IBOR Transition
Frequently Asked Questions

May 2023

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IBOR Transition – Frequently Asked Questions (FAQ)

Background

Over recent months, the transition from LIBOR benchmarks, to risk free replacements, has started. The first currencies to be impacted were CHF, Euro, GBP and JPY. The final currency to be moved and the one with the greatest regional impact will be US$ and US$ LIBOR is set to cease on 30th June 2023. These FAQ's are designed to provide background and to give some detail related to the transition of interest rate benchmarks. Please note that this does not apply to AED and no changes to the EIBOR process are seen at this time.

1. What is LIBOR?

The London Interbank Offered Rate (LIBOR) was designed to reflect the interest rates at which banks could borrow from and lend to each other, in the unsecured short-term market, at a fixed time each day, in specific currencies. To determine LIBOR, ICE Benchmark Administration (IBA), surveys/surveyed a pool of banks to estimate the rate at which they could borrow from other banks at 11.00 London time. This has been the key benchmark for hundreds of trillions in financial contracts worldwide for many years and LIBOR was originally produced for five currencies - GBP, USD, EUR, CHF and JPY.

2. Why does it need to change?

The integrity of LIBOR was called into question during the height of the financial crisis when several banks contributing to its calculation were accused of manipulating the rate. This resulted in recommendations, by the Financial Stability Board, for the global financial industry to reform and end the IBOR rate benchmarks by developing a set of alternative rates that are more representative of the current financial environment.

The recommendations included measures to:

- Strengthen IBORs by anchoring them to a greater number of transactions, where possible;
- Improve the processes and controls around submissions;
- Identify alternative near Risk Free Rates (RFRs);
- Encourage derivative market participants to transition new contracts to an appropriate RFR, where suitable.

Besides these recommendations, the report discussed transition issues and how market adoption will be monitored in the period ahead. The European Union (EU) followed with the introduction of the Benchmark Regulation (BMR), which incorporates a fundamental principle that benchmarks, including IBORs, need to be based on actual transactions to the fullest extent possible.

3. What alternatives were considered?

ICE Benchmark Administration (IBA), as the administrator of LIBOR, then reformed the methodology of LIBOR to a more transaction-based one. However, the number of underlying transactions in the interbank market had fallen and as a result, the calculation under the reformed methodology was viewed as being on the expert judgment of the LIBOR panel banks. The FCA agreed with the LIBOR panel banks that they would continue making submissions for all rates until the end of 2021. In late 2020, IBA issued a consultation on its intention to cease the publication of most LIBORs at the end of 2021, with an extension for certain USD LIBOR tenors to the end of June 2023. On 5 March 2021, after the consultation period, the IBA confirmed these intentions. Additionally, the FCA announced it would allow synthetic LIBOR like rates to be published beyond the cessation date to support those contracts that qualify as tough legacy.

At the end of 2021 IBA ceased the publication of GBP (1 and 6 month tenors) and CHF, EUR and JPY LIBOR (all tenors) and USD LIBOR (one week and two month tenors). The remaining 3 month GBP will be available until end of March 2024 and USD LIBOR tenors will be published by IBA until the end of June 2023 and 1,3 and 6 month synthetic rates will still be available until the end of September 2024.

For transparency, the synthetic LIBOR rates will be calculated using CME Term SOFR plus the respective ISDA fixed spread adjustment (Point 8. Below). The intention is that these rates will only be used for legacy positions and not to generate new business.

With the cessation of these IBOR rates, the market will need to switch from LIBOR benchmark references to Alternative Reference Rates (ARR).

4. What are Alternative Reference Rates?

Market participants and industry bodies put in a significant amount of effort to find a way to either reform existing benchmark rates or, alternatively, to develop replacements that meet regulatory requirements. The outcome is a set of alternative rates based on overnight transactions, which are designed to be representative of a nearly risk free rate. They are frequently referred to as Risk Free Rates (RFR). Below is an overview of the recommended alternative rates per LIBOR (London Interbank Offered Rate) currency. RFRs are considered to be more robust and representative than IBORs because transactions in the underlying market form the determined rate to a greater extent than is currently the case for many IBORs. For each existing IBOR and the recommended replacement RFR, proposals within the various jurisdictions are at different stages and vary in scope and transition timing.

