LIBOR Transition and Transfer Pricing Implications

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According to the Financial Conduct Authority (FCA), UK, LIBOR (London Interbank Offer Rate) will either be discontinued by any administrator or no longer be considered a representative rate.

As a result of the above, the Reserve Bank of India (RBI) issued a letter to all Indian banks to ensure that no new transaction undertaken by them, or their customers rely on or are priced using the LIBOR or the Mumbai Interbank Forward Offer Rate (MIFOR) which is derived from LIBOR.

This article analyzes and discusses recent developments in the transition away from LIBOR from a Transfer Pricing perspective.

Alternate Reference Rate (ARR's)

While businesses adjust to a world without LIBOR, the potential impact of this fundamental change on their arm's-length interest rates for intercompany borrowings is need of an hour. As a result, ARRs have gained prominence which are as follows:

Table: Currency-wise ARRs

LIBOR currency	Proposed Replacement	Transaction Type
USD	SOFR – Secure Overnight Funding Rate	Secured
GBP	SONIA – Sterling Overnight Index Average	Unsecured
Euro	ESTR – Euro Short Term Rate	Unsecured
CHF	SARON – Swiss Average Rate Overnight	Secured
JPY	TONAR – Tokyo Overnight Average Rate	Unsecured

The terms 'near risk-free rates', 'risk-free rates', and ARRs are generally accepted as interchangeable and should be defined as LIBOR alternatives developed by international central banks.

LIBOR v. ARRs

The only commonality between LIBOR and ARRs is the risk-free component. The major differences between LIBOR and ARRs are as follows:

Table: Key difference between LIBOR & ARRs

Parameter	LIBOR	ARR
Calculation Methodology	Submission from panel banks	Based on actual transactions in liquid markets
Term Structure	Term structure with seven different forward-looking tenors, from overnight to 12 months	Backward-looking overnight rates
Credit Risk Premium	Reflects cost of borrowing by panel banks and thus, includes credit premium component	Are proxies to risk-free rates and have no credit premium
Timing of rate publication	Based on consistent methodology across the 5 currencies and published at the same time	ARRs have different methodologies and publication timelines for each currency
Methodology	All 5 Currencies follow same methodology	Each Currency has different methodology

Transition Challenges

A primary challenge is identifying and adopting suitable ARRs to replace LIBOR. Various jurisdictions and markets have chosen different rates, which are as follows:

- As the basket of currency becomes wider, banks and financial institutions must assess the suitability of these rates for their specific products and contracts to avoid contractual fallback(s). This can be a complex process, as it involves changes to legal, operational, and documentation provisions.
- Additionally, shifting from LIBOR requires significant adjustments to internal processes, systems, and models.
- The ARRs also pose challenges in terms of market liquidity and product availability, which can lead to market inefficiency and potentially affect the pricing and availability of certain financial products.

Credit Spread Adjustment

A spread adjustment is meant to reduce the difference between LIBOR and SOFR. ISDA (International Swaps and Derivatives Associations) – has prescribed using 5-year historical median difference between LIBOR and SOFR compounded-in-arrears to arrive at the static spread adjustment.

Transfer Pricing Implications

As per the Transfer pricing requirements, the interest on intercompany loans will be required to be benchmarked and justified to be at arm's length. Such transition will affect the interest rates for existing intercompany loans which are required to be freshly benchmarked and updated.

APAs

The transition of LIBOR may have an impact on concluded APAs ((1) Loan and (2) Corporate Guarantee Transactions).

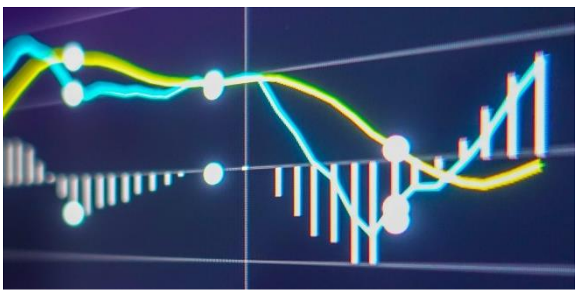
Safe Harbour Rules

The Safe Harbour Rules provide margins with LIBOR as a base which will require an update.

Way Forward

Due to the scope of the LIBOR phase-out's impact, it is important for group companies having existing intercompany loans and guarantees to manage this transition carefully and to account for any differences between the two rates (i.e., LIBOR and new ARRs). The recommended first step is for companies to identify intercompany agreements containing LIBOR references and modify those agreements.

To the extent LIBOR is referred to in existing agreements, appropriate fallback language should be included – for both Related and Third-party Agreements. Now is the time to create/update robust documentation along with detailed benchmarking and backup should be maintained to explain any position if challenged.



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