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## End of LIBOR

### Why in news?

The London Inter-Bank Offered Rate (LIBOR) nears its end by the end of December 2021.

### 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.

### How does LIBOR work?

Administered by ICE Benchmark Administration (IBA)

Regulated by the UK's Financial Conduct Authority (FCA)

- Each day, Intercontinental Exchange asks major global banks how much they would charge other banks for short-term loans.
- It then calculates the average from these numbers.
- So LIBOR is the average interest rate at which major global banks borrow from one another.
- It is based on five 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.

### What is the recent decision?

- Following scandals in LIBOR (2012) and questions subsequent questions around its validity as a benchmark rate, it is being phased out.
- The FCA confirmed in March, 2021 that 26 LIBOR settings will end on December 31, 2021.
- However, overnight, 1, 3, 6, and 12 Months US Dollar LIBOR settings will end only by June 30, 2023.

### Why is this move significant?

- LIBOR is an indicator of the health of the financial system, and provides an idea of the trajectory of impending policy rates of central banks.

- A total of \$ 400 trillion of financial products are presently exposed to LIBOR.
- Of this, at least \$52 trillion of financial products will still be exposed to LIBOR after December 31, 2021.
- India has about \$532 billion of external loans which are exposed to LIBOR.
- So, a transition away from the LIBOR poses certain challenges for banks and the financial system.

## Why is LIBOR brought to an end?

### Susceptibility to manipulations

- 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.
- All these led to breach of market trust.
- After the 2012 Wheatley Review, a number of reforms were introduced to reduce subjective input and make LIBOR a transaction-based benchmark.
- Thus, IBA became LIBOR's administrator and FCA the supervisory authority for IBA.

### Illiquidity

Illiquidity refers to a condition where assets cannot be exchanged for cash easily.

- Despite the reforms introduced, 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.
- Notably, financial transactions are better suited to reference rates that are close to risk free.

## What are the alternative reference rates?

- Secured overnight financing rate (SOFR) is being widely used as a substitute for LIBOR across the world.
- 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.

Other Benchmarks rates - (1) CHF - SARON; (2) EUR - ESTER; (3) GBP - SONIA (Already in use since March 31, 2021); (4) JPY - TONA

- All these benchmarks are having an overnight tenor as opposed to LIBOR which had a tenor from overnight to 1 year.

### **What are the limitations to SOFR?**

- Since it 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.

### **What are the other challenges?**

- There are multiple complexities involved in the shifting from LIBOR to another regime
- There could be a lot of volatility in the financial markets as the deadline arrives.
- The RBI has issued two circulars giving the road map to the transition and arrangements to be made for the same.

**Source: Business Line, Investopedia**



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