Libor Currency	Administrator	RFR	Secured/Unsecured
USD	Federal Reserve Bank of New York (Fed)	Secured Overnight Financing Rate (SOF)	Secured
GBP	Bank of England (BoE)	Sterling Overnight Index Average (SONIA)	Unsecured
EUR	European Central Bank	Euro Short Term Rate (€STR)	Unsecured
CHF	Six Swiss Exchange	Swiss Average Overnight Rate (SARON)	Secured
YEN	Bank of Japan (BoJ)	Tokyo Overnight Average Rate (TONA)	Unsecured

5. How do Risk Free Rates differ from IBOR?

The key difference is that LIBOR is a forward-looking rate and the LIBOR-linked rate in a contract is known at the start of the relevant interest period. All the RFRs are overnight rates and therefore the term rate is not known in advance. One approach to create a term rate from these overnight rates is on a backward-looking basis. The backward looking term rate can be constructed by calculating a simple or compounded average of the daily fixings of the RFR over the given term. This means that the determination and accounting for any term period, based on RFRs, requires significantly different mechanics. A spread adjustment is also needed to account for the fact that IBOR's incorporate a bank credit spread and liquidity premium. Those differences can be seen in the diagram below:

	IBORs	RFRs
Calculation basis	Based primarily on panel banks submissions	Based on actual transactions
Tenor	IBORs have several tenors	RFRs have a single overnight tenor
Horizon	IBORs are forward-looking (providing borrowers a known interest for the time period)	RFRs are backward-looking
Risks	IBORs include liquidity premium & bank credit risk component	RFRs are considered as risk-free and expected to be lower than IBOR equivalent as no liquidity premium & bank credit risk are priced in.

6. How can overnight rates be used for term instruments?

When calculating the rate in arrears, a business day lookback (2, 3 or 5 days) with no observation shift is recommended. This lookback enables the administrative agent/counterparts to calculate the rate of interest, for the interest period, before the period ends and the interest payment is due. This gives the agent/counterparts time to invoice the borrower and for the borrower to pay the interest in a timely fashion. The most frequent lookback is five business days and the following is an example of a five business day lookback, for a 90-day loan:

Interest Date	Observation Date	Day Count	RFR Rate
06/16/2022	06/09/2022	1	0.75000
06/17/2022	06/10/2022	4	0.75000
06/21/2022	06/13/2022	1	0.73000
06/22/2022	06/14/2022	1	0.69000
06/23/2022	06/15/2022	1	0.70000
06/24/2022	06/16/2022	3	1.45000
06/27/2022	06/17/2022	1	1.45000
06/28/2022	06/21/2022	1	1.45000
Hidden for presentation purposes			
09/07/2022	08/30/2022	1	2.29000
09/08/2022	08/31/2022	1	2.29000
09/09/2022	09/01/2022	3	2.29000
09/12/2022	09/02/2022	1	2.29000
09/13/2022	09/06/2022	1	2.29000

From 16th June – 14th Sept (90 days), with 5 days lookback, the rate would be 1.79536% compounded in arrears. The five day lookback means that the administrative agent will be able to invoice the borrower and the borrower will be able to pay the interest by September 14th. This method will apply irrespective of the calculation being simple or compounded.

While the preference from many Regulators is to use the RFR's, the Alternative Reference Rate Committee (ARRC), in the US, an industry group, recognized that there could be conditions when adapting to an overnight rate that could be difficult. They therefore recommended the use of CME Term SOFR – a series of derivative contracts traded on the Chicago Mercantile Exchange representing market participants views as to the expected SOFR rate for various tenors, 1, 3 6 months etc. ARRC noted that it could be especially helpful for business loans. While not a regulatory body, 1, 3 and 6 month SOFR are recommended, for US$, based on a depth of underlying transactions and since they come at a reasonable cost, to smooth the LIBOR transition. Products where Term SOFR can be used are shown below:

Legacy	New	Derivatives
Floating rate loans	Multi-lender facilities	Limited to end-user hedging cash products that reference the SOFR rate
Bilateral loans	Small/Mid-cap loans	
Syndicated Loans	Trade Finance	

In other currencies, the progress on the development of forward-looking term RFRs has been mixed. For example:

- In the UK, authorities have made it clear that their preference for the market is to adopt a broad-based transition to SONIA compounded in arrears, with the use of a forward-looking term SONIA rate being limited. Nevertheless, some benchmark administrators have started publishing forward term RFRs for SONIA for one, three, six and twelve month tenors.

