

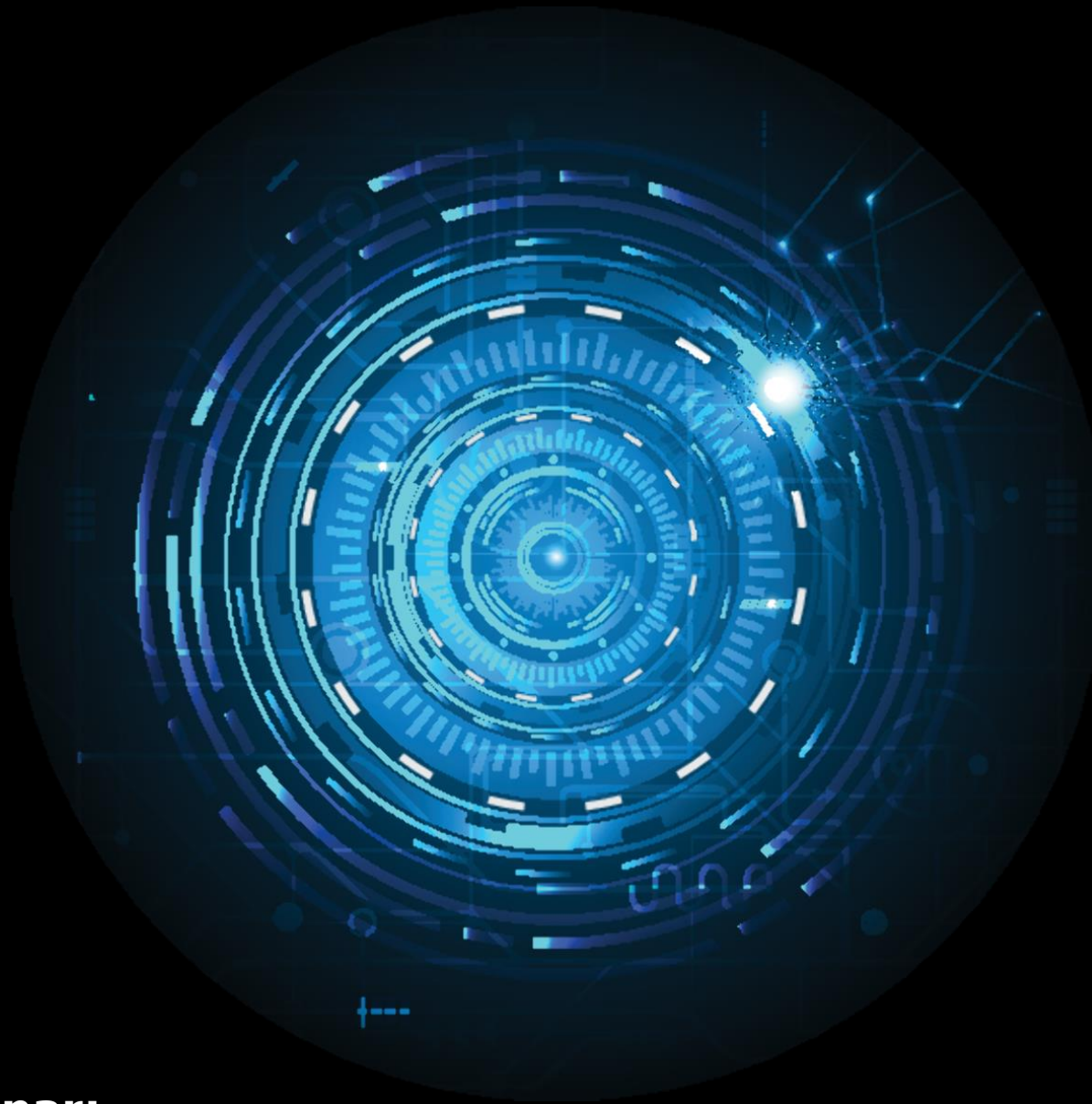


THOMAS HUG

# **(L)IBOR TRANSITION AND INTRA-GROUP FINANCING – TRANSFER PRICING ASPECTS OF AN UNPRECEDENTED TRANSFORMATION**

DELOITTE, 25 AUGUST 2020

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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



**THOMAS HUG**

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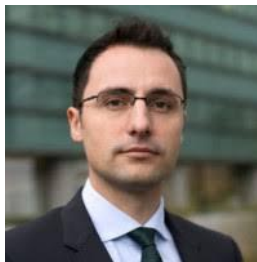
**Deputy Head Group Tax,  
Julius Bär Group**



