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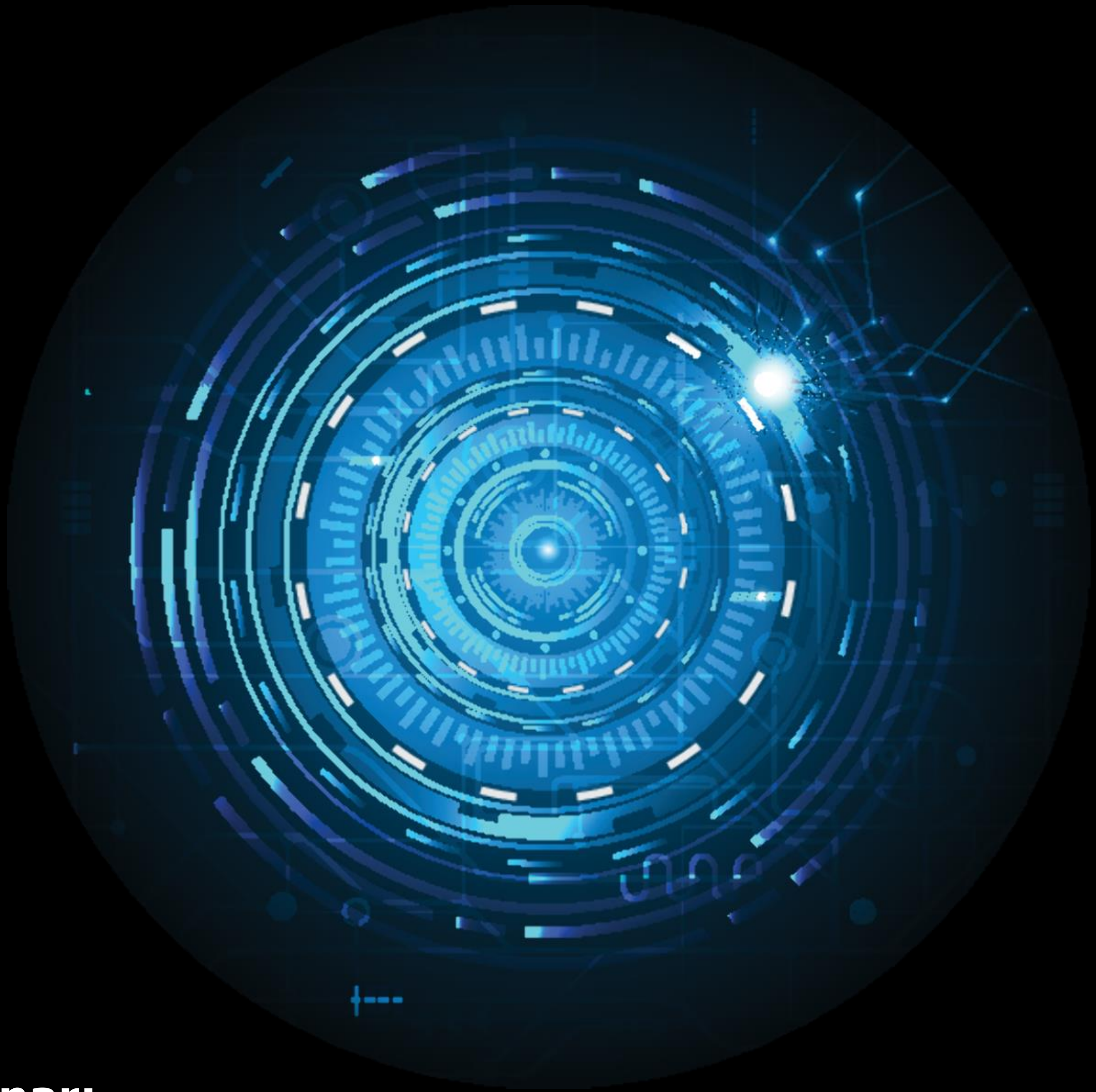

Transfer Pricing webinar:
(L)IBOR Transition and Intra-Group Financing – Transfer Pricing Aspects of an Unprecedented Transformation

25 August 2020

Greetings and introductions

With you today

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Agenda

Main aspects of the (L)IBOR transition

What are (L)IBORs?