Given the variety of conventions allowed by regulators and those followed by the market, CBD will be flexible to support your requirements. Should you require Term or backward looking SOFR, or a 2 or 5 day look-back for example, CBD will be able to support you. However, preference would be given to the following waterfall:

- Term SOFR
- SOFR compounded in arrears with a five day look-back (No observation shift).
- SOFR compounded in arrears with 2 days look-back if an existing Libor IRS is already in place that has transitioned under ISDA Protocol (No observation shift)

7. Why do we need Credit Adjustment Spreads during the benchmark transition?

As highlighted earlier, Risk-Free Rates (RFRs) are not economically equivalent to Interbank Offered Rates (IBORs). Some elements included within IBORs such as a term liquidity premium and a bank credit risk element are not found in the alternative rates. In most cases, RFRs are therefore expected to be lower than their IBOR equivalent for these reasons. In line with recommendations of the relevant working groups, when existing contracts are transferred onto RFRs, a credit adjustment spread (CAS) should be applied in addition to the RFR. To explain further, this is to capture the interbank credit risk previously imbedded in LIBOR, it is not a representation of customer credit risk. This is to minimize the economic impact of transitioning away from the relevant IBOR. The purpose of applying the credit adjustment spread is to ensure that existing contracts referencing an IBOR continue to function as closely as possible to what was intended in economic terms before the replacement with the RFR.

8. How are CAS calculated?

To create the CAS, the relevant RFR/IBOR difference is observed over a period of time. In the case of calculation in arrears (ISDA Protocol), the spread adjustment is determined using a "historical median approach" based on the median spot spread between the relevant IBOR and the adjusted RFR, calculated over a five-year lookback period. These fallback spread adjustments for each LIBOR currency and tenor were determined and published by Bloomberg and fixed as of 5 March 2021, for trades that will transition on 30th June 2023.

The replacement rate therefore will equal the term-adjusted RFR plus the spread adjustment. The spreads for US$ are shown below;

Tenor	ISDA CAS
1 week	0.03839
1 month	0.11448
3 month	0.26161
6 month	0.42826

For an example of how this would reflect on a transaction, please see table below:

	Benchmark	**Margin**	**Total**
Original Terms	**3m LIBOR**	**+50bp**	**3mL+50bp**
New Terms	**3m CME Term SOFR or compounded SOFR**	**+50bp+CAS 0.26161**	**3m CME Term SOFR or compounded SOFR +76.161bp**

For the other indicative IBOR fallback rates please refer to IBOR Fallbacks Spread Adjustment. However, it should be noted that for Euro, most fixings are taking place on EMMI (EURIBOR) and for GBP on ICE Synthetic.

9. Which products and financial contracts are impacted by benchmark reforms?

Products that are impacted by benchmark reforms, are products that are linked to an Interbank Offered Rate (IBOR), for example 3-month USD LIBOR plus a margin. Please note that products that are based on a fixed interest rate, or a variable interest rate that is not based on an IBOR (for example an "all-in" variable interest rate or "Cost of Funds") do not have to be amended.

Examples of products that are linked to IBORs include (but are not limited to):

- Retail mortgages with a variable interest rate linked to an interest rate benchmark (i.e. not fixed rate mortgages or mortgages on the basis of an "all-in" variable rate);
- Overdraft facilities linked to an interest rate benchmark plus a margin;
- Bilateral or syndicated loans linked to a variable interest rate;
- Trade Finance;
- Bank accounts in foreign currencies (FX accounts) and
- Derivatives (For example an interest rate swap).

In the UAE the greatest impact will be in US$'s and that transition must take place by the end of June 2023. Before that date, market participants must decide on the replacement benchmark and identify the optimal solution for business needs and systems.

Currently, market consensus looks to be a waterfall for pricing on conventional products:

- Term RFR/Compounded RFR +CAS
- Other bilateral agreement (to accommodate arrears preferences). ISDA CAS is the norm.

For Islamic loans only, CBD will use Term RFR+CAS with its counterparties.

