Schroders

London Interbank Offered Rate Transition

Frequently Asked Questions for Clients

LIBOR – An overview

The London Interbank Offered Rate (LIBOR) was officially adopted in 1986, with roots dating back to the 60s. Underpinning some $300 trillion (Refinitiv, October 2019) of financial instruments, it is one of the most widely quoted reference rates in the world. It is expected that most LIBOR settings and most other Interbank Offered Rates (IBORs) will cease to exist after the end of 2021.

1. What is LIBOR?

LIBOR is based on submissions by a panel of global banks. Each bank is asked every day to provide the rate at which they could secure short term lending from another major bank and those submissions are used to calculate LIBOR in accordance with an agreed methodology.

LIBOR is used as a reference rate in a wide range of financial contracts, including derivatives, bonds and loans. It is set for seven maturities (or tenors), ranging from overnight to 12 months, and five different currencies for each maturity. LIBOR rates exist for the US dollar, sterling, euro, yen and Swiss franc.

Where there are insufficient actual transactions or transaction-related data on which to base their LIBOR submissions, the panel banks must use their "expert judgement" within certain agreed parameters to provide their submissions.

2. Why is LIBOR being replaced?

A significant decline in interbank lending and some high-profile instances of LIBOR manipulation resulted in the publication of the Financial Stability Board's (FSB) recommendation in 2014 to develop alternative so-called "risk-free" rates (RFRs) for use instead of LIBOR and other IBORs. In July 2017, the former Chief Executive of the Financial Conduct Authority (FCA) Andrew Bailey, said in a speech that "…the underlying market that LIBOR seeks to measure – the market for unsecured wholesale term lending to banks – is no longer sufficiently active."

In the same speech, Andrew Bailey also said, "In our view, it is not only potentially unsustainable, but also undesirable, for market participants to rely indefinitely on reference rates that do not have active underlying markets to support them". He went on to say that the FCA would not compel banks to make LIBOR submissions after the end of 2021 which was widely understood as a sign that LIBOR would cease to exist post-2021.

The FCA further confirmed that LIBOR would be discontinued at the end of December 2021 by publishing statements throughout 2020 asking for firms' plans for the transition away from LIBOR; clarifying that it remains the central assumption that firms cannot rely on LIBOR being published after the end of 2021 and setting out their expectations for the end of LIBOR.

3. What is LIBOR being replaced with?

Following the FSB's recommendation in 2014, industry working groups were established to develop the new Risk Free Rates ("RFRs" and also known as "alternative reference rates") that are expected to replace LIBOR and other IBORs. Most currencies/tenors of LIBOR still have an expected cessation date of 31 December 2021. However there have also been recent announcements from the FCA and a number of US regulators that whilst 1-week and 2-month USD LIBOR are due to be discontinued on 31 December 2021, all remaining USD LIBOR settings will continue to be published until 30 June 2023.

The new RFRs selected for the five major currencies of LIBOR are as follows:

LIBOR currency	New risk free rate
Sterling LIBOR	Reformed SONIA (Sterling overnight index average)
US dollar LIBOR	SOFR (Secured overnight financing rate)
Yen LIBOR	TONA/TONAR (Tokyo overnight average rate)
Swiss franc LIBOR	SARON (Swiss average overnight rate)
Euro LIBOR	€STR (Euro short term rate)

4. What is Schroders' plan for the transition away from LIBOR?

Schroders has a robust plan for the effective management of the impact on our clients' investments as a result of the transition away from LIBOR and has established a dedicated team responsible for this task.

Impact assessment

Schroders has completed an assessment to determine the impacts of the transition away from LIBOR, and certain other key IBOR, to RFR for our clients and our business. As part of this impact assessment we have analysed the work required to transition investments, change legal documents and update operational and technology systems.

Shaping the future use of RFR, post LIBOR

We believe that it is essential for the industry to move together as a whole to define a consistent approach and that remaining in step with the broader industry will ultimately be in the interests of our clients. Schroders is participating in industry working groups (e.g. the Bank of England's Working Group on Sterling Risk-Free Reference Rates) and following developments in the transition away from LIBOR, with the aim of adopting, in due course, measures aimed at managing transition risks that are consistent with industry best practice.

