For Investment Professionals only

M&G INSTITUTIONAL

Our preparation for the reform of LIBOR

Some Frequently Asked Questions

May 2020

- Alternative rates have been identified to replacement LIBOR and other IBORs as market standard benchmark interest rates by the end of 2021. In the UK, sterling LIBOR is being replaced by SONIA, the Sterling Overnight Index Average.
- M&G has formed a company-wide project team to orchestrate the transition from LIBOR to the replacement rates.
- Any effect on the value of your investments, at the time the change occurs, is expected to be minimal and we undertake not to introduce inferior terms to our clients as a consequence of this process.
- You do not need to take any action. We will communicate to you any planned changes to objectives of funds you are invested in before they take effect.

The value of investments will fluctuate, which will cause prices to fall as well as rise and you may not get back the original amount you invested. Where past performance is shown, please note that this is not a guide to future performance.

GENERAL

What is LIBOR and what is happening to it?

LIBOR stands for the London Interbank Offered Rate and is the interest rate (or more specifically, a family of interest rates) at which banks lend to each other on a short-term basis. It has been a mainstay of the financial markets for more than thirty years and is provided for a number of currencies and across a number of defined time horizons. Many financial contracts reference one or other LIBOR rate as its benchmark, for determining interest payments, for instance.

The production of LIBOR is being brought to a close and is expected to cease by the end of 2021. Similar Interbank Offered Rates (IBORs) used in other markets are also being replaced. In the UK, for sterling, LIBOR is being replaced by SONIA, the Sterling Overnight Index Average. An industry-wide consultation determined that SONIA represents the most appropriate way to replace LIBOR for the sterling market.

Why is LIBOR being withdrawn and these changes taking place?

Financial regulators want standard measures of market interest rates to be trusted and relevant and for the process used to calculate them to be credible, transparent and robust for the long term. Whereas LIBOR arises from quotes provided by a panel of banks, regulators want benchmark rates to be both administered by central banks and based on actual transactions in deep and liquid markets. Introducing SONIA to replace LIBOR for sterling interest rates aims to achieve those objectives.

In the wake of the Global Financial Crisis over a decade ago, banks have been making less use of the interbank lending market. This feature has raised the question of robustness and reliability of some of the rates that arise from that process(particularly some at the less frequently used maturity points). Additionally, LIBOR has faced concerns regarding its reputation, since manipulation of quotes for the rates by some market participants was discovered to have taken place around the time of the Global Financial Crisis.

What is SONIA?

SONIA (the Sterling Overnight Index Average rate) is an interest rate that is already in widespread use in many areas of the financial markets. It is based solely on transactions, and is published and administered by the Bank of England and widely regarded as a reliable market standard for interest rates in day-to-day use.

What other rates are being introduced as a result of LIBOR being removed?

Other markets are going through similar developments to replace their IBOR rates with new Risk Free Rates (RFRs), similar to SONIA. US dollar LIBOR and Swiss franc LIBOR for example, are being replaced by the Secured Overnight Financing Rate (SOFR) and the Swiss Average Rate Overnight (SARON) respectively. In euro markets, EURIBOR is expected to stay in use, though it has been reformed. A new rate, the Euro Short Term Rate (ESTR), has also been introduced. Rates in other markets, such as the Japanese yen, are also being replaced. (Please see Appendix for further details)

What is M&G doing about this?

M&G has formed a company-wide project team to orchestrate the transition from LIBOR to the replacement RFR's. The group is considering the effects that the change will have on our funds or strategies and how that will affect our clients' investments and take the necessary actions, as we judge them to be most appropriate, to keep any effects to the minimum. As a company we are also working closely with the Financial Conduct Authority (FCA), the Bank of England (BOE) as well as our peers, to ensure as smooth and transparent transition to the new RFRs as possible.

Why didn't we use SONIA to begin with?

LIBOR has been extensively relied upon as a central plank for reference interest rates as a mainstay of the financial markets for more than thirty years. It became deeply embedded in the fabric of the industry, and before SONIA, which was introduced in 1997, was developed. As the financial sector developed over the last decade or so, the breadth and depth of SONIA's use has grown, enhancing its reliability and robustness, allowing it to be considered as a suitable replacement for LIBOR.

