

## 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?](#)