5. What progress has been made globally for LIBOR transition?

The new RFRs have been selected for the five major currencies of LIBOR. In addition to this, interest rate benchmark transition is making good progress globally.

Asia

Across Asia, a multi-rate approach has largely been adopted for the transition away from LIBOR, which sees existing rates being used alongside replacement rates.

- **China**

In China the Shanghai Interbank Offered Rate (SHIBOR) is seen as a reliable benchmark and expectation is that it will continue in present format.

- **Hong Kong**

In Hong Kong, it is expected that an enhanced Hong Kong Interbank Offered Rate (HIBOR) will continue to exist alongside adjusted Hong Kong Overnight Index Average (HONIA) as the likely fallback rate.

- **Indonesia**

In Indonesia, the existing Jakarta Interbank Offered Rate (JIBOR) is being supplemented with IndONIA, which is replacing the overnight JIBOR as an overnight interest rate benchmark. JIBOR has also been enhanced with contributor banks having to quote rates by underpinning it to the greatest extent possible with transaction data in order to better reflect market rates.

- **Singapore**

In Singapore, a consultation report released on 29 July 2020 has recommended that the SGD Singapore Interbank Offered Rates (SIBOR) be discontinued in three to four years, and that the Singapore Overnight Rate Average (SORA) be used instead as the main interest rate benchmark for SGD financial markets.

The report recommends that the SIBOR tenors will be discontinued as follows:

- 12-month SIBOR will be discontinued by end-2020.
- 6-month SIBOR to be discontinued shortly after end-2021.
- 3-month SIBOR to be discontinued in three to four years (by end-2024).
- 1-month SIBOR to be discontinued in three to four years (by end-2024).

The Singapore Overnight Rate Average (SORA) or an adjusted form of the Singapore Dollar Swap Offer Rate (SOR) is expected to be the fallback rate for SOR.

- **Australia**

In Australia, a modified version of the existing IBOR, the AUD Bank Bill Swap Rate (BBSW), will continue to be used and co-exist alongside the Australian Interbank Overnight Cash Rate (AONIA) Australia's new RFR.

Europe

Across Europe EURIBOR is a commonly used benchmark (Note: different from EUR LIBOR). Whilst EUR LIBOR is being discontinued, EURIBOR has recently been authorised under the EU Benchmarks Regulation and is expected to continue for the foreseeable future.

6. What does the transition mean for Schroders' clients?

During the remainder of 2021 we are aiming to reduce incrementally our exposures to LIBOR for the investments we make on behalf of our clients where possible and appropriate. There may be impacts to a number of Schroders' clients who invest both via segregated mandates and as shareholders in our funds. However we will be working with our clients to minimise the impact of any changes. Where your segregated mandate has a benchmark that references LIBOR or another IBOR we will be contacting you during 2021 to agree an alternative benchmark with you.

7. What will happen to my LIBOR swap hedges and other LIBOR Derivative contracts?

LIBOR swaps and other LIBOR Derivative contracts are governed by the International Swaps and Derivatives Association (ISDA) documentation. ISDA has completed significant work over the last two years to identify a suitable fallback for relevant LIBOR exposures. The intention is to develop revised standard ISDA terms which will include fallback provisions to determine the applicable alternative rate, when LIBOR ceases to exist, or is deemed no longer-representative of the underlying market by the relevant regulatory bodies.

After significant work in consultation with a wide range of market participants, including Schroders, ISDA launched the IBOR Fallbacks Supplement and IBOR Fallbacks Protocol on 23 October 2020 to come into effect on 25 January 2021.

The supplement will amend ISDA's standard definitions for interest rate derivatives to incorporate robust fallbacks for derivatives linked to certain IBORs, with the changes coming into effect on 25 January 2021. From that date, all new cleared and non-cleared derivatives that reference the definitions will include these new fallbacks.

