FREQUENTLY ASKED QUESTIONS **December 2021**

LIBOR / SOFR transition

1. When will SOFR be used for existing loans and for new loans?

⇨ From 31st December 2021, no new loan in USD LIBOR will be signed and provided to clients.

⇨ For existing USD LIBOR loans with a maturity date before 30/06/2023, no modification is required. However, for existing USD LIBOR loans with a maturity date after 30/06/2023, a transition to SOFR will occur through an amendment to sign.

⇨ DEG, FMO and PROPARCO will start transitioning USD LIBOR existing loans in 2022.

2. Why is the LIBOR SOFR transition required?

⇨ LIBOR determination is based on submissions from selected panel banks. These submissions are supposed to reflect the real interest rate that banks are paying for borrowing in the interbank market. The LIBOR scandal of 2012 arose when it was revealed that several panel banks were deliberately inflating or deflating their submitted rates in order to make profit on their trade positions, or to give the impression by artificially lowering their rates of being more creditworthy than what the market would indicate based on an objective assessment.

⇨ That is why since January 2018, the Benchmark Regulation (BMR) has been the European answer to address the benchmark rate manipulation in 2012. Indeed, the LIBOR scandal needed a strong answer due to risks of conflicts of interest and manipulation, ensuring that rates are adequately representing market conditions on the basis of reliable data becoming Risk Free Rates (''RFRs'').

⇨ The purpose of this regulation is to reinforce the framework of benchmark rates by reviewing the computation methodology resulting in more robust interest rates (Risk Free Reference rates).

3. Is SOFR different from LIBOR and why?

⇨ SOFR is a risk free rate (collateralized by repo-ed US-Treasuries, currently equivalent to a triple A rating) whereas USD LIBOR is an unsecured interbank rate (currently equivalent to a single A area credit risk). Thus, there is a risk difference between the two rates resulting in SOFR being structurally lower than USD LIBOR.

4. How will the transition process be coordinated in case of a co-financing loan?

⇨ When the loan is co-financed with several lenders, a common methodology will be suggested to the borrower.

Term SOFR vs. other calculation methodologies

5. Do DEG, FMO and PROPARCO have a preference to convert a USD LIBOR loan to either Fixed, Term SOFR or compounded SOFR?

⇨ As lenders, we have no preference between a USD LIBOR conversion to fixed rate and transition to a SOFR floating rate. Fixed or floating remains at borrower's choice. However, it is worthy to note that in most situations, the conversion option to fixed rate is already included in the facility agreement, so no major modification of the existing contract is required. On the contrary, the transition to SOFR involved the amendment of the existing contract.

⇨ With regards to the USD LIBOR transition to SOFR rate, our three institutions are preparing for both the Term SOFR and the compounded SOFR. We should favor Term SOFR especially for syndicated transactions as it would be easier to implement as a successor rate for USD LIBOR for loans, being also a forward-looking rate so using the same interest rate setting mechanics.

6. When is the SOFR rate applicable to the interest period known?

⇨ For Term SOFR, the rate is forward looking, meaning the rate is known at the beginning of the period like USD LIBOR. By standard convention, the period interest rate is set using the Term SOFR published 2 business days before the beginning of the interest period.

⇨ For compounded SOFR, the rate is backward looking, meaning it is known at the end of the interest period. In order to allow enough delay between the computation of the applicable interest rate and the effective interest payment, a shift of a specific number of days – the lookback period – is usually applied between the observation period (during which daily SOFR interest rates are collected and compounded) and the interest period. In the loan market, diverse lookback periods are under consideration. DEG, FMO and PROPARCO have set a standard lookback of 15 or 30 business days. This means that the period rate would be known 15 (or 30) business days before interest payment date.

7. Why is Term SOFR – being based on expectations – a stronger benchmark than LIBOR, guaranteeing that no similar manipulation occurs?

⇨ As mentioned in *answer to Q2. above*, LIBOR has been subject to manipulation in the past, being based on submissions from panel banks, which happened to differ sometimes from what banks were really paying for borrowing in the interbank market.

