Hogan Lovells

LIBOR changes: what pension trustees should know

November 2020 Pension briefing

HIGHLIGHTS

Significant changes are taking place to certain inter-bank offered rates (IBORs) commonly used as interest rates in derivatives and other financial contracts. In the UK, LIBOR (the London inter-bank offered rate) is expected effectively to cease to exist after the end of 2021. Regulators and industry groups have recommended that market participants fully transition existing contracts which reference an IBOR to relevant alternative, overnight risk-free rates (RFRs) before this time.

The International Swaps and Derivatives Association (ISDA) has recently issued a protocol (the "IBOR Fallbacks Protocol") to assist with the amendment of existing derivatives contracts. Future proofing existing non-derivatives contracts, such as bonds or loans, is more complex - the IBOR Fallbacks Protocol cannot be used and bilateral amendment is required.

Pension trustees with direct investments in derivatives or other contracts which refer to LIBOR (or another IBOR) can expect to be asked to accept changes to their contract terms which adopt alternative RFRs and fully transition away from any IBOR before its cessation.

This note explains the IBOR changes in relation to derivatives and highlights the issues trustees with direct exposure to derivatives should consider.

WHAT IS HAPPENING?

(For the meaning of financial terms used in this note, please see the Glossary.)

Background

Derivatives and other financial contracts commonly include terms written by reference to one or more financial benchmarks including IBORs. IBORs are undergoing change as regulators and industry groups across the globe have recommended use of alternative, overnight risk-free rates (RFRs).

In the UK, the Financial Conduct Authority (FCA) has said that LIBOR's existence after the end of 2021 cannot be guaranteed and market participants should transition away from LIBOR before this time.

Use of IBORs in existing contracts

Many financial transactions incorporate the 2006 ISDA Definitions, some of which use an IBOR as the reference rate. There is concern that an IBOR will be discontinued while market participants (such as pension trustees and their financial counterparties) have exposure to that rate.

IBOR Fallbacks Protocol

To enable financial agreements to continue to function appropriately following the cessation of any IBORs, ISDA has developed a protocol (the "**IBOR Fallbacks Protocol**") to help market participants amend their existing derivatives contracts.

The IBOR Fallbacks Protocol contains new fallback provisions for the relevant IBORs which, broadly, will apply if either of the following occurs:

- A key IBOR is permanently discontinued; or
- The FCA determines that LIBOR (in any form) will no longer be representative.

Certain regulated entities have a regulatory duty to include robust written fallbacks for benchmarks. The FCA has clearly said that it expects regulated entities to be adhering to the IBOR Fallbacks Protocol to comply with this regulatory du

Glossary

2006 ISDA Definitions: definitions developed by ISDA for use in connection with interest rate derivatives transactions governed by ISDA Master Agreements. The 2006 ISDA Definitions are also commonly incorporated into privately negotiated derivative transactions.

IBORs: interbank offered rates, a type of interest rate benchmark.

IBOR Fallbacks Protocol: the ISDA 2020 IBOR Fallbacks Protocol, launched by ISDA on 23 October 2020.

ISDA: the International Swaps and Derivatives Association, Inc.

ISDA Master Agreement: a standard agreement, published by ISDA, commonly used to govern over-thecounter (OTC) derivatives transactions.

LIBOR: the London interbank offered rate, currently published in respect of five currencies.

RFRs: risk-free rates are benchmarks generally based on overnight deposit rates. They are considered to be more robust than the IBOR rates as they are based upon a larger volume of observable transactions .

HOW WILL THIS IMPACT PENSION TRUSTEES?

Investment in pooled funds only

Trustees whose investments are solely in pooled funds (such as insurance company managed funds, open-ended investment companies, or unit trusts) are unlikely to have any direct exposure to derivatives.

The managers of their pooled funds may be empowered to enter derivatives contracts, subject to any restrictions under the terms of the fund. Trustees (or their investment consultants) may wish to ask their fund managers about how they are responding to the transition from the use of IBORs to RFRs in financial contracts.

Direct investment

Pension trustees may only invest in derivatives to the extent that this reduces risk or facilitates efficient portfolio management. An example would be a contract to hedge against exchange rate risk in relation to assets held in another currency.

If you have entered direct derivative transactions, you can expect to be approached by your counterparties between now and January 2021 with proposal(s) for addressing the transition away from IBORs. The principal common approaches are explained below.

ADOPTING THE IBOR FALLBACKS PROTOCOL

What about existing contracts?

Legacy derivative contracts entered into before 25 January 2021 and which reference the 2006 ISDA Definitions will continue on the previous (unamended) terms unless both parties adhere to the IBOR Fallbacks Protocol.

If you agree to adhere to the IBOR Fallbacks Protocol, your investment manager or agent can adhere on your behalf.