The protocol enables market participants to incorporate the revisions into their legacy non-cleared derivatives trades with other counterparties that choose to adhere to the protocol[1]. After analysing the impacts on our funds and having engaged with our clients where required on their portfolios, Schroders has adhered to the ISDA protocol as agent on behalf of its clients and funds through its various Schroder management entities[2].

8. Will the new protocol become effective as soon as it is published?

The revised standard ISDA terms will be adapted and will also be incorporated into the clearing house rules governing cleared derivatives. These changes will be applied automatically as of 25 January 2021 to any cleared OTC positions by the clearing houses updating their rules.

However, for any bilateral OTC exposures, both counterparties to a legacy swap must agree to adhere to the new protocol for it to become effective. If one counterparty does not adhere to the new protocol and the parties do not otherwise agree to amend the terms of their transactions, the bilateral position will continue to reference LIBOR which may lead to outcomes that were unintended by the parties at the outset of the transaction if LIBOR ceased to exist. As explained above Schroders has adhered to the protocol and our trading counterparties have all also adhered.

9. What is the LIBOR fallback for ISDA based exposures?

Following a series of ISDA consultations over the last 2 years, on which Schroders has responded, the agreed LIBOR fallback for bilateral OTC derivatives exposures can be summarised as the 'Adjusted RFR + Spread Adjustment'.

'Adjusted RFR' is the compounded set-in-arrears value of the overnight RFR applicable to the LIBOR used in the OTC derivative.

'Spread adjustment' is a credit spread adjustment which is intended to allow for the bank credit-risk element embedded within LIBOR which is not factored into the calculation of a RFR. This is to be calculated as a 5-year average of the spread between relevant LIBOR and RFR until the discontinuation of LIBOR.

Bloomberg has been appointed by ISDA to make these calculations in accordance with the methodology agreed through the ISDA consultation process and, in order to give market participants transparency ahead of the transition, has already begun publishing on a daily basis

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[1] 51 of our 65 counterparties have adhered as at 27 January 2021 covering the majority of our bilateral OTC exposures
[2] Adhering parties can be found on the ISDA Website

what the calculation would be on the assumption that on that day the provisions in the revised standard ISDA terms resulted in the new fallback rates applying.

More information including the detail of the ISDA methodology to be used to calculate the 'Adjusted RFR' and "spread adjustment" can be found in the ISDA consultation papers https://www.isda.org/2020/05/11/benchmark-reform-and-transition-from-libor/

10. When do exposures move from LIBOR to the new ISDA fallback, for exposures that are governed by the new protocol?

Examples of 'trigger events' that would result in LIBOR exposures moving to the ISDA fallback rate are:

- The discontinuation of LIBOR.
- An announcement by LIBOR's administrator or relevant regulator that LIBOR will be discontinued at a future date.
- in the case of the five major LIBORs, a formal announcement by the FCA that LIBOR is no longer deemed representative of the underlying market.

These events are known as 'pre-cessation announcements' or 'Cessation announcements'. These will fix, from the date of the first of these triggers to occur in respect of the relevant IBOR, the relevant credit spread adjustments to be used in fallbacks. However the fallbacks will not be used in contracts until the date the relevant LIBOR rate becomes non-representative, or the date the relevant IBOR rate ceases to be available, whichever is earlier.

11. Will cash products use the same fallback as LIBOR swaps?

Floating rate bonds, securitisations and loans are not affected by ISDA protocols or the revisions to the standard ISDA terms.

12. Investment transition: Noteholder consent

LIBOR is used in many of the cash instruments in which we invest on behalf of our clients and in our funds. It is important to note that there are different possibilities to transition away from investments that use LIBOR over the next 12 months before LIBOR ceases to be published. One such possibility is to actively transition where noteholders would consent to transition from LIBOR to an alternative benchmark. However in some jurisdictions there are currently no easy solutions to change their terms to incorporate fallback provisions to determine an applicable alternative rate. For example, it is normal for noteholder consent to be required to amend the terms of bonds. Depending on the exact terms of the bonds the threshold for obtaining such consent can range from 75% to 100% of all noteholders. Where unanimous consent is required, which is often the case in the US market it is unlikely that the issuer of that bond will obtain the requisite consent if that bond is widely held in the market.

