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Challenges of moving from LIBOR

Why in news?

The RBI has set a deadline of June 30, 2023, for complete switch-over from LIBOR and some banks and financial institutions (FI) are yet to facilitate an absolute transition.

What is LIBOR?

- London Interbank Offered Rate (LIBOR) is a global benchmark interest rate for unsecured short-term borrowing in the interbank market.
- It combines individual rates at which banks opine they may borrow from each other (for a particular period of time) at the London interbank market.
- It is used as a benchmark to settle trades in futures, options, swaps and other derivative financial instruments in over-the-counter markets and on exchanges globally.
- Further, consumer lending products like mortgages and credit cards, too use it as a benchmark rate.

Why are we moving from LIBOR?

- In India, several banks and financial institutions (FIs) followed LIBOR.
- The Financial Conduct Authority (FCA) of UK ended the Libor settings in 2021, except for certain types of tough legacy contracts which could not be transitioned.
- Owing to the LIBOR scandals and reforms to provide risk-free interest rates, RBI recommended transitioning from LIBOR.

What did the central bank of India do?

- The LIBOR transition will impact a wide range of financial institutions across various sectors of the financial industry.
- These institutions will need to transition their existing contracts and develop new products based on alternative reference rates.
- The RBI has issued two circulars giving the road map to the transition and arrangements for transition from LIBOR.
- It established a system of *alternative reference rates* (ARRs) that allows banks to choose rates from a basket of currencies for international financial transactions.
- The RBI continues to monitor the efforts of banks/FIs for ensuring a smooth transition from LIBOR.

What are the challenges in transition?

- **Alternative -** Identifying and adopting suitable alternative reference rates to replace LIBOR.
- Different jurisdictions and markets have chosen different rates, such as the SOFR in the US, the SONIA in the UK, TONA in Japan and the EU-STR in the Euro Zone.
- Assessing the suitability of these rates for their specific products and contracts to avoid contractual fallback is a challenge.
- **Fallback provisions -** Transitioning these contracts to alternative rates requires addressing the fallback provisions,
- Updating these provisions can be complex, as they involve legal, operational, and documentation changes.
- **Internal Changes -** Making significant adjustments to internal systems, processes, and models.
- **Technology aspects -** Banks and FIs need to invest in the necessary technology upgrades and ensure smooth integration without disrupting day-to-day operations.
- **ARR -** The introduction of alternative reference rates (ARRs) also poses challenges of market liquidity and product availability.
- **Legal challenges -** Contract interpretation, amendment, and litigation arising from the transition process.
- **Awareness -** Effective communication and engagement with clients and stakeholders by banks and FIs needed to educate their clients about the upcoming changes.

What are the benefits of transition?

- The transition from LIBOR has the potential to reduce the cost of financing in several ways.
- **Risk Premium -** The calculation of alternative reference rates is based on more robust and transparent methodologies which certainly can help reduce the risk premium associated with LIBOR.

  "LIBOR premium" was typically included in their lending rates to compensate for the potential volatility and uncertainty associated with LIBOR.

- **Pricing** - Introduction of ARRS increases competition for reference rates which lead to more transparent and competitive pricing of financial products.
- This potentially results in lower financing costs for borrowers.
- **Liquidity** - the alternative reference rates increased liquidity can lead to more efficient pricing and tighter spreads in the market, benefiting borrowers.
- **Harmonisation -** The increased harmonisation can help reduce the cost of financing for borrowers accessing international markets.
- The alignment of Indian banks and FIs to international standards promotes consistency and comparability across markets, reducing uncertainty and facilitating cross-border transactions.

What is the way forward?

- Capacity building of financial institutions such as pension funds, insurance companies, hedge funds, and non-banking institutions needs to be done.
- Supplement the capacity of these institutions to evaluate and select appropriate alternative reference rates that are recommended by the RBI.
- Inform and educate customers and clients about the transition from LIBOR to alternative reference rates.
- Provide clear and timely communication about the changes, impacts on existing contracts, and any actions required from customers.

References

1. Business Line - The challenges of moving from LIBOR
2. The Hindu - Why are financial regulators transitioning from LIBOR?

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