How does SONIA differ from sterling LIBOR?

SONIA is based on actual transactions that took place the previous business day, on an overnight basis. Hence it applies for only one business day and is backward-looking. LIBOR, by contrast is forward-looking, with rates set at the start of different, though standardised, periods or terms (e.g. 1 month, 3 months, 6 months etc) so that the next interest payment is known at the start of the period. This feature has historically made LIBOR an appropriate rate to use as an interest rate benchmark. In order to apply SONIA over an extended period of time (a term rate), each daily interest rate needs to be compounded over time. The full and final rate applicable for a whole term is only known at the end (or close to the end) of the interest period.

Some replacement RFRs also differ from their LIBOR predecessors in that they are secured rates (e.g. SOFR in the US), whereas LIBOR is an unsecured rate. Secured lending means that the borrower provides something of value – collateral – to support its borrowing. Unsecured lending is provided "in good faith", with no collateral provided by the borrower to protect the lender.

Is SONIA better than LIBOR?

For some time, SONIA and LIBOR have been produced alongside one another, each determined and calculated through different, though related, processes, and each interest rate having features that are attractive to market participants. SONIA originated from the interest rate swap derivatives market, a market that is deep and liquid, and used to value more than £30 trillion of assets each year according to the BOE. Its transparency, liquidity and robustness make it an ideal and credible alternative to replace LIBOR. Over time, SONIA is becoming regarded as a more appropriate reflection of the underlying interest rate market, and its integrity is firmly underpinned. Regulators and market participants have been collectively working hard for some time, to ensure the transition from LIBOR to SONIA, and the other new RFRs is as smooth and transparent as possible.

If I am already an investor in an M&G fund, do I need to take any action?

No. You do not need to take any action. We are managing the transition away from LIBOR and other IBORs in a way that seeks to minimise any effect on all our customers.

We will communicate to you any planned changes to objectives of funds you are invested in before they take effect.

Will the Covid-19 outbreak affect the change or the timetable at all?

Currently there are no plans to extend the requirement for banks to provide quotes for LIBOR beyond the end of 2021, and we anticipate the transition away from LIBOR to have been completed by then. However, in the event that the Covid-19 outbreak becomes more protracted and prevents timely progress on the changes necessary for a smooth transition, the various parties may decide to extend the deadline. Recently, the interim deadline for the loans market to cease using LIBOR as a reference for new loans and focus only on SONIA-referenced lending, was extended from the end of the third quarter of 2020 to the first quarter of 2021.

EFFECTS ON FUNDS AND INVESTMENTS

How does the change from LIBOR to a new reference rate affect the fund(s) I am invested in? Which funds specifically does this affect?

There are three principle ways that a fund may be affected by the change from the existing LIBOR rate.

1) The fund holds investments where the value of the asset, or cashflows it generates, are currently specifically linked to LIBOR or another IBOR. Examples would include floating rate notes or asset-backed securities. Over time, the fund's composition will change to holding new securities that have cashflows linked to the new RFR.

2) The fund has a performance, or objective, benchmark that is linked to a LIBOR interest rate, or another IBOR. An example might be a fund which has a performance benchmark of 3-month Sterling LIBOR. We will plan to change the performance benchmark, to a suitable alternative, probably referenced to the replacement RFR.

3) The management fees charged to the fund are linked to one of the IBOR rates that are changing.

The team at M&G have identified the funds that are likely to be affected by one or more of the conditions above. They are also planning the most appropriate path and timing for transitioning the structure, benchmark or fee calculation of each fund to accommodate the market-wide changeover from the existing rate to the new rate. For existing investors, we will communicate any planned changes to the objectives of funds you are invested in, before they take effect and will not be introducing inferior terms to our clients as a consequence of this process.

Will this affect the value of my investment?

M&G actively engages in industry discussions around the LIBOR transition. This allows us to stay informed about market developments and to make the most appropriate judgements about which instances of the LIBOR transition might materially affect our clients and their investments.

