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 5currencies 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 inthe 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