentations, pricing models, risk management, communication with clients, various processes, and systems.

This important reform requires relevant entities with IBORs exposures to prepare in advance as the transition can yield potential disruption and risks to the global financial stability. The transition will also impact the products and services that AfDB currently offers and may offer in future.

AfDB, as a major development bank player, has a duty to accompany its clients through this benchmark transition phase. By providing these FAQs, the AfDB wishes to help its Non-Sovereign Guaranteed borrowers to better understand this transition and the associated challenges that may arise.

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\(^1\) London Interbank Offered Rate  
\(^2\) Euro Interbank Offered Rate  
\(^3\) Johannesburg Interbank Average Rate  
\(^4\) Interbank Offered Rate  
\(^5\) Secured Overnight Financing Rate  
\(^6\) Tokyo Overnight Average Rate  
\(^7\) EURO Short Term Rate  
\(^8\) South African Secured Overnight Financing Rate  
\(^9\) South African Rand Overnight Index Average
Overview

The FAQs are organized as follows:

1. What are IBORs? 5
2. Why the move away from IBORs? 6
3. Who is driving the IBORs transition? 7
4. What are the IBORs cessation dates? 8
5. What are the key milestones of the IBORs transition? 9
6. What are the alternative available benchmarks? 10
7. What are the differences between RFRs and IBORs? 11
8. Will there be term rates available for the RFRs? 12
9. What are the main issues to transition a loan from IBORs to RFRs? 13
10. How are borrowers affected by the IBORs transition? 14
11. How will non-sovereign loan pricing be impacted by the IBORs transition? 15
12. What will change for Non-Sovereign guaranteed loan pricing? 16
13. What are fallback provisions? 17
14. What needs to be done regarding Non-Sovereign loan documentation? 18
15. What are the impacts on loan swaps? 19
16. What can borrowers do to prepare for the transition? 20
17. Where can you find further information on the transition? 21
What are IBORs?

The Interbank Offered Rates (IBORs) are among the main interest rate benchmarks used in financial markets throughout the world. They are referenced in trillions of dollars’ worth of financial contracts to determine the interest rates.

The London Interbank Offered Rate (LIBOR) is based on five currencies (USD, EUR, GBP, CHF, JPY) and is the most widely used IBOR. Other IBORs include the Euro Interbank Offered Rate (EURIBOR) or the Johannesburg Interbank Average Rate (JIBAR). IBORs are designed to reflect the price of unsecured wholesale interbank term funding and are generally determined as an average of interest rates (rate submissions) reported by a panel of major banks (also referred to as panel banks).

Rate submissions by panel banks should mostly be made up of eligible transactions that they have carried out (except for JIBAR that uses tradable quotes). In the absence of actual transactions, various methodologies can be put in place to agree a rate submission, including expert judgment as a last resort. Each IBOR is published daily across a variety of tenors often ranging from 1-day to 12-month (e.g. 3-Month USD LIBOR, 6-Month USD LIBOR).

1 AfDB does not use EUR LIBOR but rather EURIBOR for EUR denominated loans.
Why the move away from IBORs?

The IBORs transition is a global reform of major interest rate benchmarks which aims to replace IBORs that rely on expert judgement with more robust near Risk-Free Rates (RFRs).

This transition is essential in promoting a more sound and resilient financial system. Since the recent global financial crisis, banks no longer fund themselves in the interbank market to the same extent. This has led panel banks to heavily rely on expert judgement for their respective IBORs rate submissions, making the IBORs vulnerable to potential manipulation. From 2012, regulatory as well as criminal investigations have shed light on long routed cases of misconduct where panel banks had colluded to manipulate their rate submissions to profit from trades or give the impression that they were more creditworthy than they were. The scandal sowed distrust in the financial industry and led to fines, lawsuits, and regulatory actions for the firms involved. With LIBOR’s validity as a credible benchmark now in question, it was clear that a global reform was required.

The G20 asked the Financial Stability Board (FSB) in 2013 to review and recommend reforming major interest rate benchmarks while the International Organization of Securities Commissions (IOSCO) published its “Principles for Financial Benchmarks” with the objective of creating an overarching framework of principles for benchmarks used in financial markets. In 2014, the Financial Stability Board published its recommendations, which were composed of two pillars:

(i) Reforming IBORs to ensure they are as reflective of underlying market conditions and anchored in transactions as far as possible; and
(ii) Developing alternative benchmarks that should be approximately risk-free.