Any effect on the value of your investments, at the time the change occurs, is currently expected to be minimal. However, it is not possible to guarantee that circumstances may not arise which result in a more material change to investment values. We undertake not to introduce inferior terms to our clients as a consequence of this process.

For further information you can visit the FCA website https://www.fca.org.uk/markets/libor

When are the changes going to go live?

LIBOR is expected to cease at the end of 2021 but between now and then markets and participants are expected to gradually shift and adopt SONIA and the other replacement RFRs fully. This includes financial institutions likely amending LIBOR-linked funds and products in sterling to instead reference SONIA. Many sterling assets and instruments already make use of SONIA, and the number that do are growing continually.

At M&G, we are working hard to ensure the process of making the necessary changes is smooth and that they have as little effect on customers as possible and will adopt a timetable we believe is appropriate for that. In the UK, sterling LIBOR is still being produced to allow for the timely and considered adoption of SONIA.

If my fund has an IBOR/IBOR + performance objective what do you expect the new reference rate will be and when will it change?

It is our expectation that funds which currently have an IBOR-based benchmark will change that benchmark to the respective alternative RFR, possibly adjusted by a spread. That spread will be intended to account for any general historic differential that has existed between the LIBOR rate and the new RFR (e.g. between sterling LIBOR and SONIA). Well-respected industry data providers have been involved in determining the most appropriate spread to apply to each LIBOR/RFR pair and for each term period. However, precise details of the changes may be subject to industry-wide developments.

How do M&G intend to calculate the spread required to the new RFR as it replaces its LIBOR predecessor?

We are working with market participants such as Bloomberg to understand how parties intend to calculate spread adjustments. M&G are engaged in industry discussions and are tracking developments.

For swaps and derivatives, we expect the spread adjustment to be finalised in July 2020 and effective from November 2020, via ISDA protocol.

If a fund has a performance-based fee, linked to LIBOR please explain how this will be calculated following the termination of LIBOR?

We are currently working with our client and investment teams to develop our preferred transition plans. As part to this process, we undertake not to introduce inferior terms to our clients as a consequence.

What assets, if any, do you foresee as being difficult to sell due to constrained liquidity?

There are varying levels of liquidity in assets referencing alternative rates. Some sections of the market have progressed transition and with new issuance being provided in the alternative rates. However other parts of the markets, such as loans, progress has been slower. For much of the existing stock of loans, deal-by-deal amendments may be required to incorporate the new RFRs.

M&G PROGRAMME AND READINESS ACTIVITY

What is your firm doing to progress LIBOR transition?

M&G has put in place significant resources to make the transition to the new rates as smooth as possible and with minimal effect on our clients. When it becomes appropriate, we will speak to clients to make them aware of the changes that will take place to any funds that they hold that are linked to IBOR

The M&G Plc IBOR programme is focused on :

1. Identifying and understanding the impact on our assets:

    a. M&G have completed a full impact assessment of our investments to determine the level of IBOR exposure on a monthly basis.

    b. M&G analysts and fund managers continually seek to progress the transition away from LIBOR by decreasing LIBOR exposure (selling LIBOR-linked assets and buying SONIA-linked assets), where we believe it is in the clients' best interest.

    c. M&G actively engages its fund managers to ensure a governance process is in place around investments into IBOR assets.

2. Identifying and understanding the effect on our funds:

    a. M&G have identified the range of products which benchmark off of IBOR and/or use IBOR in its performance fee structures.

    b. M&G have identified a set of criteria which may be applied to determine when to transition these funds to RFRs. These criteria continue to be refined internally.

    c. We continue to assess, where there are IBOR references in our product documentation or marketing documents.

3. Identifying and understanding the effect on our operations and systems:

    a. We have completed an analysis of the M&G in-house systems, third party systems, and operational processes to identify the nature of the nature of the impact we expect to have to address as a result of IBOR transition activity.

b. We have engaged all of M&G's third party suppliers to understand where the ending of IBORs will impact their services, and to encourage them to make changes we believe are needed, as well as adapt ourselves to those changes. Our analysis in ongoing and will continue during 2020.

c. We are actively engaged in assessing the impact of LIBOR transition on all contractual documents including product documentation and will subsequently take up remediation steps in regards to those found impacted. We do not foresee any significant issues in remediating LIBOR-linked contracts / product documentation before end of 2021.

