M&G Investments

Our preparation for the reform of LIBOR

Some frequently asked questions

March 2021

- Alternative rates have been identified to replace the London Interbank Offered Rate (LIBOR) and other IBORs as market standard benchmark interest rates as their publication comes to an end.
- Sterling LIBOR is being replaced by SONIA, the Sterling Overnight Index Average.
- M&G has a company-wide project team to orchestrate the transition from LIBOR and the other IBORs to the respective 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, although, for US dollar (USD) LIBOR, this date has been extended to 30 June 2023, for all tenors except 1-week and 2-months. 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Why is LIBOR being withdrawn and these changes taking place?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 near Risk Free Rates (RFRs), similar to SONIA.

USD LIBOR is being replaced by the Secured Overnight Financing Rate (SOFR), although SOFR has some important characteristics that are different to USD LIBOR.

In euro markets, EURIBOR is not being replaced, though the way it is calculated has been reformed. Euro Overnight Index Average (EONIA), meanwhile will cease to be published and a new rate, the Euro Short Term Rate (ESTR), has been introduced.

The Swiss franc short term yield structure will be based on Swiss Average Rate Overnight (SARON) going forward, instead of Swiss franc LIBOR.

Yen LIBOR is expected to be replaced by TONAR (Tokyo Overnight Average Rate), although the continued use of TIBOR (Tokyo Interbank Offered Rate) is slowing the build-up of liquidity in TONAR.

Rates referred to above are shown in the Appendix A.

Why didn't we use SONIA previously?

IBORs have 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 sterling 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). This means that the next interest payment is known at the start of the period, a feature that 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.

Is SONIA, or the other new RFRs, better than their LIBOR predecessor?

SONIA and LIBOR have been produced alongside one another for some time, 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 Bank of England. 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.

SONIA and the other RFRs are widely considered to be more robust than the rates they are replacing as they are transactions-based, meaning their calculations use actual market trades that have taken place rather than just quotes, as was the case for LIBOR rates.

Is the original timetable for IBOR cessation still in place?

The plan to cease publishing and using most IBORs at the end of 2021 remains. However, while the publication of 1-week and 2-month USD LIBOR will cease as planned at the end of 2021, ICE Benchmark Administration (IBA) has extended the deadline for other tenors of USD LIBOR to 30 June 2023. This extension will give more time for contracts based on USD LIBOR to mature and give banks more time to make adequate preparations for the final transition. In the meantime, all market participants are encouraged to avoid entering new USD LIBOR contracts after 31 December 2021.

While M&G holds some exposure to USD LIBOR, overall it is a small percentage and we still plan to remove most of this exposure from our portfolios before the end of 2021.

What is M&G doing as a consequence of these developments?

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

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

EFFECTS ON FUNDS AND INVESTMENTS

How does the change from LIBOR to a new reference rate affect any funds I am invested in?

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

1. The fund or mandate 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 or mandate has a performance benchmark, or an objective, 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 performance 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 assets, benchmark or performance fee calculation of each fund to accommodate the market-wide changeover from the existing rate to the new rate.

When are the changes going to be effective from?

Most IBOR are expected to cease after 31 December 2021, as planned, however USD LIBOR will now continue until 30 June 2023, for most tenors. Different parts of each market are proceeding at different speeds. Between now and then, markets and participants are expected to continue gradually shifting and adopting SONIA and the other replacement RFRs fully. This includes financial institutions likely amending LIBOR-linked funds and products in sterling to reference SONIA instead. 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 a performance objective and/or performance fee linked to an IBOR, what do you expect the new reference rate will be and when will it change?

M&G product teams are currently working through their product change recommendations and these will follow our internal product governance procedures. Our products will transition over the course of 2021.

M&G undertake not to introduce inferior terms to our clients as a consequence.

How does M&G intend to calculate the spread between a new RFR and its IBOR predecessor?

A key methodology to determine the spread between an IBOR and the replacement RFR is the credit spread adjustment specified in the IBOR ISDA Fallbacks Protocol, published by ISDA (International Swaps and Derivatives Association), and the subsequent IBOR Fallbacks Supplement. M&G have adhered to this protocol in January 2021, so this methodology will apply to fallbacks on our swaps and derivatives positions.

M&G will be using the credit spread adjustment rate supplied by Bloomberg, the acknowledged data provider of this rate.

M&G'S PREPARATIONS

What is M&G doing to progress the transition from LIBOR?

