London Interbank Offered Rate (LIBOR)

For Prelims: London Interbank Offered Rate, Mumbai Interbank Forward Outright Rate (MIFOR), **RBI**, **Interest Rate, Repo Rate**, ARR, SOFR, **Derivatives.**

For Mains: Significance of Transition from London Interbank Offered Rate to alternate Reference Rate.

Why in News?

The **Reserve Bank of India (RBI)** has advised banks and other Regulated Entities to move away from the **London Interbank Offered Rate (LIBOR)** and transition to Alternative Reference Rates (ARR).

- The transition away from LIBOR is aimed at reducing reliance on a benchmark that is susceptible to manipulation and ensuring the financial system's stability and integrity.

What is LIBOR?

- **About:**
  - LIBOR is a **widely used global benchmark interest rate.** It represents the **average interest rate at which banks estimate they can borrow from each other** in the London interbank market for specific time periods.
  - LIBOR is important because it is used **as a reference rate for settling trades in various financial instruments** such as futures, options, swaps, and other **Derivatives.**
- **Calculation:**
  - To calculate LIBOR, a group of banks submits their **estimated borrowing** rates to Thomson Reuters, a news and financial data company, every business day.
  - The extreme rates are removed, and the **remaining rates are averaged to determine the LIBOR rate**, which aims to represent the median borrowing rate.
    - Previously, LIBOR was calculated for five major currencies and seven different time periods, resulting in 35 rates published each day.
    - However, the UK Financial Conduct Authority phased out most of these rates, and after 31st December, 2021, only **U.S. dollar LIBOR rates were allowed** to be published.
- **Significance:**
  - Many lenders, borrowers, investors, and financial institutions rely on **LIBOR to determine interest rates and pricing for these transactions.**
  - Not only is LIBOR used in financial markets, but **it also serves as a benchmark rate for consumer lending products** like mortgages, credit cards, and student loans.
  - It helps determine the interest rates that individuals and businesses pay on these loans.

Why is RBI Moving Away from LIBOR?

- **Concerns Over Reliability and Integrity:**
  - The RBI is moving away from LIBOR due to concerns over its **reliability and integrity.**
  - The central flaw in the LIBOR mechanism is its **heavy reliance on banks to provide**

honest and accurate reporting of their borrowing rates, without considering their commercial interests. This creates an opportunity for manipulation and misconduct.
    - During the 2008 financial crisis, some banks **artificially lowered their LIBOR submissions** to project a more favorable image amid the crisis. Panelists were reporting significantly lower borrowing costs compared to other market measures.
- **Issue of Integrity and Fairness:**
    - There is a tendency for banks to alter their **LIBOR submissions based on their trading units' derivative positions,** aiming to generate higher profits.
    - This raises concerns about the **integrity and fairness** of the benchmark.

What is the Alternative to LIBOR?

- In 2017, the U.S. The Federal Reserve introduced the **Secured Overnight Financing Rate** (SOFR) as an alternative to LIBOR.
    - In India, new transactions were recommended to use SOFR along with the **Modified Mumbai Interbank Forward Outright Rate (MMIFOR)**, replacing Mumbai Interbank Forward Outright Rate (MIFOR).
- SOFR, is based on observable repo rates. These rates **reflect the cost of borrowing cash overnight and are collateralized by U.S.** Treasury securities.
- Unlike LIBOR, which relied on expert judgment, **SOFR is derived from actual transactions, making it less susceptible to market manipulation.**
- MMIFOR, on the other hand, incorporates the **adjusted SOFR rates, which are compounded retrospectively** for different time periods. These rates are obtained from the Bloomberg Index Services, among other components.
    - The introduction of SOFR and MMIFOR aims to provide a more reliable and transaction-based benchmark for financial contracts, reducing the risks associated with LIBOR.

What are the Challenges in Shifting from LIBOR?

- There are many products linked to LIBOR which **had to be redesigned with an Alternate Reference Rate (ARR)** as the base.
    - Two working groups constituted by the association, receiving guidance from the RBI, helped develop the same.
- Transitioning from LIBOR to an ARR poses challenges in technology and legal aspects. These challenges involved **dealing with existing contracts, making necessary modifications with counterparties, interbank entities**, and borrowers.
- Banks need to undertake essential systemic and technical changes. These changes involve identifying products tied to **LIBOR and determining the overall exposure.** Banks also have to inform **customers about the transition, incorporate fallback clauses** in contracts to address scenarios where the reference rate is no longer available, assess the impact on their profit and loss statements, and make necessary adjustments to their technology platforms.

Way Forward

- Banks need to continue their **efforts in redesigning products linked to LIBOR** with the new ARR as the basis. The two working groups constituted by the association, with guidance from the RBI, play a crucial role in developing the necessary framework for this transition.
- To overcome the challenges in technology and legal aspects, **banks must focus on handling existing contracts and making appropriate modifications** with counterparties, interbank entities, and borrowers.
- Banks need to assess the **impact on their profit and loss statements and make any required adjustments** to their technology platforms to facilitate a smooth transition.

Source: TH