**SALIM DAMJI**

---

**Partner, Transfer Pricing  
and Value Chain Alignment  
at Deloitte Switzerland**



**GEORGY GALUMOV**

---

**Director, Transfer Pricing  
and Value Chain Alignment  
at Deloitte Switzerland**



**PETER NOBS**

---

**Director, Treasury & Debt  
Advisory at Deloitte  
Switzerland**



**XAVIER TINGUELY**

---

**Manager, Transfer Pricing  
and Value Chain Alignment  
at Deloitte Switzerland**

# Agenda

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# **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, GBP, 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

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

| Administrator                | LIBOR Index | USD  | EUR  | GBP  | CHF             | JPY                                    |
|------------------------------|-------------|--|--|--|-----------------|--|
|                              |             | Federal Reserve Bank of New York             | European Central Bank                                | Bank of England  | Swiss Exchange  | Bank of Japan                          |
| National Working Group (NWG) | N.A.        | Alternative Reference Rates Committee (ARRC) | ECB on this issue, Reference Rates for the Euro Area | WG on Sterling Rate, Reference Rates for the Euro Area | WG on CHF       | Study Group on the New Reference Rates |
| Benchmark (overnight rate)   | LIBOR       | SOFR   | ESTER  | SONIA  | SARON           | TONIA                                  |
| Term Rate                    | Yes         | Planned, mid 2021, based on OIS              | No release (M3) rates, but probably based on OIS     | Planned, Q3 2020, based on OIS                         | Not recommended | Planned, mid 2021, based on OIS        |
| Secured / Unsecured          | Unsecured   | Secured                                      | Unsecured  | Unsecured  | Secured         | Unsecured                              |

#### 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

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?



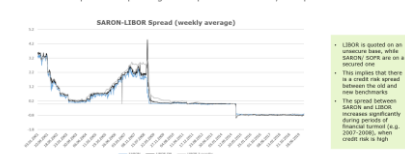
#### Economic changes

- 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 reference rates will be economically different, in particular SARON and SOFR  
SARON/SOFR are quoted as secured rates (LIBOR is unsecured), there will therefore be a transition spread – depending on the period considered, the spread will be different



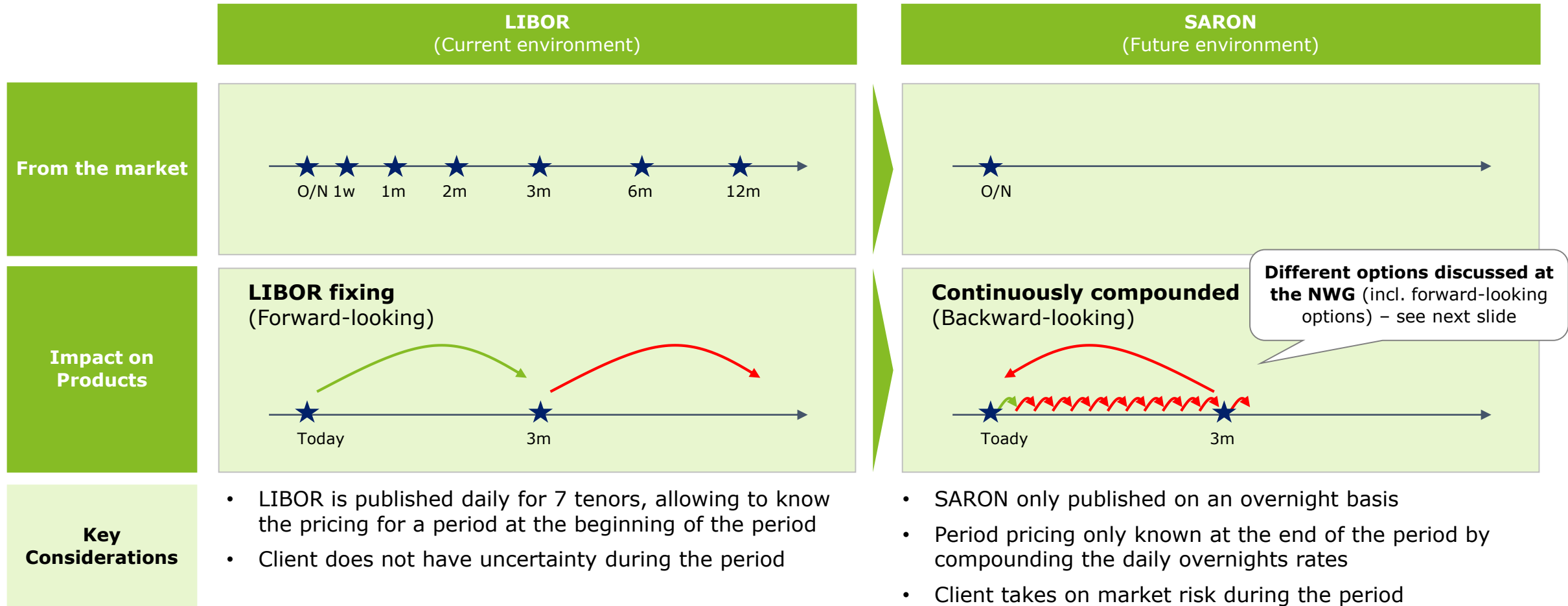
New benchmarks have been determined, but only exist for “overnight”