What are (L)IBORs

(L)IBORs are **benchmarks interest rate** at which major global banks lend to one another in the international interbank market for short-term loans

- Published on a daily base for **tenors ranging from overnight to 12 months**
- Calculated by averaging panel **banks submissions**
- Include both the expected cost of lending funds and the interbank **credit risk** (i.e. they are quoted on an "unsecured" base)

Major (L)IBORs

The major (L)IBORs are

- **LIBOR** – London Interbank Offered Rate – published for USD, EUR, GPB, CHF and JPY / administered by ICE and regulated by the FCA
- **Euribor** – Euro Interbank Offered Rate – published for EUR / administered by EMMI
- **TIBOR** – Tokyo Interbank Offered Rate – published for EUR / administered by EMMI

There are (L)IBORs across other currencies, but the bulk of the volume leverages the above reference rates

Who uses (L)IBORs and what for?

Who uses (L)IBORs

(L)IBORs are one of the **most used benchmark globally**, there is an estimated USD **350tn of financial products** linked to (L)IBORs

- Main categories of products: Loans, Bonds (FRNs), Derivatives (e.g. IRS), Structured Products
- All industries impacted: Banks, Asset Managers, Corporates, supranational entities

What are (L)IBORs used for

They are broadly used across institutions

- To price products;
- As discounting factor to value assets (e.g. collateral);
- As benchmark performance; or
- In treasury/risk processes/intercompany agreements (e.g. FTP)

Why change?

In the aftermath of the 2007-08 financial crisis, it became apparent that **these reference rates are inadequate due to their lack of robustness**

- Decline in liquidity
- Reluctance from Panel Banks to submit quotes
- Scandals related to alleged manipulations

In 2017, the FCA announced that due to insufficient meaningful data to sustain the LIBOR rate, the benchmark will be discontinued at the end of 2021

By end of 2021, FCA will not compel banks to contribute to LIBOR

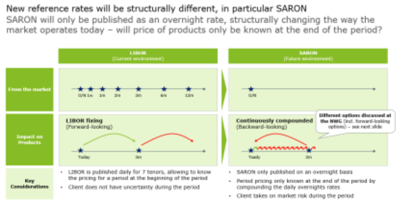
The (L)IBOR transition will not be a simple rate replacement transition

Three key changes leading to operational, structural and economic challenges that need to be addressed to avoid top- and bottom-line impact

Key changes	Current state	Future state	Impact
Decentralised governance	• Same administrator (ICE) across main currencies (EMMI in case of EURIBOR)	• Different administrators across the different currencies (e.g. SIX for SARON, The Fed for SOFR)	• Reference rate different across different currencies, with likely different standards, leading to operational challenges
Structural changes	• Term rates published on a daily basis for 7 tenors (from overnight to 12 months)	• Benchmarks are overnight rates • Plan for some currencies to publish term rates based on derivatives markets (OIS, futures)	• Absence of term rate with potentially strong impact on pricing methodology • Clear communication internally and toward clients to mitigate conduct risk
Economic changes	• IBOR (and EURIBOR) published on an unsecured basis, i.e. inclusion of credit risk in values	• Secured or unsecured depending on the currency	• Transition with spread adjustment required for CHF and USD • Transition likely with winners and loser


New benchmarks have been determined, but only exist for "overnight"
Replacement rates are currently being defined by the different National Working Groups, decentralised governance leading to operational challenges