⇨ CME Term SOFR rates are derived from CME SOFR future contracts, traded on the CME Designated Contract Market (DCM), and with volume averaging $218 billion in representative notional per day in H1 2021. Based on effective transactions and executable orders in these SOFR Futures, CME then models projections to get market expectations of daily SOFRs in the coming days and months, and it computes these forward daily rates to determine Term SOFR for each tenor. No expert judgement is applied to the determination of the CME Term SOFR. More information on CME Term SOFR methodology: https://www.cmegroup.com/market-data/files/cme-term-sofr-reference-rates-benchmark-methodology.pdf

8. Is Term SOFR used for both loans and derivatives?

⇨ CME Term SOFR is available for licensing in the cash market (including loans), and in the derivatives market with restrictions (derivatives that hedge Term-SOFR cash instruments, or permissible derivatives based on FRAND – fair, reasonable, and non-discriminatory – principles).

⇨ CME Term SOFR benchmarks are made available to market participants subject to execution of a license agreement.

9. Where can we find the evolution of SOFR?

⇨ The historical data on SOFR is available on Fed website:

https://apps.newyorkfed.org/markets/autorates/SOFR

10. For daily SOFR compounded in arrears transactions, what option on observation shift is offered?
- ⇨ PROPARCO will only offer shift (= with observation shift) option.
- ⇨ DEG will offer both lag (= without observation shift) and shift options.
- ⇨ FMO will offer both lag (= without observation shift) and shift options from April 2022 onwards.

11. Does a recommendation exist for the reset frequency of Term SOFR?
- ⇨ There is no recommendation on the use of a specific tenor (3- or 6-month). The tenor should be aligned with the interest payment frequency, which is usually aligned with the repayment schedule frequency. For example, for a loan having Term SOFR as benchmark and with a half-yearly repayment schedule, the interest rate should be reset every six months based on the Term SOFR 6-month tenor.

12. How are hedging agreements impacted by the transition?
- ⇨ FMO, DEG and PROPARCO do not provide any hedging instrument to borrowers. Fixed rate conversion is not to be considered as a hedging agreement, but for information, the transition will not impact outstanding fixed rate loans.
- ⇨ Borrowers having entered into hedging agreements with other counterparties are being invited to liaise with them directly. For swaps and derivatives under ISDA Protocol, information is available here: https://www.isda.org/2020/10/23/isda-launches-ibor-fallbacks-supplement-and-protocol.

Adjustment Spread

13. How the adjustment spread will be introduced in the pricing conditions? And how this spread will impact the cost of the loan?
- ⇨ For existing LIBOR loans transiting to SOFR, LIBOR will be replaced by SOFR + adjustment spread (economic equivalence).
- ⇨ For new SOFR Loans, the SOFR margin will be higher than the LIBOR margin because the adjustment spread will be carried in the SOFR margin instead of being included in the reference rate.
- ⇨ The adjustment spread is not supposed to modify the overall pricing of the loan. It aims to maintain the economic balance of the transaction, to compensate for the differences between LIBOR and SOFR

14. How will the adjustment spread be determined?
- ⇨ From 30 June 2023 (and for early conversion before that date), we may use the ISDA adjustment spread (0.42826% for USD 6-month tenor, 0.26161% for USD 3-month tenor) and expected to be market practice. Indeed, the ARRC recommends spread adjustments for commercial cash products (including loans) would match the spread adjustment values for fallbacks in ISDA's documentation, which has been fixed on 5 March 2021 by Bloomberg.
- ⇨ The specific conversion strategy will be determined in the course of 2022 and will be communicated at the time

Alternatives

15. Is a conversion from variable rate to fixed rate on a USD LIBOR loan possible?
- ⇨ Yes, according to the conversion to fixed rate clause (conversion fee applicable, can be waived on case-by-case basis) when included as part of a loan contract.
- ⇨ You can approach your client relationship manager anytime for such conversion.

16. Is voluntary prepayment of a USD LIBOR loan possible?
- ⇨ Yes, according to the voluntary prepayment clause conditions (prepayment fee applicable).

17. Are break-cost applicable to:
- ⇨ Daily SOFR loans? No, daily interest rate reset, on-lend the proceeds at daily SOFR
- ⇨ Term SOFR loans? Yes, comparable to LIBOR break clause

Other questions

18. What about EURIBOR?
- ⇨ On EURIBOR, the computation methodology has evolved to be compliant with the BMR regulation. EURIBOR Hybrid methodology is fully implemented since December 2019. Thus, all contracts will be able to continue to use EURIBOR as benchmark rate after 1st of January 2022.

19. What about local currencies?
- ⇨ For fixed rate loans: no impact.
- ⇨ For floating rate loans: to be assessed according to local regulation. This depends who a local currency loan is funded (swap based on LIBOR or EURIBOR).