

Benchmarking Rates: Alternatives to LIBOR

Why in news?

The announcement of FCA and the ICE Benchmarking Administration (IBA) about the end dates of London Interbank Offer Rate (LIBOR) has become a challenge from a Transfer Pricing perspective.

What is LIBOR?

- It is a benchmark interest rate at which major global banks lend to one another in the international interbank market for short-term loans.
- It serves for short-term loans with maturities from overnight to 1 year.
- It also acts as a basis for Corporate and Government Bonds, mortgages, student loans, credit cards, derivatives and other Financial Products.
- It is administered by ICE Benchmark Administration (IBA) and regulated by the UK's Financial Conduct Authority (FCA).
- LIBOR is the average interest rate at which major global banks borrow from one another based on 5 currencies including the U.S. dollar, the euro, the British pound, the Japanese yen, and the Swiss franc, and serves 7 different maturity periods
- The combination of 5 currencies and 7 maturities leads to a total of 35 different LIBOR rates calculated and reported each business day.

Why was LIBOR brought to an end?

- **Susceptibility to manipulation-** LIBOR's credibility was damaged by rate-fixing scandals in 2012.
- The panel banks submissions were alleged to be inaccurate or manipulated to project market strength which led to breach of market trust.
- **Illiquidity-** Illiquidity refers to a condition where assets cannot be exchanged for cash easily.
- The number of transactions in the short-term wholesale funding market reduced over time because financial institutions became more reluctant to lend on unsecured basis for terms longer than overnight.
- Thus, LIBOR became more vulnerable to short-term market illiquidity and amplification of price moves that could cause systemic risks.
- **End to LIBOR-** In July 2017, the FCA declared it would no longer compel panel banks to submit the rates which are required to calculate LIBOR.
- On 5 March 2021, the FCA and the ICE Benchmarking Administration (IBA) announced that the publication of all Euro and Swiss Franc, most Sterling and Japanese Yen as well as the one-week and two-month US Dollar-LIBORs will be ceased immediately after December 31, 2021.
- The publication for remaining US Dollar-LIBORs is intended until June 30, 2023, while the publication of remaining rates for Japanese Yen and Sterling after the end of 2021 for one additional year.
- The RBI notice stated that banks and financial institutions should not enter any new LIBOR related contracts after December 31, 2021.

What are the other rates alternative to LIBOR?

- Various alternative reference rates have been used across the world which includes

- Secured Overnight Financing Rate (SOFR),
- Sterling Overnight Interbank Average Rate (SONIA),
- Singapore Overnight Rate Average (SORA)
- CHF - SARON
- EUR - ESTER
- JPY - TONA
- SOFR is based on transactions in the US Treasury repo market.
- While LIBOR is an unsecured reference rate (submitted by banks), SOFR is an overnight secured reference rate.
- It is secured because it is transaction-based, collateralized and representative of wholesale borrowing.
- It is administered by the New York Fed that broadly measures the borrowing cash overnight with US treasuries as collateral.
- All these benchmarks are having an overnight tenor as opposed to LIBOR which had a tenor from overnight to 1 year.

What are the challenges in new rates?

- **Dependence on REPO markets-** Since SOFR is based upon the repurchase (repo) markets, it is at the repo markets mercy.
- In September 2019 a spike in repo rates resulted in SOFR soaring from 2.14% to 5.25% in a single day.
- **Unsettling the settled position -** As everything was settled based on LIBOR, currently there is not much clarity on the benchmarking rate.
- In the absence of any guidance from tax authorities, there may be modifications in the existing financial contract which may lead to a reframing of safe harbour rules and revision of the Advance Pricing Agreements (APA) which are valid beyond 2021.
- **Existence of current agreements with floating rates-** The agreement might need an update/change from the existing rate to a new rate.
- There is no clarity on whether this change needs to be on a prospective or retrospective basis.
- **Impact of the faceless assessment regime in India-** The risk of litigation and a detailed explanation about the change of the existing rates becomes more challenging in the world of faceless assessment.

How can the challenges be addressed?

- If Alternate Risk-free Rate (ARR) is applied, inter-company agreement can be reviewed and the ARR rates selected may be considered as close as possible to the originally agreed rates.
- The complexities involved in such financial transactions needs mindfulness along with the impending faceless assessment regime.
- Robust documentation along with detailed benchmarking and backup working should be maintained to aid in explaining the position to the tax office if challenged.
- Any change in a settled practice that was established over decades should be embraced with a pragmatic mindset based on facts.
- As new interest rate regime will impact transfer pricing pacts, a seamless transition holds the key.

Reference

1. <https://www.thehindubusinessline.com/opinion/benchmarking-rates-alternatives-to-libor/article37916060.ece>



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