Mazars Tax Newsletter

Are you ready for LIBOR transition?

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05/05/2021 Regulators kicked off the final countdown for the London Interbank Offered Rate (LIBOR) on 5 March 2021. The U.K. Financial Conduct Authority confirmed that the final fixings for most LIBOR rates will take place at the end of this year, with just a few key dollar tenors set to live on for a further 18 months.

Along with a number of other IBORs – such as the Euro Interbank Offered Rate (EURIBOR) and Tokyo Interbank Offering Rate (TIBOR) – LIBOR is commonly used as a benchmark or reference rate for trillions of dollars of financial products and contracts. Despite the increasing importance of IBORs, regulators and some other industry participants have been looking to move away from these reference rates, largely because of long-running debates on data integrity and validity.

There are two main reasons for the shift:

- On the one hand, a LIBOR quote is not based on actual transactions, but instead on a bank's self-reported funding cost measures. Some banks have manipulated IBORs – notably LIBOR during the financial crisis – through false reporting, to avoid exposure of possible credit issues at those banks. Several banks paid large fines for that manipulation, making it less attractive for them to continue participating on the LIBOR panel. Regulators in U.S. and U.K. levied $9 billion in fines.
- On the other hand, since the financial crisis and the start of quantitative easing, liquidity in unsecured interbank markets has declined, causing significant instability in IBORs during economically stressed times, therefore making IBORs less meaningful benchmarks.

Unlike the LIBOR, EURIBOR is set to survive beyond the end of 2021. Regulators have focused on reforming rather than scrapping EURIBOR. The method of calculating the rate has changed to prioritize actual transaction data over bank quotes. Yet there is speculation that it could eventually be phased out as part of a wider overview of benchmarks affected by manipulation scandals. However, the European Central Bank (ECB) began phasing in the Euro Short-term Rate (ESTR) in October 2019, and the benchmark will fully replace the Euro Overnight Index Average (EONIA) in early 2022.

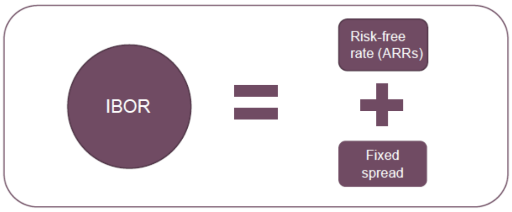
Regulators believe the **replacement benchmarks should be based on observable, independent transactions** (rather than self-reported bank quotes) in active markets with prices driven by supply and demand. These replacement benchmarks are called the alternative reference rates (ARRs) which are detailed in the table below.

Region	IBORs	Selected Alternative Reference Rate (ARR)	Reference rate description	Transaction based?	Nature	Expected cessation date
U.S.	USD LIBOR	Secured Overnight Financing Rate (SOFR)	Cost of borrowing overnight collateralized by Treasury on a secured basis	Yes	secured	1-week and 2-month tenors: 31 Dec. 2021 All other tenors: 31 June 2023
U.K.	GBP LIBOR	Sterling Overnight Index Average (SONIA)	Based on actual transactions and reflects the average of the interest rates that banks pay to borrow Sterling overnight from other financial institutions on an unsecured basis	Yes	unsecured	31 Dec. 2021
Switzerland	CHF LIBOR	Swiss Average Rate Overnight (SARON)	Based on transactions posted in the Swiss repo market on a secured basis	Yes	unsecured	31 Dec. 2021
Japan	JPY LIBOR	Tokyo Overnight Average Rate (TONAR)	A transaction-based benchmark for the uncollateralized overnight call rate provided by money market brokers on an unsecured basis	Yes	unsecured	31 Dec. 2021
EU	EONIA / EUR LIBOR	Euro Short Term Rate (€STR)	Based on transaction data as part of daily money market reporting from the 52 largest euro banks. Reflects the wholesale euro unsecured borrowing cost or euro area banks	Yes	secured	31 Dec. 2021
EU	EURIBOR	Reformed EURIBOR	EURIBOR is the rate at which euro interbank term deposits are being offered within the EU and EFTA countries	Partly	unsecured	31 Dec. 2021

As shown above the ARRs differ from one another, while some are based on secured, the others are linked to unsecured transactions. There are also differences in terms of track records, as SONIA has the longest existence. The security background of the transactions will create extra complexities of the transition because each of these rates will react differently to market stress.