In July 2017, the UK Financial Conduct Authority (FCA); supervisor of LIBORs, announced that the LIBORs panel banks had agreed to continue to submit to LIBORs until the end of 2021. The FCA also announced its intention to dissuade or deter banks from submitting to LIBORs after the end of 2021, making it clear that the publication of LIBORs is not guaranteed from the beginning of 2022. As a result of this announcement, financial regulators worldwide have strongly encouraged financial institutions exposed to LIBOR to prepare for its replacement before the end of 2021.
Who is driving the IBORs transition?

At international level, the Financial Stability Board (FSB) has been tasked by the G20 to review the major interest rate benchmarks and recommend appropriate reforms. The International Organization of Securities Commissions (IOSCO) has set an overarching framework of principles for benchmarks used by market participants. These principles have been endorsed by the G20, the FSB and the National Working Groups (NWGs). The latter have been set up in all major IBORs jurisdictions to develop and ensure a successful transition to RFRs. The National Working Groups (NWGs) are groups of private market participants convened by the relevant central bank with a wide array of official sector entities (including financial sector regulators as ex-officio members). NWGs organize market wide consultations and make recommendations that are not legally binding on market participants. However, they provide orientation and represent the prevailing market consensus regarding the preferred RFRs and applicable conventions. In July 2016, the FSB tasked the International Swaps and Derivatives Association (ISDA) to enhance the robustness of derivatives contracts referencing IBORs. Other industry associations such as the Loan Markets Association (LMA) play an important role, for example developing templates for legal documentation to illustrate recommendations made by the NWGs. Other key players in the transition are benchmark administrators and their supervisors as summarized below:

<table>
<thead>
<tr>
<th>Benchmark</th>
<th>Administrator / Supervisor</th>
</tr>
</thead>
<tbody>
<tr>
<td>USD, EUR, GBP, CHF, JPY LIBOR</td>
<td>InterContinental Exchange Benchmark Administration (IBA) under the supervision of the FCA</td>
</tr>
<tr>
<td>EURIBOR</td>
<td>European Money Markets Institute (EMMI) under the supervision of a college chaired by the Belgian Financial Services and Markets Authority (FSMA). The European Securities and Markets Authority (ESMA) will take over the supervision from January 2022.</td>
</tr>
<tr>
<td>JIBAR</td>
<td>Calculated by the Johannesburg Stock Exchange (JSE) and administrated by the South African Reserve Bank (SARB)</td>
</tr>
</tbody>
</table>
What are the IBORs cessation dates?

Following a market-wide consultation, on 5th March 2021 both the administrator and supervisor of LIBORs announced the future cessation dates for LIBORs. GBP, EUR, CHF, JPY, 1-week and 2-month USD LIBORs will cease immediately after 31st December 2021. The remaining tenors of USD LIBOR will continue to be published until 30th June 2023. No target cessation date has been defined for EURIBOR and JIBAR at present.

The table below summarizes the expected cessation date for different IBORs.

<table>
<thead>
<tr>
<th>IBOR</th>
<th>Expected Cessation Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>USD LIBOR</td>
<td>a. 31/12/2021 for 1W/2M tenors&lt;br&gt;b. 30/06/2023 for other tenors</td>
</tr>
<tr>
<td>JPY LIBOR</td>
<td>31/12/2021</td>
</tr>
<tr>
<td>EURIBOR</td>
<td>No target date</td>
</tr>
<tr>
<td>JIBAR</td>
<td>No target date</td>
</tr>
</tbody>
</table>

What are the key milestones of the IBORs transition?

The announcements on 5th March 2021 by the IBA and FCA are considered as a pre-cessation trigger event for LIBORs. However, the occurrence of this trigger event does not require an immediate replacement of the LIBOR rates in existing loans. Instead, the replacement of LIBORs can happen on the first reset following the date that LIBORs will cease to be published or will be non-representative, i.e. 30th of June 2023 for USD LIBOR and 31st December 2021 for JPY LIBOR. It can also be earlier as agreed with borrowers.

For new loans, the Federal Reserve Bank of New York (FED) together with other US agencies have insisted that banks should cease entering new contracts that use USD LIBOR as soon as practicable and in any event by 31st December 2021. The Cross-Industry Committee on Japanese Yen Interest Rate Benchmarks also targeted end Q2 2021 for institutions to cease issuing new loans based on JPY LIBOR.