10. What will happen to the existing products or contracts that mature after the relevant LIBOR cessation date?

IBOR-based contracts and products that mature after the cessation date of the relevant Interbank Offered Rate (IBOR) will need to transition to an alternative benchmark rate. Such transition and the selection of the alternative benchmark rate may have some governance from fallback provisions in the contract.

The older, existing contracts may, however, not have appropriate provisions to deal with a permanent cessation of the initially agreed upon benchmark rate. If the contract terminates after the relevant LIBOR will cease to exist, the contract needs to be amended to reflect a suitable alternative interest rate benchmark.

11. Problems to watch for:

a) Systems:

Currently, the market is using forward looking benchmark and systems are generally set up to manage this. The closest replacement product to this will be CME Term SOFR, another forward looking rate.

However, if SOFR in arrears is required, then the system will be required to book a daily rate (with a lookback) and the final rate will not be known until settlement. Your systems will need to be able to accommodate this change.

b) Derivative contracts:

ISDA has conducted a number of consultations to support the transition process for the derivatives markets and published the long-awaited updated IBOR Fallback Supplement (IBOR Supplement) to the 2006 ISDA Definitions on 23 October 2020. The IBOR Supplement has amended the 2006 ISDA Definitions to incorporate robust fallbacks for derivatives referencing relevant IBORs, with the changes effective on 25 January 202 1. From this date, all new derivatives that reference the 2006 ISDA Definitions will incorporate the fallback mechanisms. Legacy trades initiated prior to 25th January 2021 will be covered under the ISDA protocol, which sets terms and conditions for the transition and all migrating trades will follow these terms and conditions.

Trade migration, will depend on loan and the benchmark for that transaction. For the two types:

- US$ Customer deals based upon SOFR in arrears:
    - While CBD has signed up for the ISDA Protocol, it is understood that not all customers will do so. However, the same terms and conditions are likely to remain the same and deals to take up Bloomberg/ISDA CAS;
    - It should also be noted that ISDA protocol is a 2-day look-back for settlement, while loan convention is a 5-day look-back. This needs to be matched.
    - Customer loan based upon SOFR in arrears
    - All in rate, CAS, and other conventions are standardized by ISDA, but have flexibility to change using ISDA's confirmation templates.
- US$ Customer deals based upon Term SOFR (including Islamic):
    - Deals to take Bloomberg/ISDA CAS
    - Customer loan based upon Term SOFR.

In all cases, it will be essential to ensure that benchmarks match.

c) Trade:

While LIBOR may be referenced for local transactions that mature before June 30th 2023, the market is switching to the respective CME term plus a credit adjustment spread.

d) Deposits:

For deposits that mature before June 30th 2023, some may use US$ LIBOR. For anything over that date (or before if required), a switch to CME Term SOFR, or a calculation in arrears will be required. This will need to match with your loan booking and overall business requirements.

14. What do I need to do next?

Hopefully, these FAQ's explain and will give some direction for this material change to our operating environment. As a customer of CBD, your RM will reach out to you, over the coming months to discuss the transition and agree on amended documentation.

In the meantime, we provide several links below which will give you an overview of the main interest rate benchmarks that are subject to the transition.

If you have any further questions, then please contact your RM directly or email the IBOR Transition Group on IBORTransition@cbd.ae

Additional information on the benchmark reforms:

Regulators, central banks and related institutions produced considerable material on the benchmark reforms which is available on their respective websites:

- European Central Bank (ECB)
- European Securities and Markets Authority (ESMA)
- UK Financial Stability Board (FSB)
- UK Financial Conduct Authority (FCA)
- Financial Services and Markets Authority (FSMA)
- ISDA Benchmark Reform & Transition from Libor
- https://www.fca.org.uk/news/news-stories/fca-announces-decision-synthetic-us-dollar-libor
- https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2021/ARRC_Scope_of_Use.pdf

Each of the industry-led working groups has established a specific website to provide market participants with information regarding key transition topics and steps and other relevant data:

- USD: Alternative Reference Rates Committee
- EUR: Working Group on Euro Risk-Free rates
- GBP: Working Group on Sterling Risk-Free Reference Rates
- JPY: Committee on Japanese Yen Interest Rate Benchmarks

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