What are the main differences between IBORs and ARRs?

LIBOR is the average interbank interest rate at which a selection of banks on the London money market are prepared to lend to one another. LIBOR comes in 7 maturities (from overnight to 12 months) and in 5 different currencies. The LIBOR rate is forward-looking, so borrowers know the interest rate for a given interest period at the beginning of the period. As LIBOR represents an unsecured bank-to-bank lending rate, it includes a component for the credit risk premium, while as a risk-free rate an alternative reference rate does not.



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ARRs are backward-looking overnight risk-free rates, and even within the ARRs there could be differences in terms of the security type of the underlying financial transactions. SOFR and SARON represent secured, while €STR, SONIA and TONAR are based on unsecured financial transactions. The table below compares the LIBOR base rate to the SOFR reference rate.

LIBOR	SOFR
Bank-to-bank lending rate (includes credit risk)	Risk-free rate (no credit risk)
Unsecured	Secured with US Treasury Securities
Forward looking	Overnight – Backward looking
Term structure is available	No term structure is available
Based on bank submissions and expert judgement	Transaction based

The key transfer pricing implications

The impacts of IBOR transition are potentially wide ranging, and they are likely to include all of risk management, legal, IT and financial reporting departments within a multinational group. Multinational enterprises (MNEs) with intra-group financings or valuations relying on variable interest rates based on LIBORs could be affected and should consider the following main concerns with regards to their intra-group dealings.

Pricing differences

When it comes to converting LIBORs to a specific ARR, special attention needs to be paid to the credit risk component of the bank-to-bank financing risk. LIBOR cannot be simply changed to SOFR in existing contracts referencing LIBOR, appropriate adjustments need to be carried out. There are different approaches in this regard (e.g. forward spread approach, historical spread approach, etc.); however, the arm’s length principle needs to be accounted for. The lack of term structures for ARRs will make the conversion from LIBOR rates to ARRs even more difficult in the first years following the discontinuation.

Multiple currency transactions e.g. cash-pooling arrangements should be dealt with care, as the transactions are denominated in different currencies, multiple ARRs with different specifications need to be applied.

During the transition period, market liquidity might be volatile, which might lead to difficulties in accessing reliable comparable data, making the transfer pricing analysis less robust.

Intercompany agreements

Multinationals need to review and amend their existing intercompany agreements in relation to transactions affected by the transition. An important aspect would be to add a fallback provision to specifically lay down for the counterparties what base rates will be used in the arrangement on what timeline once LIBOR rates are no longer available. With respect to new intercompany transactions between now and the end of 2021, a fallback language should already be included in the agreements.

Due to the amendment of the existing agreements, it could be the case that tax authorities might evaluate these IBOR transition related modifications as significant, which could trigger a new benchmarking analysis in order to be in line with the arm's length principle.

Transfer pricing policy

In light of the above, the structural differences between IBORs and ARRs may create comparability difficulties with the economic analyses applied to price intercompany financial transactions that currently apply an IBOR base rate. Therefore, the transfer pricing policies of multinational groups might also need to be reviewed and amended to account for the changes in the pricing methodologies and the use of different reference rates or new ARRs once IBORs are no longer available.

Key takeaways

For multinational enterprises affected by the transition, the recommended first step would be to identify intercompany agreements containing LIBOR reference rates and undertake the processes to modify those agreements, adding the relevant and most appropriate fallback provisions.

Considering the numerous differences in the IBORs and ARRs, MNEs will need to carefully review their valuation methodologies and pricing of intercompany financial arrangements to prevent shifts of value from one jurisdiction to another, which may trigger potential transfer pricing exposures.

MNEs should be up-to-date with the new development in connection with the IBOR transition as these processes could lead to a significant impact on the MNE's financial position and on their intercompany financial transactions.

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