In the Euro market, following the recent reforms of the EURIBOR, the benchmark has been declared compliant with the European Union Benchmark Regulation (BMR) and can continue to be used for both existing and new loans. At the same time, the Working Group on Euro RFRs (Euro WG) has recommended the Euro Short-Term Rate (€STR) as the alternative RFR for Euro-denominated financial instruments. Since May 2021, the working group has made recommendations on EURIBOR fallback trigger events and rates that could be used in developing contractual fallback provisions for a scenario in which EURIBOR may permanently cease to exist or be non-representative. These fallback provisions are expected to be inserted in existing and new loans based on EURIBOR.

For JIBAR, the Market Practitioners Group (MPG) has also indicated that JIBAR can continue to be used while undergoing reforms. However, it has also indicated that the reformed JIBAR is not a viable long-term solution hence a clear target cessation date should be decided whilst working to develop RFRs. Both existing and new ZAR loans can continue to use JIBAR until further notice regarding its cessation date. Fallback provisions will also need to be developed and inserted in loan documentation.

For the African Development Bank’s legacy Non-Sovereign guaranteed loans using USD LIBOR, an early and gradual replacement is being considered. New Non-Sovereign guaranteed loans will use SOFR for USD loans and TONA for JPY loans, from the beginning of 2022. For EUR and ZAR loans, EURIBOR and JIBAR respectively will continue to be used.

National Working Groups (NWGs) for each of the five LIBOR currencies have identified alternative, transaction-based, and robust near risk-free benchmarks. For the IBORs used by AfDB, the NWGs have identified the following alternative reference rates:

<table>
<thead>
<tr>
<th>IBORs</th>
<th>USD LIBOR</th>
<th>JPY LIBOR</th>
<th>EUR LIBOR/EONIA</th>
<th>JIBAR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Description</td>
<td>Secured Overnight Financing Rate. Cost of borrowing cash overnight, collateralized by U.S. Treasury securities</td>
<td>Tokyo OverNight Average Rate, uncollateralized overnight call rate is the weighted average of call rates for uncollateralized overnight transactions</td>
<td>Euro Short-Term Rate. Wholesale euro unsecured overnight borrowing cost of euro area banks</td>
<td>• South African Secured Overnight Financing Rate (ZASFR)  • South African Rand Overnight Index Average (ZARONIA)</td>
</tr>
<tr>
<td>Administration</td>
<td>New-York FED</td>
<td>Bank of Japan</td>
<td>European Central Bank</td>
<td>South African Reserve Bank</td>
</tr>
</tbody>
</table>
There are key differences between IBORs and the nominated alternative RFRs that have implications for financial markets:

1. Alternative RFRs are overnight rates whereas the IBORs are forward-looking term rates over various tenors (e.g. 6-month USD LIBOR gives a rate applicable from a specific date over the next 6-month period). The graph above illustrates the difference in application between a forward-looking 6M USD LIBOR and an overnight SOFR.

As daily overnight rates, RFRs require a “term adjustment”. To derive a term rate, RFRs can be averaged through simple or compound interest over the interest period (backward-looking term rates). It can also be a forward-looking term RFR derived from RFR-linked derivatives.

Backward-looking term RFRs require a mechanism to allow borrowers time to pay (Payment Notice Adjustment) because the rate for an interest period is known only at the end of the period when using simple or compound averaging of the overnight RFRs.

2. Due to historical differences with IBORs, RFRs require a Spread Adjustment (SA) to avoid value transfer as much as possible. Indeed, IBORs include a “bank credit risk” component as well as variety of other factors (e.g. term premia, liquidity, fluctuations in supply and demand in wholesale unsecured funding markets) which are not reflected in the RFRs.
Will there be term rates available for the RFRs?

The National Working Groups (NWGs) have been working to develop term rates based on the RFRs considering mainly two approaches:

(i) Define and calculate backward-looking term rates by averaging through simple or compound interest of the daily RFRs through the interest period or a defined observation period,
(ii) Develop forward-looking term rates based on the RFRs derivatives markets.

Different methodologies have been considered for the backward-looking approach including simple average and compounding of observed RFR rates.

For the forward-looking approach, the NWG for USD, ARRC, recommended in July 2021 the use of the CME Group’s forward-looking SOFR term rates. The production rates of the forward-looking term TONA named Tokyo Term Risk Free Rate (TORF) are published daily since April 2021. While the second approach has the advantage of producing a forward-looking term rate like the current IBOR regime (from a “term structure” perspective), it needs to be based on nascent RFRs derivatives markets which are still developing. It is also worth noting that for the derivative market a backward-looking compounding in arrears is recommended by ISDA.

