Sixty second summary

LIBOR reform

In July 2017, Andrew Bailey, then CEO of the Financial Conduct Authority, indicated that LIBOR's role as a reference interest rate benchmark was unsustainable. LIBOR is now due to cease by the end of 2021. Here we look at the key areas pension schemes should be considering in order to manage the transition away from LIBOR.

Why is it changing?

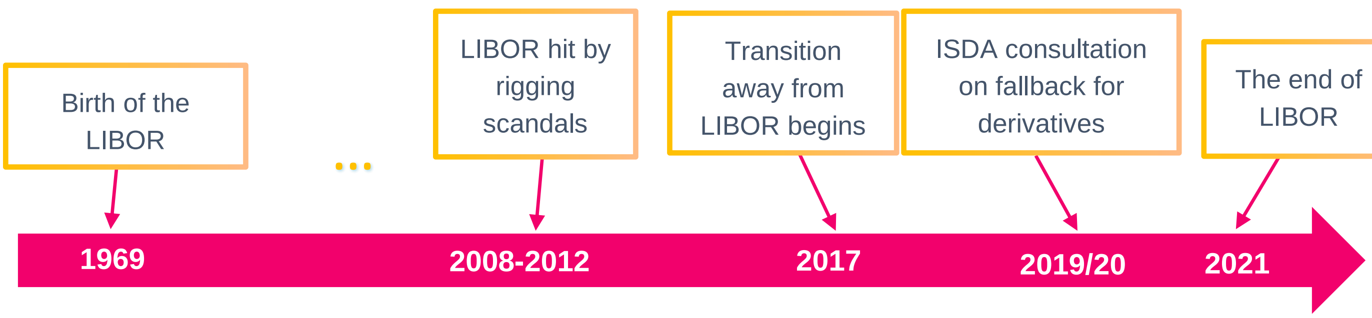
For decades, LIBOR (the London Interbank Offer Rate) was the interest rate benchmark for the majority of UK corporate borrowers. However, since the 2008 financial crisis, the level of overnight lending between banks has fallen dramatically. This has meant LIBOR benchmarks are based on estimates of borrowing costs from banks in a market with little activity. Despite reforms following the LIBOR rigging scandal in 2012, consensus remains that LIBOR and other IBOR benchmarks globally, are no longer fit for purpose.

What is it changing to?

LIBOR will be replaced by alternative risk-free rates – in most UK cases by the Sterling Over Night Indexed Average (SONIA). Unlike LIBOR which is fixed in advance for a set period (e.g. 3 months), SONIA is an overnight rate, based on actual sterling transactions.

As there is a gap between LIBOR and SONIA, an adjustment needs to be made to try and maintain economic equivalence. For derivative contracts, this adjustment was determined through a series of market-wide consultations and includes a margin of the median spread between LIBOR and SONIA over a five-year historical period. Once the end of LIBOR is triggered, this spread adjustment will be calculated and become a fixed spread.

What has happened to date?



The end of LIBOR will be triggered when a public statement is made confirming the publication will cease. This announcement could take place before the end of 2021, for example, if liquidity in LIBOR markets reduces to the point where maintaining it becomes unviable.

Despite the impact of the global pandemic, there has been no change to the timeline for the transition away from LIBOR.

Impact on pension schemes

Liabilities

Schemes that have a swaps based discount rate may be impacted by the discontinuation of LIBOR. This may also apply to schemes with an asset-based discount rate if the assets underpinning the discount rate reference LIBOR. **Please speak to your consultant to discuss the implications for your scheme.**

Assets

The cessation of LIBOR and its corresponding impact on the assets of a pension scheme can be categorised into three key areas, each of which we explore in turn.

1. **Does your scheme have any manager benchmarks that are defined as 'cash plus'?**

Many mandates such as absolute return, diversified growth and other 'cash-plus' strategies usually have a benchmark defined as LIBOR plus a performance target, e.g. LIBOR+4% p.a. It will be necessary to adopt new benchmarks for these mandates, for example, SONIA plus a fixed spread.

This may also impact any performance fee arrangements in place with investment managers. Investors with mandates with a LIBOR-based hurdle should seek a change in this performance hurdle that maintains economic equivalence.

- ✓ **Action -** Speak to your investment managers or investment consultants about ensuring benchmarks remain fit for purpose, in particular if defined in relation to performance fees.
- ✓ **Action -** Ensure your manager documentation, performance reporting and Statement of Investment Principles reflect any newly agreed benchmarks.

2. **Does your scheme have exposure to LIBOR-based derivatives?**

LIBOR-based derivatives are most commonly found within LDI portfolios in the form of interest rate swaps and swaptions. New swaps being transacted for LDI mandates should be using SONIA as the reference rate, but existing swaps, some of which extend out for decades, will need to be converted.

In October 2020, the International Swaps and Derivatives Association (ISDA) launched the IBOR Fallbacks Supplement and Protocol, which took effect from 25 January 2021. ISDA is a trade organisation which creates standardised contracts for the derivatives market.

The purpose of these updates is to ensure there is robust fallback language governing the rates that the LIBOR-linked legacy derivative positions will adopt following the LIBOR cessation. Individual market participants will agree to the changes by adhering to the protocol. The FCA and Bank of England has encouraged all market participants (i.e. counterparty banks and investment managers) to adhere to the protocol and to do so as soon as possible.

If you have a segregated LDI portfolio, you may need to update your derivative documentation. Your LDI manager should be actively engaging with this topic and formulating a plan for dealing with any legacy LIBOR swaps within portfolios to try and minimise costs and/or loss of value.

- ✓ **Action –** check with your investment manager, investment consultant and your scheme lawyers

3. **Does your scheme have exposure to floating rate debt instruments?**

Loans or bonds which pay floating rate coupons, e.g senior secured loans and asset-backed securities, almost always define the interest payments in terms of LIBOR plus a fixed adjustment. If these mature after 2021, the contracts governing the debt may have to be updated to convert them to a new reference rate. Managers should be preparing for the change by requiring issuers to incorporate reasonable change-of-rate language in new deals and rejecting deals that lack sufficient fallback provisions.

- ✓ **Action –** check with your investment managers or investment consultant that sufficient progress is being made. In some cases, wording in fund documentation or investment manager agreements may need updating.

Longevity hedging

For buy-ins, the impact of LIBOR cessation is not expected to be significant. The main LIBOR exposure is in the calculation of interest when carrying out data cleansing, and interest on any termination costs. **If you are in the process of carrying out a buy-in transaction, please speak to your consultant to ensure any implications are being considered in the project plans.**

For schemes with longevity swaps in place, it is worth noting that LIBOR is referred to in the rates used to discount the value of the swap and again, on interest on any longevity swap termination costs. **Any documentation should be checked to see if updates are required.**

Next steps

All parties who currently rely on LIBOR need to be preparing for its discontinuation to ensure there is a smooth transition. This largely involves ensuring any contracts underlying assets can deal with the transition to a new rate and updating any documentation that refers to LIBOR.

We would encourage you to speak with your investment consultant and investment managers to determine the next steps in relation to your scheme.

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