Where both parties to a transaction have adhered to the IBOR Fallbacks Protocol, amendments introduced by the IBOR Fallbacks Protocol will then take effect on the later of 25 January 2021 or the date of adherence.

Bilateral amendment of existing contracts

An alternative to adhering to the ISDA Fallbacks Protocol is to amend contacts bilaterally. Bilateral amendment allows a more bespoke approach to your contracts, for example if you have already negotiated a fallback for your contracts or you wish to include additional documents within the scope of the ISDA Fallbacks Protocol.

ISDA has produced a suite of template documents to enable counterparties to incorporate the new fallbacks on a bilateral basis.

Alternatives to amending a legacy contract

Instead of amending a legacy derivative contract, the parties may decide to address the risk associated with the IBOR changes by:

- "closing-out" the contract at the transaction or portfolio level and entering into new transaction(s);
- entering into a "compression exercise" that increases exposure to the adjusted RFR (please see New fallback rates below) while reducing exposure to the IBOR; or
- entering into an "offsetting basis" swap, which counters the risk associated with the original contract.

Trustees should consider the financial, tax and regulatory treatment of such alternatives before deciding on their preferred approach.

Do we have to amend our contracts by 25 January 2021?

Existing contracts do not have to be amended by 25 January 2021 (when the IBOR Fallbacks Protocol comes into effect) but the sooner your contracts are updated to incorporate the new and more robust fallback provisions, the lower the risk that you could be left with exposure to an IBOR which has been discontinued. Regulators across the globe have urged market participants to prioritise their transition efforts.

New transactions

The new fallbacks introduced by the IBOR Fallbacks Protocol will form part of a new Supplement to the 2006 ISDA Definitions and will apply to any new transaction which incorporates the 2006 ISDA Definitions entered into on or after 25 January 2021.

NEW FALLBACK RATES

What are the new fallback rates?

The fallback rates in the IBOR Fallbacks Protocol are adjusted versions of the RFRs identified by public or private sector working groups in each jurisdiction as alternatives to the IBORs.

Replacement rates vary by jurisdiction. In the UK, the Working Group on Sterling Risk-free Reference Rates selected the Sterling Overnight Index Average (SONIA) as its proposed benchmark for use in sterling derivatives and relevant financial contracts.

For information about the IBORs and alternative RFRs, their administrators and working groups across jurisdictions please see here.

How are the new fallback rates different from the IBORs?

The RFRs are fundamentally different from IBORs in that:

- IBORs have a term structure and an element of credit risk.
- RFRs do not have a term structure; do not include an element of counterparty risk or credit risk but are "risk free" overnight rates, set in arrears.

What IBORs does the IBOR Fallbacks Protocol cover?

As well as LIBOR (with no reference to the currency), the following IBORs are in scope of the IBOR Fallbacks Protocol:

- Sterling LIBOR (**GBP LIBOR**)
- Swiss franc LIBOR
- U.S. dollar LIBOR
- euroLIBOR
- the euro interbank offered rate (**EURIBOR**)
- the Japanese yen Tokyo interbank offered rate (**TIBOR**)
- the euroyen Tokyo interbank offered rate (**euroyen LIBOR**)
- the Australian bank bill swap rate (BSSW)
- the Canadian dollar offered rate (**CDOR**)
- the Hong Kong interbank offered rate (**HIBOR**)
- the Singapore dollar swap offer rate
- the Thai baht interest rate.

Adjusting RFRs for use in legacy contracts

Given the differences between IBORs and RFRs, adjustments are needed to ensure that legacy derivative contracts which were originally negotiated to reference an IBOR continue to meet the counterparties' original economic objectives as far as possible.

Trustees should understand that the adjustments and methodologies adopted in the IBOR Fallbacks Protocol could change the economic consequences of their contracts. You should evaluate these potential consequences with help from your investment consultant, before deciding whether to adhere to the IBOR Fallbacks Protocol.

For technical detail on the adjustments, please see the note from our debt capital markets team.

Next steps

If you have direct investment contracts which reference an IBOR, or are unsure whether you are exposed to such contracts, we recommend you speak to your investment consultant to confirm your position. You may already have been contacted by your counterparty asking you either to adhere to the IBOR Fallbacks Protocol (for derivatives contracts) or to enter into bilateral amendments.

When deciding whether to adhere to the IBOR Fallbacks Protocol or amend your contracts bilaterally, you should take advice from your investment consultant and consider the economic, regulatory, tax, accounting and hedging implications.

Hogan Lovells pension team works closely with our financial services and derivatives colleagues and will be pleased to assist trustees with the legal aspects of the transition away from LIBOR.

This note is written as a general guide only. It should not be relied upon as a substitute for specific legal advice.

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