The African Development Bank is assessing the different methodologies and related conventions that it will propose to its borrowers. In deciding the final methodology and conventions, AfDB will thrive to ensure fairness and transparency. AfDB is considering market developments and working with other MDBs and DFIs to achieve as much harmonization as possible. The Bank will also work to ensure as much as possible that there is no transfer of economic value from one party to another because of the transition.
What are the main issues to transition a loan from IBORs to RFRs?

The main parameters in transitioning legacy loans using fallback language are:

1) The transition triggers: The loan contract needs to include a trigger when switching to the new RFR and should include fallback language. The main triggers to consider are:
   a. “Permanent cessation” in case of permanent discontinuation of the IBOR;
   b. “Non-representativeness” before the cessation of an IBOR because of a regulatory announcement on non-representativeness;
   c. “Early opt-in” where loan parties agree to transition before any permanent cessation or non-representativeness.

2) The replacement or fallback rate: As the interest rate in the loan contract needs to be replaced, an alternative replacement rate based on RFRs needs to be decided. The replacement rate is the sum of an Adjusted RFR and a Spread Adjustment (SA):
   a. The Adjusted RFR can be a forward-looking or a backward-looking term rate. In the case of a backward-looking term RFR, it can be a simple average or a compounded average rate which needs to be adjusted to allow for time to pay;
   b. The Spread Adjustment (SA) needs to be added to the Adjusted RFR to ensure equivalence with IBORs.
      - For derivatives, Bloomberg has already fixed the Spread Adjustment for LIBORs in accordance with the ISDA recommended methodology. The corresponding fixed SA for 6M USD LIBOR is 42.82 bps and for 6M JPY LIBOR 5.809 bps using a 5-year historical median of the difference between LIBOR and SOFR Compounded in Arrears.
How are borrowers affected by the IBORs transition?

AfDB borrowers have been offered throughout the years loan products with IBORs as a floating base reference rate. Non-Sovereign guaranteed loans (NSGLs) are priced at IBORs plus a fixed lending margin. Since 2016, an interest rate floor of zero (0%) is applied directly on the IBOR benchmark for NSGLs. Borrowers also benefit from interest rate and currency hedging options when the Bank provides a fixed base rate or another currency through loan swaps where the Bank exchanges a fixed base rate or a local currency interest rate against the floating IBOR benchmark. Borrowers with these AfDB loans and hedging products will be impacted by the IBORs transition because IBORs will need to be replaced by the RFRs in existing applicable loans and related hedging products pricing. Borrowers benefiting from new NSGLs and related hedging products will also be impacted because they will directly use the RFRs within each loan agreement. It is therefore important for borrowers to understand the new pricing, when it will start being applied, what documentation is needed for the changes and how it will impact the loan payment billing and the communication with the Bank. It is also important for borrowers to start their own preparations in order to manage the transition through a timely assessment of their own internal processes, systems and requirements.

How will Non-Sovereign loan pricing be impacted by the IBOR transition?

The graph below illustrates the main components of AfDB Non-Sovereign guaranteed loans pricing that could be impacted by the transition.

Main components of AfDB Sovereign pricing:

- Base Rate
- Contractual Lending Margin
- Fixed Fees
- Late Payment Fees
- Break Costs
- Swaps Unwinding Costs

Impacted by IBOR transition

Impacted by IBOR transition
For Non-Sovereign guaranteed loans (NSGLs), IBORs in the existing loans will be replaced by the equivalent Adjusted RFR plus Spread Adjustment (SA). In new loans, the Adjusted RFR will be supplemented by a target funding margin that will allow AfDB to cover its funding costs. There are still discussions among Multilateral Development Banks and other development finance institutions to ensure harmonization on the targeted funding margin and how to present it in the loan pricing architecture (for instance include it in Lending Margin or keep it as a separate component). Where a floor is used on IBORs in existing loans, an equivalent floor will apply following the IBOR replacement. For new loans, it is possible to directly implement the floor at zero on the daily RFR. However, the implementation of the floor may depend on how existing operational systems can handle the new calculation methodologies. The schematic diagram below summarizes the interest rate architecture for both existing NSGLs transitioning from IBORs to RFRs and new NSGLs to be issued directly based on RFRs.
What are fallback provisions?