Replacement rates are currently being defined by the different National Working Groups, decentralised governance leading to operational challenges

|                                     | <b>LIBOR</b> (today)            | <b>USD</b>                                   | <b>EUR</b>  | <b>GBP</b>                               | <b>CHF</b>         | <b>JPY</b>                               |
|-------------------------------------|---------------------------------|--|---|--|--------------------|--|
| <b>Administrator</b>                | Intercontinental Exchange (ICE) | Federal Reserve Bank of New York             | European Central Bank                             | Bank of England                          | SIX Swiss Exchange | Bank of Japan                            |
| <b>National Working Group (NWG)</b> | 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 |
| <b>Benchmark (overnight only)</b>   | LIBOR                           | SOFR   | ESTER   | SONIA                                    | SARON              | TONAR                                    |
| <b>Term Rate</b>                    | 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   |
| <b>Secured / Unsecured</b>          | Unsecured                       | Secured                                      | Unsecured   | Unsecured                                | Secured            | Unsecured                                |

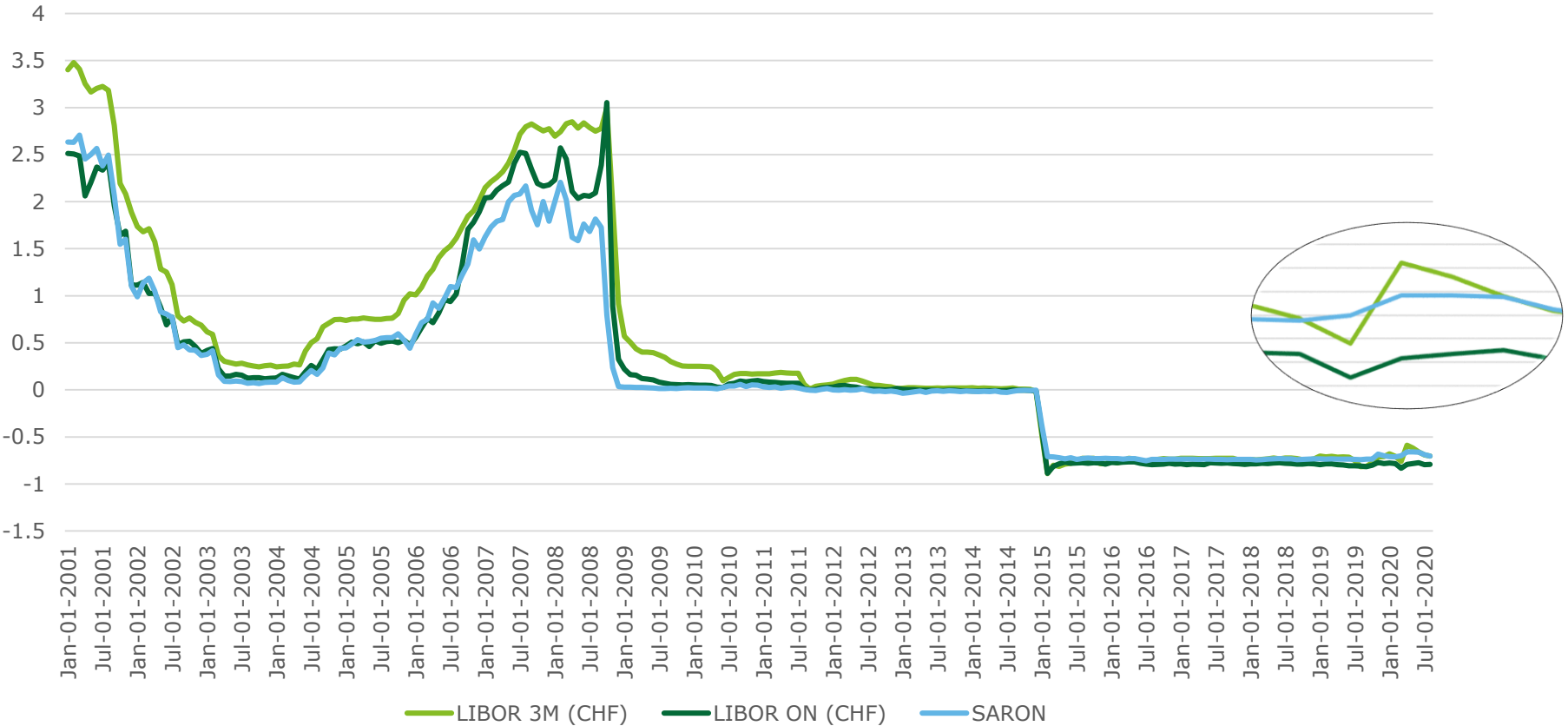
# New reference rates will be structurally different, in particular SARON

