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