Floating benchmark rates used to calculate interest amount due from a borrower on a given date may not be available for various reasons. It is hence necessary to include in loan agreements fallback language that sets out the alternative rates, usually in the form of a waterfall of priority, which may replace the originally referenced benchmark rate when it is no longer available following defined trigger events. These fallback provisions can be hardwired when the replacement rate and its relative conventions are defined into the facility agreement thereby providing upfront a form of certainty. The fallback provisions can also use the “amendment approach” through the provision of a streamlined amendment mechanism (such as a lower consent threshold) for negotiating a benchmark replacement. The amendment approach does not itself define the benchmark that would apply although it sets out some parameters for its selection. Existing AfDB loan agreements do include fallback provisions in case IBORs are not available. However, the fallback provisions used for NSGLs are mainly for temporary unavailability of the benchmark. The provisions need to be adapted in the context of permanent cessation or non-representativeness of the benchmark.
Current fallback provisions in Non-Sovereign guaranteed loans (NSGLs) are mainly designed to cover a temporary unavailability of IBORs not their permanent cessation or non-representativeness. To facilitate the IBORs Transition, in January 2020, the Bank started to include an “amendment” version of fallback provisions into its new loans. These fallback provisions allow a light negotiation process to be adopted during the definition of the replacement rate once the transition triggers are achieved. However, for an orderly and streamlined transition, hardwired provisions are needed as recommended by ARRC for USD legacy loans.

The African Development Bank is currently developing hardwired fallback provisions that it will propose to its existing Non-Sovereign guaranteed borrowers in respect of its current portfolio of loans (also referred to as legacy loans). From September 2021, the Bank started organizing interactive webinars and follow-up sessions with its borrowers to inform them and receive their feedback on the changes to both existing and new loans. The Bank will then engage individually with its Non-Sovereign borrowers to negotiate the amendment of loan documentation to include the fallback provisions. Once the amendments are executed, existing loans based on USD LIBOR will transition to SOFR as agreed with the borrower, not later than the first loan interest reset date applicable to each loan following June 30th, 2023. EUR and ZAR indexed loans will continue using EURIBOR and JIBAR respectively until a transition trigger event occurs for them. The African Development Bank plans to start issuing new loans using SOFR for USD and TONA for JPY from the beginning of the year 2022.
Currently an option to request the fixing of the floating base rate is included in AfDB loans (except for few loans). Some borrowers have exercised the fixing option and are currently paying a Fixed Base Rate in lieu of the IBOR benchmark. Loan swaps are executed to implement these options. Loan agreements provide that in case of the occurrence of an event (in general prepayment or default) that require adjustment or unwinding of the loan swap, the borrower will pay the costs incurred by the Bank on the hedge if any.

Since 2016, loan swaps executed for Non-Sovereign guaranteed (NSGLs) that have a floor at 0 on the IBOR benchmark, also include a floor at 0 on the IBOR. Loan swaps executed by the Bank are governed by the ISDA agreements with swap counterparties. ISDA agreements provide for fallback provisions mainly in case of temporary unavailability of IBORs. To allow an orderly transition, ISDA has developed new fallbacks for derivatives to address permanent cessation and non-representativeness triggers. These new fallbacks have been integrated in the 2006 ISDA Definitions (ISDA Supplement) to apply automatically to new derivatives executed on or after the date the Supplement comes into effect (since January 25th, 2021). The new fallback provisions are also integrated into the ISDA Protocol which enables market participants to choose to incorporate the revisions into their legacy non-cleared derivatives trades with counterparties that also opt to adhere to the ISDA protocol. The methodologies used to determine the fallback rate were defined through a series of market-wide consultations conducted by ISDA. The Adjusted RFR will be determined using a compounding in arrears methodology over the interest period while the Spread Adjustment (SA) have been fixed using a 5-year historical median of the difference between an IBOR and the corresponding RFR compounded in arrears over the same tenor. For the Bank and its clients, it is important to ensure alignment between the hedged loans and the loan swaps. The Bank is assessing the implications for this alignment.
To prepare for the transition, borrowers can:

- Set up a dedicated team (including a technical expert and legal counsel) to understand the transition and the different pricing methodologies. This team should participate in the different workshops to be organized by the African Development Bank;

- Clarify internal processes and timelines to validate the expected changes;

- Identify any potential regulatory, operational or system challenge in implementing the new pricing.
Where can you find further information on the transition?

For specific questions on the impact of the transition on AfDB loans, you can contact AfDB teams at libortransition@afdb.org. For more general information on the transition, you can visit the below for relevant NWGs or regulators:

- For transition from USD LIBOR to SOFR: visit ARRC website
- For information on LIBOR cessation: visit IBA website or FCA website
- For transition from JPY LIBOR to TONA: visit JPY WG website
- For transition from EURIBOR to €STR: visit the website of the Working Group on Euro Risk-Free Rates
- For transition from JIBAR: visit the MPG webpage
- For transition on derivatives: visit ISDA website or Bloomberg website