ADB

Proposed Reference Rate Transition for ADB's Financial Loan Product

June 2021

Today's Agenda

- Background on LIBOR Transition
- New Proposed Reference Rates
- ADB's Proposed Transition Approach
- Numerical Example

Recap on LIBOR Transition

- LIBOR has been widely used as a reference rate for financial contracts.
- A decline in underlying transactions and reliance on expert judgment opened LIBOR to manipulation.
- In response, regulators decided to phase out LIBOR. In 2013, the G20 requested the Financial Stability Board to reform reference rates to strengthen the global financial system. Alternative reference rates based on more active overnight lending markets have been identified as replacements.
- On 5 March 2021, regulators announced that yen LIBOR will end on 31 December 2021 and 3- and 6-month USD LIBOR on 30 June 2023.
- Regulators also issued guidance to financial market participants that all new loans, bonds, and derivatives cease to use USD LIBOR by 31 December 2021 at the latest.

New Reference Rates to replace LIBOR

- **For USD LIBOR:**
  - the Secured Overnight Financing Rate (SOFR)
  - SOFR is based on transactions in the US Treasury repurchase market, where banks and investors borrow or lend US Treasury securities overnight. SOFR is fully based on transaction data and is a near risk-free rate.

- **For yen LIBOR:**
  - the Tokyo Overnight Average Rate (TONA)
  - TONA reflects the cost of borrowing yen overnight on an unsecured basis in the money market. TONA is fully based on transaction data and is a near risk-free rate.

- **For euro:**
  - EURIBOR will continue to be the reference rate used for euro currency loans, as it has been reformed and found compliant with European regulations.

SOFR Compared to LIBOR

SOFR and LIBOR reflect short-term borrowing costs but there are key differences.

SOFR	LIBOR
Relies entirely on transaction data from over $700 billion in daily repurchase transactions.	Is based partially on market-data and partially on expert judgment.
Measures the cost of collateralized borrowing overnight based on interbank trades and secured by US Treasury securities.	Measures the cost of uncollateralized borrowing in the interbank market and incorporates a built-in credit-risk and liquidity component.
A backward-looking rate, published daily.	A forward-looking rate, published daily, with term rates from 1 day to 1 year.

ADB's LIBOR Transition Approach

- The objective of ADB's LIBOR transition approach is to ensure an orderly transition process to safeguard ADB's AAA credit rating and to continue to pass on the most stable and cost-effective rates to borrowers.
- In October 2020, ADB's Board of Directors approved the R-paper on preparing for the reference rate transition of ADB's sovereign loans.
- The R-paper comprised amendments to ADB's loan regulations to accommodate the reference rate transition and the principles to be adopted by ADB in the LIBOR transition process.

ADB's LIBOR Transition Approach

- In early June 2021, the working paper on the proposed reference rate transition of ADB's financial loan product was reviewed by ADB's Board of Directors.
- Due to the reference rate reforms, ADB must select alternative reference rates for its financial loan product and transition the existing loan and derivative portfolios into the post-LIBOR world.
- Feedback from this borrower outreach will be incorporated into the R-paper, which is scheduled for Board consideration in the third quarter of 2021.

Proposed Changes: Loan Product Name

- ADB proposes to rename its loan product to Flexible Loan Product (FLP)

- The name FLP captures the flexible options currently offered, including options for rate fixings, loan conversions, and tailored amortization structures.

Proposed Changes: Reference Rate

- ADB proposes to change the reference rate for USD- and yen-denominated loans from 6-month LIBOR to 6-month SOFR compounded in arrears and 6-month TONA compounded in arrears. Compounded in arrears calculates an interest rate based on compounding a rate over the interest period to produce a backward-looking rate.

- In line with peer multilateral development banks, ADB will use the SOFR Index published by the Federal Reserve Bank of New York, continue to bill sovereign loans semi-annually, and continue to generate the billing statements 2 months before due date. For the last 2 months, interest will be projected based on the 30-day SOFR Average published by the Federal Reserve Bank of New York. The difference between this proxy and the actual rate will be included in the next billing.

Proposed Changes: Cost Base Rate

- ADB's cost pass-through principle refers to passing on its cost of funding to borrowers.
- ADB will continue to determine rebates and surcharges based on the cost pass-through principle, which applies the difference between ADB's actual funding cost and the relevant reference rate—albeit benchmarked against the new SOFR and TONA reference rates.

Sovereign Loans Transition: Regulatory Guidance

- Regulators issued guidance to cease the use of USD LIBOR in new financial contracts by 31 December 2021.
- Therefore, from 1 January 2022, it will no longer be commercially acceptable for ADB to use LIBOR for the purposes of its asset and liability management.
- ADB therefore proposes to transition its sovereign loans to the terms of the FLP from 1 January 2022.

Sovereign Loans Transition: Implementation

- New ADB Ordinary Capital Loan Regulations will reflect the terms of the FLP and become effective on 1 January 2022.
- All new regular sovereign loans approved on or after 1 January 2022 will apply the new loan regulations reflecting the terms of the FLP.
- After approval of the new loan regulations, notices will be sent to borrowers of existing sovereign loans setting out changes to their loan agreements to reflect the terms of the FLP. These changes will apply from 1 January 2022.

Existing Sovereign Loans Transition: SOFR-Based Billing

- SOFR-based billings will begin from the first interest period commencing on or after 1 January 2022 for each loan. Interest payment dates are on the 1st or 15th of any month, and 6 months thereafter.

- To illustrate, some loans will receive SOFR-based billings on 1 May 2022 for the interest period commencing on 1 January 2022, as ADB sends out its billings 2 months in advance of the interest payment date on 1 July 2022. While some loans receive the first SOFR-based billings on 15 October 2022 for the interest period commencing on 15 June 2022, with the interest payment date on 15 December 2022.