13. Investment transition: Legislative solutions

There are potential legislative solutions in the UK, U.S. and EU which may also be factors in determining the transition of Cash instruments. Such legislation would apply fallback provisions into the terms of such bonds where none currently exist. However, there are likely to be challenges in making such a proposal become law and at the time of writing Schroders and other market participants are not in a position to rely on this change in law as a certainty. Schroders is monitoring and, in some cases, participating in, developments by the Bank of England's Sterling RFR Working Group, the UK Loan Market Association, the European Central Bank's Euro RFR Working Group and the Alternative Reference Rate Committee in the US on these solutions.

- **UK**

The forthcoming Financial Services Bill includes legislation to give the Financial Conduct Authority (FCA) enhanced powers for extending LIBOR's publication in certain limited cases by requiring a change to the methodology used to determine LIBOR so that it is no longer reliant on panel bank contributions. These legislative steps could help deal with the narrow pool of 'tough legacy' contracts that genuinely have no or inappropriate alternatives and no ability to be amended. The FCA are currently consulting on these proposed powers.

- **U.S.**

The New York Fed's Alternative Reference Rates Committee (ARRC) have proposed changes under New York law which would apply to certain LIBOR-based financial contracts executed prior to LIBOR's discontinuation. This would amend these contracts, by operation of law, to include ARRC's recommended fallback rate (SOFR) plus a spread adjustment. There has also been recent announcements by ICE Benchmark Administration (IBA) on its intention to consult on cessation dates for LIBOR and that whilst 1-week and 2-month USD LIBOR are due to be discontinued along with other LIBOR currencies on 31 December 2021, all remaining USD LIBOR settings will continue to be published until 30 June 2023. However US authorities have issued supervisory guidance in relation to limiting new use of USD LIBOR after end-2021.

- **EU**

Amendments have been proposed to the EU Benchmark Regulation to empower the European Commission to designate a statutory replacement rate (likely to be ESTR plus a spread adjustment) that would replace the reference to LIBOR.

14. Securitised Products

Within securitised products like ABS, IBORs could be referenced in underlying loans, the actual bonds, swaps within deals, and any combination of these. Securitised products will transition differently from FRNs as remediation and refinancing are not possible outcomes. Fallback language is therefore of even greater importance and is likely to differ depending upon when these products were issued, with more recent products more likely to have anticipated the discontinuation of IBORs. Securitised products may refer to a range of alternative rates which will be used to calculate their coupons and the impact of the change from an IBOR is often priced in.

15. Benchmark transition

Where funds or segregated mandates have LIBOR benchmarks these will need to be updated. For Schroders' fund range, there is a plan in place to migrate remaining fund benchmarks over the next 12 months. Where mandates have LIBOR benchmarks we will be working with our clients to set new benchmarks and will be recommending the same changes that we are applying to our own funds. We have published an article explaining our plans to replace fund benchmarks and what it means for our clients.

16. Investment Management Agreement (IMA) changes

We have conducted a review of all our IMAs and other legal documentation. Where there are references to LIBOR in IMAs these will need to be remediated as part of this transition and we will be working with our clients to make these changes.

17. Operational changes

We are making updates to our operational processes and technology systems so that we can support the transition from LIBOR, this includes extensive engagement with our third party vendors to understand their transition plans.

18. Are there risks for investors resulting from the LIBOR transition?

There is arguably an inherent risk of market disruption in any significant transition exercise that impacts a significant number of market participants and instrument types.

However, market participants (including Schroders) are working to minimise the impact of LIBOR / IBOR transition, including impacts on underlying clients, by adopting measures (e.g. protocol arrangements facilitating the remediation of relevant OTC derivatives documentation) developed through market participant feedback on an industry-wide basis.