4. M&G is actively participating in industry engagements

a. M&G actively engage in industry discussions around IBOR transition through industry associations and industry working groups. These allow us to stay informed of any ongoing regulatory and market developments.

b. M&G carefully consider whether consultations regarding IBOR transition have impacts on our clients, and respond accordingly.

c. M&G's industry engagements help inform actions we take to remediate IBOR exposures, ensuring the optimal outcomes for our clients.

Will M&G stop launching LIBOR-linked products by Q3 2020 as suggested by the FCA?

Our intention is to meet each of the targets set by the regulator in their Dear CEO letter, including:

1. Key infrastructure ready to use RFRs by end-Q2 2020
2. Ceasing issuance of GBP LIBOR-linked funds from end-Q3 2020
3. Ceasing investments into GBP LIBOR-linked assets from end-Q3 2020
4. Ceasing launches of GBP LIBOR-linked products from end-Q3 2020
5. Significantly reducing our exposure to LIBOR by end-Q1 2021

We actively review the ability to meet these targets in light of market developments resulting from the coronavirus pandemic.

Does M&G expect to hold any instruments/products with LIBOR exposure post Dec 2021?

M&G aim to not have any LIBOR exposures after December 2021.

Does M&G foresee any issues with removing LIBOR from any instruments or products?

1. Instruments:

Where M&G are invested into LIBOR-linked assets such as bonds and loans, we endeavour to actively engage with the issuers to understand their LIBOR transition plans. M&G are dependent upon issuers in many cases to enact changes to replace the LIBOR references in these contracts.

2. Products:

Market conditions will be judged for the most ideal time to convert our LIBOR-linked products. M&G do not foresee any significant issues to remediating these products by the end of 2021.

In some instances, amendments to certain LIBOR contracts may not be practicable due to their legal structure. In these instances, M&G considers there to be a case for regulatory action to facilitate these changes and closely tracks these..

When will you be communicating to clients?

We will be contacting investors of affected funds once we have finalised our proposed changes. We currently expect this to take place in 2020, but you can find information about the changes to IBOR on the M&G website.

APPENDIX

IBORs and RFRs Overview

Current Reference Rate		Expected Alternative		First Publish Dates (as alternatives)	Alternative Rate Supervisor	Cut off date
LIBOR	London Inter-Bank Offered Rate	SONIA	Sterling Overnight Index Average **(Unsecured)**	23rd April 2018	Bank of England	31 Dec 2021
USD LIBOR	USD London Inter-Bank Offered Rate	SOFR	Secured Overnight Financing Rate **(Secured)**	3rd April 2018	Federal Reserve Bank of New York	31 Dec 2021
EURIBOR	Euro Inter-Bank Offer Rate	EURIBOR	Reformed EURIBOR	Staggered reform	European Money Markets Institute	N/A
EONIA and EUR LIBOR	Euro Overnight Index Average / Euro London Inter-Bank Offered Rate	ESTR	Euro Short Term Rate **(Unsecured)**	2nd October 2019	European Central Bank	31 Dec 2021
CHF LIBOR	CHF London Inter-Bank Offer Rate	SARON	Swiss Average Rate Overnight **(Secured)**	December 2017	SIX Swiss Exchange Ltd	31 Dec 2021
JPY LIBOR and TIBOR	JPY London Inter-Bank Offered Rate / Tokyo Interbank Offered Rate (TIBOR) (derivatives only)	TONA	Tokyo Overnight Average Rate **(Unsecured)** / TIBOR	December 2016	Bank of Japan	31 Dec 2021
NIBOR	Norwegian Interbank Offered Rate	NOWA	Norwegian Overnight Weighted Average **(Unsecured)**	1st Jan 2020	Norges Bank	31 Dec 2021
Note: CDOR (Canadian IBOR), HIBOR (Hong Kong IBOR), SIBOR (Singapore IBOR) and other currencies not included as no IBOR exposure found.						

Source: M&G, May 2020

www.mandg.com/institutions

Please note that this website has not been reviewed by the SFC and will contain information about funds that are not registered with the SFC.

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