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.

The M&G IBOR programme is focused on :

1. Identifying and managing the effect on the assets we manage:
    - A M&G is tracking the IBOR exposures within the assets we manage on a monthly basis. This data helps us to understand the extent to which our fund managers are moving away from IBORs and adopting the new RFRs. Our analysis shows that the levels of IBOR exposures are decreasing and we expect this to accelerate in the coming months.
    - B M&G analysts and fund managers continually seek to progress the transition away from IBORs by decreasing IBOR

exposures 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.

D M&G has started work within its private asset deal teams to address existing deals that rely on IBOR references.

2 Identifying and understanding any effects on our products:

A Product teams within M&G are developing recommendations to replace IBOR where it is being used as a benchmark or in its performance fee structure.

B M&G will ensure all changes follow our internal product governance procedures.

C We have identified the marketing materials where IBOR references are apparent and these will be amended in line with the product change timetable.

D We have identified product documents such as investment management agreements (IMAs) which contain references to LIBOR or another IBOR, and these will be redrafted and bilaterally agreed with clients where applicable. Documents such as prospectuses and marketing materials that contain IBOR references will also be refreshed appropriately.

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

A Following an assessment of M&G internal systems we confirm that the effects are minimal, and do not pose any risks to the business.

B Our third-party suppliers and system vendors all have significant IBOR programmes in place, and we have engaged them to understand their operational readiness. We have identified the key areas we need to monitor and engage on and will continue to apply oversight over our suppliers.

C Our operational teams have reviewed their processes and, where potential issues have been identified, we have plans in place to ensure any effects on our operations are minimized. M&G is already operationally capable of supporting the new RFRs. We have been trading in instruments that link to the new RFRs and some legacy instruments have already transitioned away from LIBOR.

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 maintains a close and continuous dialogue with our FCA supervisors and other regulators, regarding the progress of the transition process.

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

D M&G's industry engagements help inform the actions we take to accommodate transitions and the remaining IBOR exposures, aiming to ensure optimal outcomes for our clients.

What is M&G's progress in meeting the target dates set by the regulator regarding launches of, and investments in, IBOR-linked products?

Our intention is to meet each of the targets set by the FCA, in their Dear CEO letter published 27 February 2020, including:

1. **Having essential infrastructure in place to use RFRs - achieved** - M&G have met this target as we have necessary infrastructure in place to support assets that use RFRs.
2. **Ceasing launches of funds and products linked to Sterling LIBOR by end-Q3 2020** - This target has been met.
3. **Implementing governance and controls around adding exposure to IBOR-linked assets** - we can confirm we haveimplemented a controls framework that monitors our IBOR exposure.
4. **Ceasing further issuance of loans linked to Sterling LIBOR by end-Q1 2021** – we anticipate meeting this target date for our loans business.
5. **Significantly reducing the proportion of our assets under management that are exposed to an IBOR by end-Q1 2021** – we continue to make progress against this objective.

We continually review the progress we are making toward meeting the outstanding targets.

Does M&G expect to hold any instruments or products linked to IBORs beyond December 2021?

M&G does not expect to hold any IBORs within its products after Dec 2021.

However, certain legal complexities mean that it is possible some assets cannot be amended to reflect an appropriate new RFR by that date. Deals or holdings of this nature are classified as ‘Tough Legacy’ assets. It should be noted that the definition of tough legacy has yet to be formalised. We are currently awaiting HM Treasury’s Consultation Paper to be published regarding the definition and treatment of such assets.

Does M&G foresee any issues with removing IBOR references from any assets or products?

1. Assets: Where M&G are invested in IBOR-linked assets such as bonds or floating-rate notes, we endeavour to engage actively with the issuers to understand their IBOR transition plans. In many cases, M&G are dependent upon issuers to enact changes to replace the IBOR references in these securities.

   Where we hold loans, we are working, or will endeavour to work, with the borrowers and their agents to make appropriate amendments to the deal terms, to accommodate the cessation of the respective IBOR. In this process, we are dependent on consent from the borrower, and often from other lenders.

   In some instances, amendments to certain LIBOR contracts may not be practicable due to their legal structure, these are known as “tough legacy”. The definition of tough legacy has not yet been fully defined but we understand there would need to be a case for regulatory action to facilitate these changes. We continue to closely track these developments.

2. Products: M&G will aim to judge prevailing market conditions to determine the most appropriate time to convert our IBOR-linked products. We do not currently foresee any significant issues relating to that process prior to the end of 2021.