The conversion from a LIBOR-linked product to a RFR-linked product will most likely result in a payment being made from one party to the other to account for the change in the characteristics of the underlying reference rate. While the use of industry developed methodologies (such as those developed by ISDA for the derivatives markets) to calculate the alternative reference rate should help to minimise this value transfer it will not remove it entirely. This payment could be due to or required to be paid by, a client’s portfolio. These costs related to the transition will need to be considered as part of each client’s transition plan.

19. By what date will Schroders stop referencing LIBOR for new business?

The FCA has confirmed the central assumption that firms cannot rely on LIBOR being published after the end of 2021 and that market participants should continue to focus on active transition away from LIBOR, as this is the only way for parties to have certainty and control over their contractual terms when LIBOR ceases or is no longer representative. Schroders is committed to meeting the milestones set by the FCA and other global regulators and we are working towards the transition away from LIBOR for all our clients by the dates of LIBOR cessation, in line with market developments, subject to viable alternative investments being available which reference RFRs. Even in the USD LIBOR settings that are likely to continue post 31 December 2021, market participants are being encouraged to cease entering into new contracts that use USD LIBOR as a reference rate as soon as practicable and in any event by 31 December 2021.

Glossary

Alternative Reference Rate Committee (ARRC) – a group of financial industry participants focused on the successful transition from United States Dollars (USD) London Interbank Offered Rate to an alternative rate.

Asset-Backed Securities – a financial asset that is supported by a pool of assets, e.g. credit card debt, loans.

Benchmark – a standard against which the performance of a financial asset or a fund can be measured. Benchmarks are used in our funds for a range of purposes including a standard against which to compare the return or "performance" of the fund, as a target for the fund's returns to outperform and for defining what types and amounts of financial assets the fund will invest in. In some instances, they are also used to calculate performance fees, being fees that are paid to the investment manager of the fund if the fund's performance rises above a set threshold.

Bonds or Notes – a form of financial asset that represents a loan from a financial investor (the bondholder or noteholder) to a borrower called the "issuer" (usually corporates or governments).

Credit Risk – the risk that a borrower will become bankrupt or otherwise fail to repay a loan.

Derivatives – a financial asset with a value that is set by reference to other assets e.g. shares, bonds, interest rates.

Derivatives exchange – a form of organised market place for the trading of derivatives on certain prescribed terms.

Fallback – a contractual term of a financial asset that outlines the alternative rate to be used if London Interbank Offered Rate or Interbank Offered Rate is discontinued.

Financial Conduct Authority (FCA) - the conduct authority for financial services firms in the United Kingdom.

Financial Stability Board – an international body that works to promote international financial stability.

Floating Rate Notes (FRN) - a note (see above) with a variable rate of interest that resets at specified intervals.

Interbank Offered Rate (IBOR) - a rate at which major global banks expect they can borrow from other major global banks. This is often not based on actual loans between those banks but is created from estimates submitted by those banks.

Interest Rate – the amount a lender charges a borrower for a loan.

International Swaps and Derivatives Association (ISDA) - a trade association representing participants in the derivatives market.

Maturities - represents the number of days before a financial asset must be repaid.

Note – see bonds above.

Noteholder consent – a process whereby the issuer of a note has to obtain the consent of a certain percentage of the noteholders before the terms of that note can be amended.

Over-the-counter derivative – a derivative entered into bilaterally between two parties and not traded on a derivatives exchange.

Portfolio – a range of investments held by a person or company.

Reference Rate - an interest rate benchmark used to set other interest rates in financial assets. London Interbank Offered Rate and Interbank Offered Rates are examples of reference rates.

Risk Free Rate – a reference rate that does not include in its calculation the credit risk of the borrower.

Risk Free Rate Working Group (RFRWG) - the Bank of England and Financial Conduct Authority's group of financial services members focused on the transition away from London Interbank Offered Rate.

Swaps – a type of derivative between two parties to exchange the cash flows or liabilities of two financial assets for a defined period.

Important Information: This document should not be considered as legal or regulatory advice or relied upon as such. We encourage all our clients to seek independent legal advice in respect of their legal and regulatory obligations.