	LIBOR (today)	USD	EUR	GBP	CHF	JPY
Administrator	Intercontinental Exchange (ICE)	Federal Reserve Bank of New York	European Central Bank	Bank of England	SIX Swiss Exchange	Bank of Japan
National Working Group (NWG)	N.a.	Alternative Reference Rates Committee (ARRC)	WG on Risk-Free Reference Rates for the Euro Area	WG on Sterling Risk-Free Reference Rates	NWG on CHF	Study Group on Risk-Free Reference Rates
Benchmark (overnight only)	LIBOR	SOFR	ESTER	SONIA	SARON	TONAR
Term Rate	Yes	Planned, end-2021, based on OIS	No release date know, but probably based on OIS	Planned, Q1 2020, likely based on OIS	Not recommended	Planned, mid-2021, likely based on OIS
Secured / Unsecured	Unsecured	Secured	Unsecured	Unsecured	Secured	Unsecured



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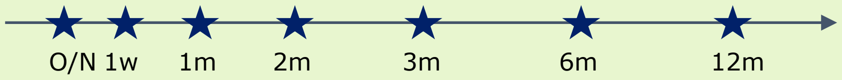
New reference rates will be structurally different, in particular SARON

SARON will only be published as an overnight rate, structurally changing the way the market operates today – will price of products only be known at the end of the period?

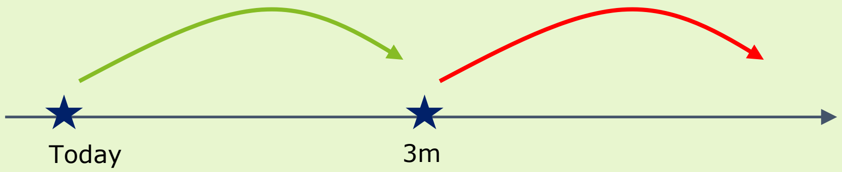
LIBOR (Current environment)

From the market



Impact on Products

LIBOR fixing
(Forward-looking)



Key Considerations

- LIBOR is published daily for 7 tenors, allowing to know the pricing for a period at the beginning of the period
- Client does not have uncertainty during the period

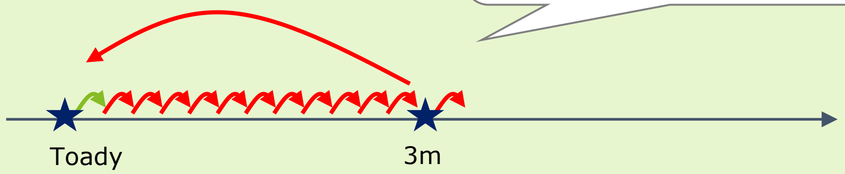
SARON (Future environment)

From the market

Impact on Products

Continuously compounded
(Backward-looking)

Different options discussed at the NWG (incl. forward-looking options) – see next slide