How will M&G communicate with its clients?

We have been communicating with clients throughout 2020 and 2021 and will continue to do so.

Our plans to communicate changes to our products will depend upon the rules which govern the fund. We may need to obtain prior client consent to the proposed changes, which will be achieved via a shareholder resolution. Where prior consent is not required we may communicate details of changes to take place in advance via an informal client communication. Alternatively, in line will prevailing product governance processes, communications with clients may occur following the transition.

Where our clients work closely with Investment Consultants we will be engaging with these firms to ensure they understand the changes we are proposing so that they can advise their clients appropriately.

All investors will receive some form of communication as we finalise the changes we propose.

Is M&G dependant on any market initiatives to help it prepare for the cessation of the IBORs?

Yes. The IBOR transitions are occurring internationally and being driven by market participants and different regulatory bodies. M&G actively engages in industry discussions regarding forming market conventions for the use of RFRs in the future. The industry initiatives involve use of RFRs in new issuance, and how to convert IBOR contracts to RFRs (known as legacy transition). The initiatives are as follows:

New Issuance:

1. Conventions for interest calculation;
2. Forward looking term-rates;
3. Fallback documentation (for IBOR contracts to fallback to RFRs).

Legacy Transitions:

1. Credit spread adjustment i.e. the increment (usually given in terms of basis points, or one-hundredths of a percentage point) to be applied to an RFR to make it equivalent to the IBOR it is replacing;
2. Standardising the legal language relating to converting an IBOR contract;
3. Standardising the legal language to convert an IBOR-related contract by way of a fallback i.e. when the IBOR ceases to be published
4. Tough legacy solutions i.e. contracts that cannot be amended easily and require an alternative, potentially legislative, solution.

   See Appendix B for more information.

OTHER INFORMATION

How are the market initiatives being governed and what is M&G's role?

Market initiatives in Sterling markets are governed through the Working Group on Sterling Risk-Free Reference Rates (RFRWG). This was established by the Bank of England to coordinate the transition, and it is responsible for producing reports and making recommendations to market participants. The Bank of England is an ex-officio member, and the group itself is chaired and attended by private sector actors.

The RFRWG is split between the main working group, and technical sub-groups. The sub-groups consider the technical issues being faced in the transition and return recommendations to the main Working Group. These technical issues are raised either through the RFRWGs members, or through the two-way communication between the RFRWG and the wider sterling market. When the RFRWG has settled on recommended solutions to these issues, these are put to the wider market as a consultation so that industry conventions may be agreed. Occasionally, when a legislative solution or regulator recommendation is deemed necessary, the RFRWG will make this request on behalf of the wider Sterling market to the Bank of England.

M&G is one of five asset managers on the RFRWG, out of a total of twenty six private sector attendees. M&G co-chairs two of the five sub-groups of the RFRWG.

What coordination has there been in the industry at an international level?

The regulators work closely on developing solutions to the issues raised in the IBOR transitions process, particularly the Bank of England and the Federal Reserve Board (Fed) in the US. The Alternative Reference Rates Committee (ARRC) is the US version of the RFRWG. Meetings held by the ARRC are attended by RFRWG representatives, and vice versa, who give updates of the respective markets so that approaches to market initiatives can be aligned, or made to differ, where appropriate.

Is the ISDA spread important to non-swap transactions such as bonds and loans?

Following similar industry-wide consultations, it was agreed in 2020 that the ISDA spread should be used when calculating the difference between the RFR and LIBOR for bonds and loans should they convert at the point of a fallback. It is also the primary recommended method of calculating a spread when amending a contract before the point of fallback, a process known as 'active transition'.

An active transition occurs when a bond issuer / loan agent seeks approval from the note holders / lenders to change the terms of an IBOR contract to reference the RFR in its place.

On 6 January 2021, the RFRWG sent an open letter to Bloomberg requesting that the ISDA spread also be made available for use by market participants in non-swap transactions, following the consultations. Bloomberg have subsequently affirmed this request.