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?



New reference rates will be economically different, in particular SARON and SOFR  
 SARON/SOFR are quoted as secured rates (LIBOR is unsecured), there will therefore be a transition spread – depending on the period considered, the spread will be different

**SARON-LIBOR Spread (monthly average)**



- LIBOR is quoted on an unsecured 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

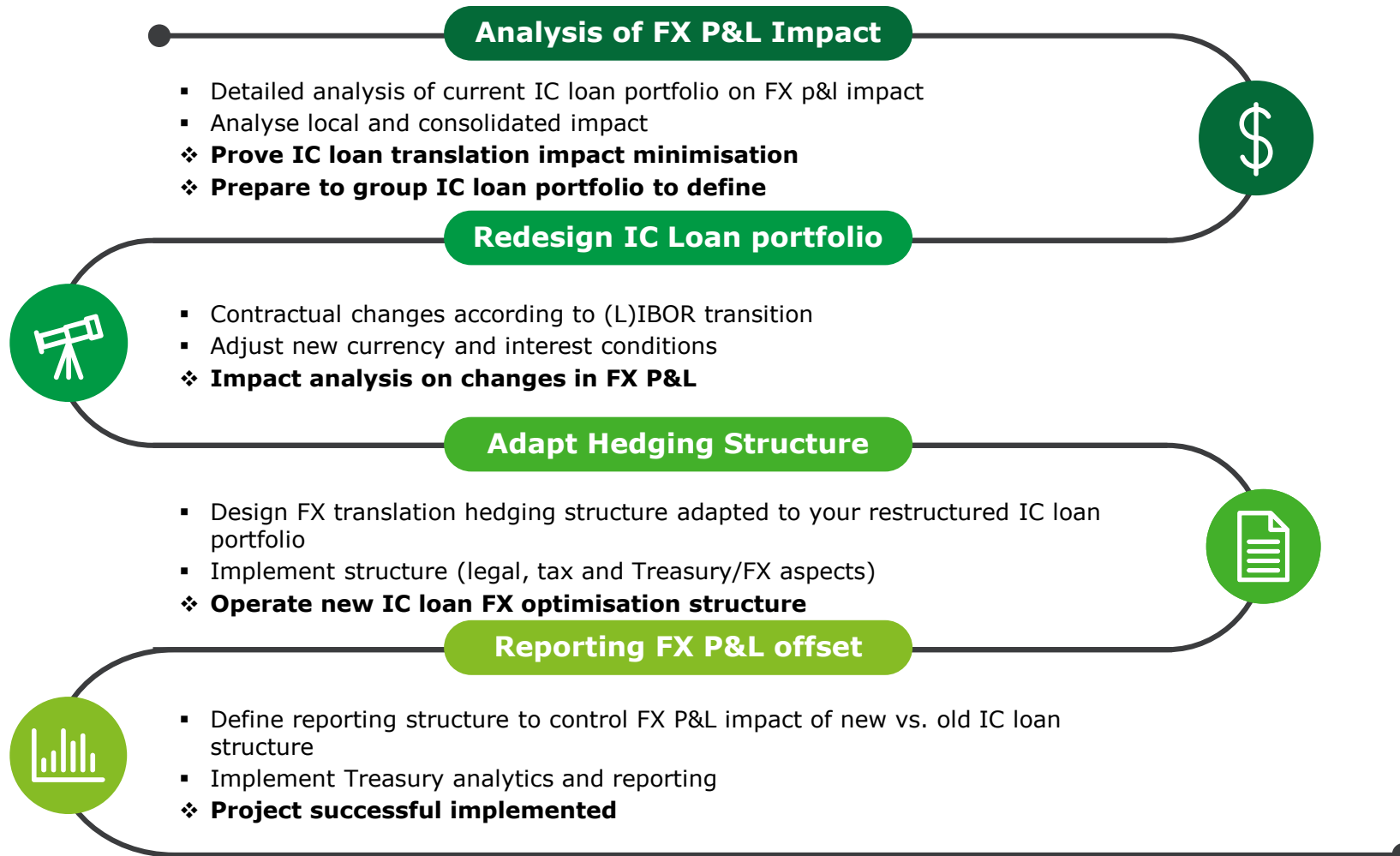
### Impact Analysis

### 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<br>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



- 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 amounts 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 ARR, 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

