Global Benchmark Interest Rates

Why in news?

Financial institutions are yet to facilitate an absolute transition away from the London Interbank Offered Rate (LIBOR) benchmark.

What is London Interbank Offered Rate (LIBOR) benchmark?

- **Transparency** - LIBOR was created in the 1970s as a way to provide a more transparent and efficient way to set interest rates.
- **Global bench mark interest rate** - LIBOR or London Interbank Offered Rate is a global benchmark interest rate.
- **Estimated interest rate** - LIBOR is calculated daily based on the estimated interest rates at which banks can borrow unsecured funds from other banks in the London wholesale or interbank market.
- **Reference rate** - LIBOR is used as a reference rate for a wide range of financial products including floating-rate loans, derivatives, and securities.

What are the issues associated with LIBOR?

- **Central flaw** - LIBOR relies heavily on banks to be honest with their reporting disregarding their commercial interests.
- **Manipulation by banks** - The manipulation was particularly on display during the 2008 financial crisis when submissions were artificially lowered.
- In 2012 it was also revealed that some banks had been manipulating LIBOR rates in order to profit from their own trading positions.
- **Phase out** - In 2021 the UK's Financial Conduct Authority (FCA) announced that it would be phasing out LIBOR by the end of 2023.
- **Concerns in India** - RBI stated that both LIBOR and MIFOR would cease to be a representative benchmark from June 30 2023.

> *The interbank market is an informal market where banks borrow from and lend to each other with established internal limits based on an institution's risk appetite.*

What are the alternates to LIBOR?

- **Secured Overnight Financing Rate (SOFR)** - Is a broad measure of the cost of borrowing cash overnight collateralized by Treasury securities.
- In 2017 the U.S. Federal Reserve that SOFR as a preferred alternative to LIBOR.
- **Mumbai Interbank Forward Offer Rate (MIFOR)** - Is the rate that Indian banks

use as a benchmark for setting prices on forward-rate agreements and derivatives.

- MIFOR is a mix of the London Interbank Offered Rate and a forward premium derived from Indian forex markets.
- RBI issued an advisory in mid-2021 encouraging all national banks to stop using MIFOR for new contracts by the end of 2021 as a result of the plan to phase out LIBOR.
- **Modified Mumbai Interbank Forward Outright Rate (MMIFOR)** – It would be used to adjust SOFR among other components.
- **SOFR and MMIFOR** - In India ***new transactions*** were to be undertaken using the SOFR and the Modified Mumbai Interbank Forward Outright Rate (MMIFOR), replacing MIFOR.
- It is based on ***observable repo rates***, or the cost of borrowing cash overnight, which is collateralized by U.S. Treasury securities.
- This would make it potentially less prone to market manipulation.

What are the challenges faced by the banks?

- Indian Banks' Association said that there were many products linked to LIBOR which had to be redesigned with an alternate reference rate (ARR) as the base.
- Challenges related to technology and legal aspects (such as handling of legacy contracts, modification of contracts with the counter parties/interbank as well as borrowers).
- Banks have to intimate the customers about the transition, insertion of fallback clause in the contracts, assessment of the impact on their P&L, changes in the technology platform and so on.
- Some banks and financial institutions were yet to facilitate an absolute transition away from the London Interbank Offered Rate (LIBOR) benchmark due to fullback clauses.

Quick facts

International Finance Corporation (IFC)
• IFC was founded in ***1956*** with a key objective that the private sector has the potential to transform developing countries. • IFC is a ***member of the World Bank Group***, advances economic development and improves the lives of people by encouraging the growth of the private sector in developing countries. • IFC is the largest global development institution focused on the private sector in developing countries.

Reference

1. The Hindu | Issues With LIBOR

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