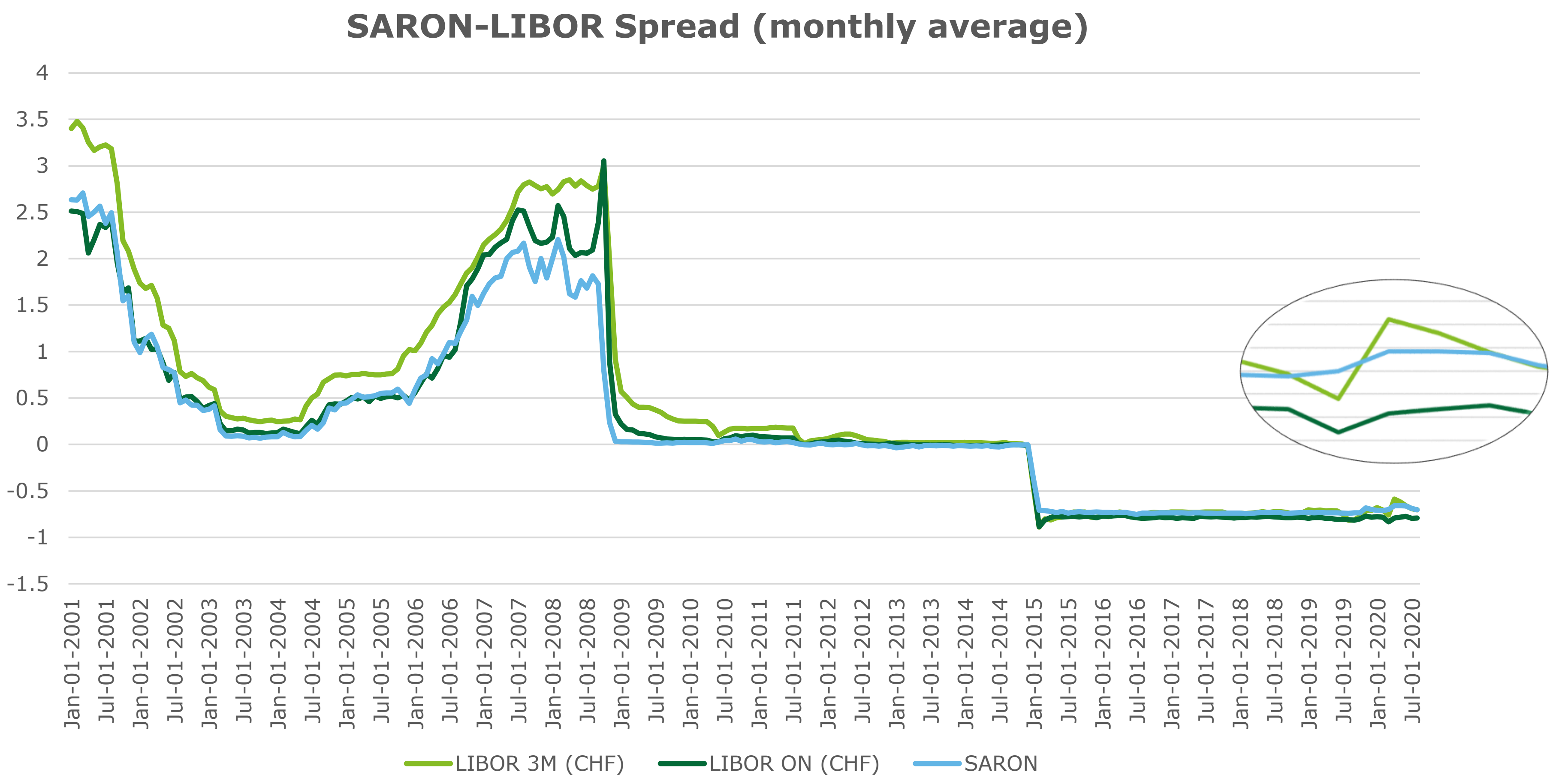


Key Considerations

- SARON only published on an overnight basis
- Period pricing only known at the end of the period by compounding the daily overnights rates
- Client takes on market risk during the period

New reference rates will be economically different, in particular SARON and SOFR

SARON/SOFR are quoted as secured rated (LIBOR is unsecured), there will therefore be a transition spread – depending on the period considered, the spread will be different



- LIBOR is quoted on an unsecure base, while SARON/SOFR are on a secured one
- This implies that there is a credit risk spread between the old and new benchmarks
- The spread between SARON and LIBOR tends to increase during periods of financial turmoil (e.g. 2007-2008), when credit risk is high

Overview of treasury and commercial considerations

What needs to be done before (L)IBOR is terminated by 2021

Focus on five key topics

- Establishing the scenarios and assumptions
- Defining the scope, methodology, tooling and Technology
- Gathering and analysing the inputs and data needed to complete the assessment

- Prepare programme plan including activities, timings, resource, costs and delivery risks

	Impact Analysis	Solution Design
Fallback Language	Identify contracts with duration longer than 2021	Review contracts around trigger event, fallback rate and fallback spread
FX / IR program	Identify implications to FX / IR hedging program	Define tactical changes needed now for existing products Define long-term strategy
Accounting	Identify hedge accounting of interest rate cash flows and instrument valuation techniques based on (L)IBOR	Review possibilities of applying IFRS 9 and IAS 39 relief from the effects of (L)IBOR reform on prospective assessment
Taxes	Review impacts from changes in FV as well as transfer pricing agreements incl. LIBOR references	Define measures to avoid changes to financial instruments which could trigger tax events
IT Infrastructure	Identifying systems using (L)IBOR (e.g. yield curves)	Define program architecture and capabilities versus requirements

