FAQ- Questions on Calculation Methodologies

What is a credit spread adjustment and how will it be applied?

A credit spread adjustment will need to be applied to RFRs to make them equivalent to their respective IBORs in order to transition legacy transitions that are LIBOR based. LIBOR is the rate at which global banks in each jurisdiction lend and borrow amongst each other on a short term unsecured basis. This activity takes place because banks face each other bilaterally so the transaction is facilitated based on bank credit. Since RFRs do not have a bank credit premia component, this will make it difficult to transition legacy transactions based on LIBOR to RFRs. To account for this difference, ISDA has proposed a credit spread be applied to RFRs to make them equivalent. Through numerous industry consultations ISDA determined that a credit spread calculation of the median historical lookback of a period of five years from the time the transition is triggered would be the best approach. A different spread would be calculated for each LIBOR tenor respectively. Unlike the credit spread in LIBOR which is sensitive to prevailing credit conditions in the market and thereby dynamic, the credit spread applied to the RFRs will be static.

What is Compound Setting in Arrears and how is it calculated?

As a result of extensive consultation with market participants and other industry stakeholders ISDA elected to utilize a compound setting in arrears calculation methodology for all RFRs covered by the consultation. Compound setting in arrears is a backward looking calculation, unlike LIBOR which is forward looking. With LIBOR interest payments can be calculated at the time of the transaction opposed to RFRs the interest payments are only available once the loan has expired. For RFRs, the interests is compounding the rate overnight for each day of the loan period, so it looks back but represents the actual (not anticipated) cost of funds. For some market participants this difference can be problematic and has caused a bifurcation in the market between those who operationally prefer forward looking term rates and those who find backward looking compounded rates agreeable, cash and derivative market participants respectively. In order to ease the transition to backward looking compounded rates mechanisms such as lockouts, lookbacks (observational shifts) and payment delays can be applied so that interest can be known to some degree in advance.

What are Lockouts, Lookbacks and Payment Delays and how are they applied?

Lockouts, lookbacks and payment delays are mechanisms that can be applied to compounded overnight rates in order to provide some advance notice to the borrow of the interest they owe. A lockout mechanism allows the interest due to be calculated ahead of the loans end date by establishing a rate freeze period of 2-5 days ahead of the end date called the lockout period. During the lockout period, or rate freeze period, the rate becomes static or unchanged going forward for however many days until the loan period is complete. Since the rate will continue to be the same it allows the borrower and lender to proceed with the interest owed calculation ahead of time. For example, if the loan is a 30 day loan on day

25 the rate becomes static and will be whatever it was on that date for the rest of the loan period, the next five days.

A lookback mechanism also referred to as an observational shift or backward shift, allows for advance notice by shifting the calculation period backwards 2-5 days into the previous period. By shifting the calculation period backwards 5 days into the previous period, parties are able to get ahead of the interest calculation and finish ahead of the loan end date thus providing the advance notice. For example, a loan initiated on day one of Month B will lookback 5 days into the previous Month A to start its calculation period. The loan calculation period will encapsulate that last 5 days of Month A and the net 25 days of Month B but the actual loan will mature 5 days later on day 30 in Month B. Shifting the loan calculation period allows for advance notice of the interest owed.

A payment delay mechanism is the easiest to implement but the least popular and it is often used in conjunction with a lockout period. Essentially the payment is simply delayed 2 to 3 days following the expiry of the loan giving parties time to calculate interest and arrange payment. Each mechanism comes with advantages and disadvantages and operational considerations.

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