Appendix A

Current Reference Rate		Cut-off date	Expected Alternative		First Publish Dates (as alternatives)	Alternative Rate Supervisor
Sterling LIBOR	London Interbank Offered Rate	31 Dec 2021	SONIA	Sterling Overnight Index Average **(Unsecured)**	23 April 2018	Bank of England
USD LIBOR	USD London Interbank Offered Rate	30 June 2023 (except 31 Dec 2021 for 1-week and 2-month USD LIBOR)	SOFR	Secured Overnight Financing Rate **(Secured)**	3 April 2018	Federal Reserve Bank of New York
EURIBOR	Euro Interbank Offer Rate	N/A	EURIBOR	Reformed EURIBOR	Staggered reform completed end-2019	European Money Markets Institute
EONIA and EUR LIBOR	Euro Overnight Index Average / Euro London Interbank Offered Rate	31 Dec 2021	ESTR	Euro Short Term Rate **(Unsecured)**	2 October 2019	European Central Bank
CHF LIBOR	CHF London Interbank Offer Rate	31 Dec 2021	SARON	Swiss Average Rate Overnight **(Secured)**	December 2017	SIX Swiss Exchange Ltd
JPY LIBOR and TIBOR	JPY London Interbank Offered Rate / Tokyo Interbank Offered Rate (TIBOR) (derivatives only)	31 Dec 2021	TONAR	Tokyo Overnight Average Rate **(Unsecured)** / TIBOR	December 2016	Bank of Japan

Source: M&G. As at February 2021.

Appendix B

Additional information concerning market wide initiative and standards that M&G are dependent upon.

New Issuance:

1. Conventions for interest calculation refers to the conventions for constructing an RFR-linked contract, and the terms and technical detail around calculating interest and payments on these.
2. Forward looking term-rates refers to the adjustment of the RFR to be forward, rather than backward looking. This is done by taking data from overnight RFR swap markets and extrapolating them over term periods to match the IBOR, eg. 1 month, 2 months, 3 months, 6 months, 12 months. In contrast to the normal use of RFRs as compounded-in-arrears rates, forward looking term-rates have the interest payment known at the start of the interest period, rather than at the end. Because of this the rate is not as robust, as it is derived from a calculation on one day rather than several days as in the compounded-in-arrears approach. The forward looking term-rates are not deemed appropriate for only a small section of the sterling markets.
3. Fallback documentation refers to the standardised legal language in a new IBOR issue, such that its fallback language allows it to smoothly transition to a different rate once that IBOR ceases.

Legacy Transitions:

1. Credit spread adjustment refers to the value to be applied to achieve equivalence between an RFR and its respective IBOR. This credit spread is required as IBORs are forward looking rates that build in a bank's credit risk, whereas the new rates are risk free. As a result an IBOR tends to be a higher rate than an RFR.
2. Standardising the legal language to actively convert an IBOR contract refers to the process by which an existing contract is amended to replace the IBOR reference with an RFR reference. In bond and loan markets, each contract is a unique, so this process can only be standardised to a certain extent. However due to the number of contracts in the sterling markets, standardising this language is important to ensure that firms have the technical and legal capacity to convert the large quantity of contracts in a regulatory compliant and fair way.
3. Standardising the legal language to convert an IBOR contract by way of a fallback refers to amendments to the fallback terms of a contract, such that it converts to an RFR when the IBOR ceases to be published. As opposed to the above, this would allow the contract to convert at a later date and may be preferable eg. when the contract is hedged.
4. Tough legacy solutions refer to contracts legislative solutions required to convert certain IBOR contracts. This would be because there is no reasonable means to convert the contract, including contracts with multiple parties that need 100% consent to amend, or asset backed securities where there is no deal sponsor who can initiate a consent solicitation.

What is the ISDA 2020 IBOR Fallbacks Protocol?

Following multiple market-wide consultations in 2018-2020, an agreed method of calculating the difference between an RFR and a respective IBOR was agreed in the derivatives markets by the International Swaps and Derivatives Association (ISDA). This methodology involves calculating the median difference between the IBOR and the RFR over a five year period. This difference is known as a credit spread adjustment, and called the 'ISDA spread'. They may differ from market to market and are calculated by Bloomberg.

The ISDA Fallbacks Protocol amends the language on existing bilateral swaps, almost all of which are governed by ISDA. This creates a legal mechanism by which, once an IBOR ceases, the contract automatically begins calculating interest based on the RFR in addition to (or reduced by) the ISDA spread. The shorthand for this mechanism is the 'ISDA fallback'.

Concurrently to this, ISDA amended their 2006 ISDA definitions, effective from 25 January 2021, which will govern all new swap transactions. New contracts will therefore by default have built-in ISDA fallbacks to replace IBOR once the rate ceases.

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