What can be done in addition during (L)IBOR transition

Focus on optimisation of IC loan portfolio and FX translation P&L impact minimisation

Analysis of FX P&L Impact

- Detailed analysis of current IC loan portfolio on FX p&l impact
- Analyse local and consolidated impact
- ❖ **Prove IC loan translation impact minimisation**
- ❖ **Prepare to group IC loan portfolio to define**

Redesign IC Loan portfolio

- Contractual changes according to (L)IBOR transition
- Adjust new currency and interest conditions
- ❖ **Impact analysis on changes in FX P&L**

Adapt Hedging Structure

- Design FX translation hedging structure adapted to your restructured IC loan portfolio
- Implement structure (legal, tax and Treasury/FX aspects)
- ❖ **Operate new IC loan FX optimisation structure**

Reporting FX P&L offset

- Define reporting structure to control FX P&L impact of new vs. old IC loan structure
- Implement Treasury analytics and reporting
- ❖ **Project successful implemented**

- Besides (L)IBOR aspects focus on FX translation impacts on local and group (consolidation) level
- Use contractual adaptations to verify a restructuring of IC loan portfolio by grouping loans by few currencies
- Implement FX translation hedging structure to offset FX P&L impact from IC loans
- Implement reporting to permanently control impact

Focus on key transfer pricing implications

Main implications from a tax & transfer pricing perspective (I/II)

From a tax & transfer pricing perspective, the IBOR transition and the resulting implications are underpinned by the existing transfer pricing rules relating to intra-group dealings:

OECD Guidelines

As per chapter IX of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, the **termination and/or substantial renegotiation of existing arrangements may be perceived as business restructuring and may have to be compensated at arm's length** if such termination and/or substantial renegotiation would be compensated between independent parties in comparable circumstances.

In addition to this, on 11 February 2020, the OECD issued the final version of the Transfer Pricing Guidance on Financial Transactions (the "FT Guidance"). The guidance covers the following:

- Accurate delineation of financial transactions
- Treasury function:
    - Treasury centre services
    - Intra-group loans
    - Passive association
    - Cash pooling
    - Hedging
- Guarantees
- Captive insurance
- Risk-free and risk-adjusted rates of return

Main implications from a tax & transfer pricing perspective (II/II)

From a tax & transfer pricing perspective, the IBOR transition and the resulting amendments to existing contracts or valuations may result in significant tax & transfer pricing issues:

Implications

As a consequence, before amending existing contracts (e.g. loans, derivatives), companies should consider whether this could:

- give rise to a disposal of the existing contract for tax & transfer pricing purposes;
- result in step ups/downs of the principal mounts under consideration;
- require one-off payments in relation to the changes;
- impact the effective margins applied to the arrangements under consideration.

Long-term funding contracts based on IBOR (which extend beyond 2021) should already take the transition into account.

Where intra-group IBOR funding is being replaced or novated, companies should check that the new method of pricing is on arm’s length basis in accordance with transfer pricing rules, so as to ensure there are no tax return adjustments to deny the deductibility of financing expenses.