Existing Sovereign Loans Transition: Board-Approved Principles

This transition meets the principles for the following reasons:

- **Market-based approach.** This approach is fully consistent with peer multilateral development banks, especially World Bank and AIIB
- **Cost pass-through principle.** One pool of liabilities will fund newly approved and existing loans which allows ADB to apply the cost pass-through principle uniformly.
- **Uniformity.** This approach meets the important criteria that all borrowers are offered the same loan terms.
- **Transparency.** ADB will disclose all relevant calculations to borrowers and the Board of Directors.

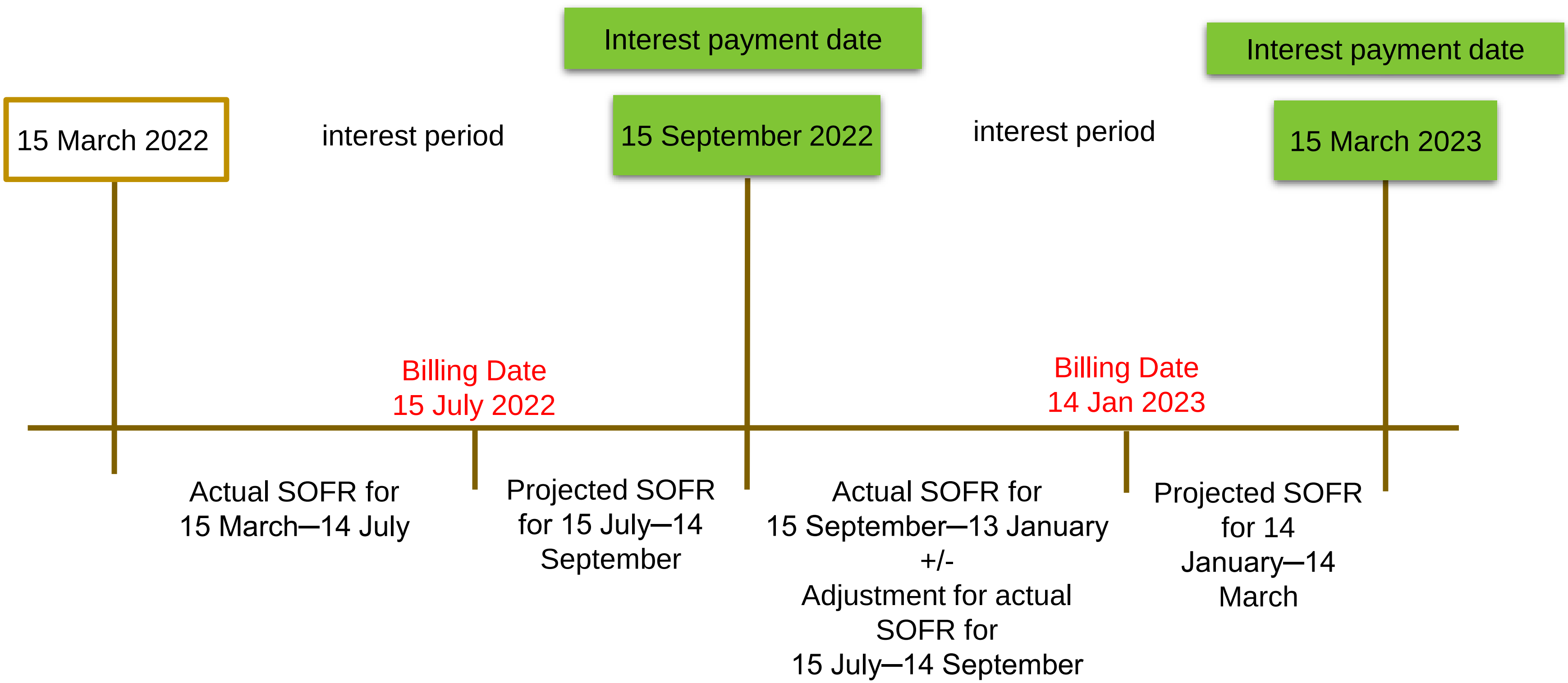
Example: 6-Month SOFR Compounded in Arrears Interest Period

Interest = SOFR + Contractual Spread + Maturity Premium + Rebate or Surcharge

Example:

- Interest period: 15 March 2022—15 September 2022
- Interest payment date: 15 September 2022
- Billing cut-off date for interest calculation: 15 July 2022
- Interest rate is based on actual SOFR for 15 March—14 July 2022 and projected SOFR for 15 July—14 September 2022.

Example:
6-Month SOFR Compounded in Arrears Interest Period



Q & A

The preferred method for the Q&A is through the chat box. You can either:

- indicate that you wish to ask a question, or
- directly post your questions in the chat box.

The moderator will ask you to speak up or refer your question to the appropriate speaker.

Appendix

6-Month LIBOR Interest Period

- Loans are billed on a semi-annual basis and payment dates are on the 1st or 15th of the month.
- Interest is paid at the end of the interest period. The interest rate is based on 6-month LIBOR as of 2 business days before the start of the period.
- Interest is calculated 60 calendar days before the period end and payments are due at the end of period.

Example:
6-Month LIBOR Interest Period

Interest = LIBOR + Contractual Spread + Maturity Premium + Rebate or Surcharge

Example:

- Interest period: 15 March 2014—14 September 2014
- Interest payment date: 15 September 2014
- Interest rate: 6-month LIBOR as of 13 March 2014
- Billing cut-off date for interest calculation: 15 July 2014