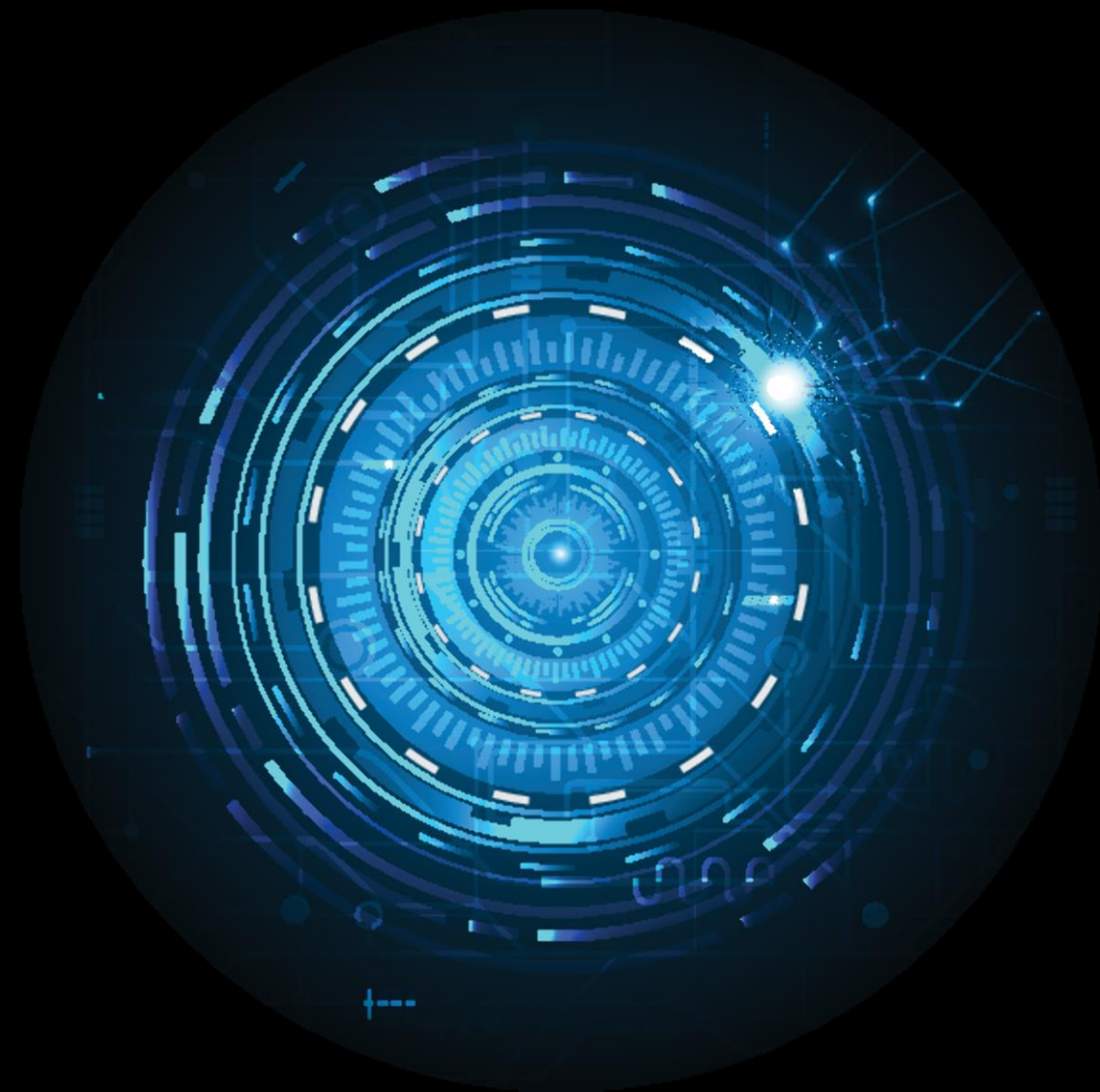
Evaluation of the tax & transfer pricing risks related to the arrangements impacted by the IBOR transition and definition of a transition roadmap to mitigate these risks.

## 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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