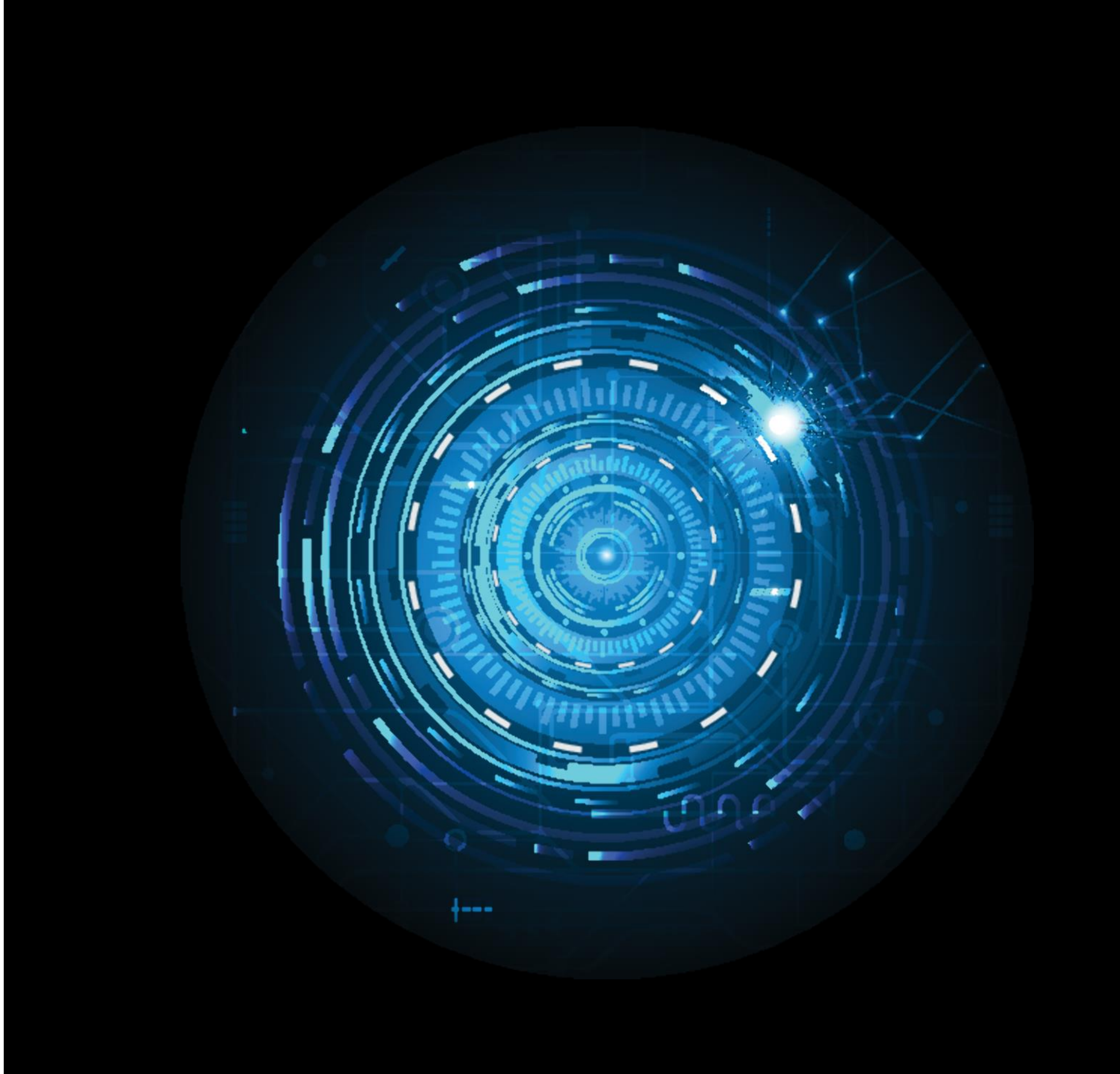
How to ensure a seamless (L)IBOR transition from a tax & transfer pricing perspective?

Ensuring a seamless (L)IBOR transition requires a holistic approach covering all aspects of the transition:

Knowledge sharing and learning	Development of an understanding for the IBOR transition and its implications, the differences between IBORs and ARRs, and how other companies are organized to handle this transformation from a tax & transfer pricing perspective.
Exposure assessment	Identification and review of arrangements potentially impacted by the IBOR transition from a tax & transfer pricing perspective.
Risk mitigation	Evaluation of the tax & transfer pricing risks related to the arrangements impacted by the IBOR transition and definition of a transition roadmap to mitigate these risks.
Operational readiness	Implementation support to ensure a compliant IBOR transition from a tax & transfer pricing perspective including transfer pricing documentation and contract remediation.

Industry perspective

Questions?



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