LIBOR transition

Transfer pricing and legal impacts for intercompany financing arrangements

LIBOR is often used in the pricing of loans and it is the reference rate in many intercompany agreements. LIBOR will cease to be published from 31 December 2021, with important transfer pricing and legal implications for both new and existing intercompany financing arrangements

What is happening?

LIBOR has a long established role as one of the primary benchmarks for setting term interest rates and it is used as a reference rate in a wide variety of arm's length and intercompany agreements. Currently LIBOR is published for five currencies (CHF, EUR, GBP, JPY, USD) and eight tenors (overnight, spot next, 1 week, 1 month, 2 month, 3 month, 6 month and 12 month).

However, the Financial Conduct Authority announced on 5 March 2021 that the majority of LIBOR term rates for those currencies will either cease to be provided by an administrator or will cease to be representative by the end of December 2021 and will therefore be replaced with a new benchmark risk free interest rate for the relevant currency.

In practice this will mean the end of all sterling, euro, Swiss franc and Japanese yen settings, and the 1-week and 2-month US dollar settings after 31 December 2021, and the end of all other US dollar LIBOR term rates after 30 June 2023.

A number of replacement interest rates have been developed, including SONIA (GBP), SOFR (USD) and ESTER (EUR).

In contrast to LIBOR, which is a forward-looking term reference rate determined by a panel of banks, the replacement rates are risk-free rates, backward-looking and determined by market transactions over a reference period.

The fact that the new replacement rates do not price in bank credit risk or the liquidity premium applicable to a forwards looking term rate like LIBOR mean that the replacement rates are inherently lower than LIBOR rates. To maintain the same pricing levels, credit adjustment spreads may need to be adopted to ensure no shift in value.

Why does this matter for intercompany financing arrangements?

LIBOR is often used in pricing intercompany financing transactions and in calculating interest payments under intercompany financing agreements. The end of LIBOR means that interest calculations under those arrangements need to be updated, along with the relevant intercompany loan agreements.

What does this mean for your transfer pricing?

Intercompany loan arrangements will remain subject to arm's length pricing requirements for transfer pricing, with important impacts for both existing intercompany loans and new intra group lending transactions. Those impacts include:

- **Existing loans:** interest rates will often be based on a LIBOR reference rate, which will no longer be available after 2021. This means that the basis of the interest rate needs to be updated, and the legal agreement for the funding transaction amended, especially if it does not contain transitional language regarding the LIBOR transition (particularly unlikely in older agreements)

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- **New loans:** the pricing data which is available for benchmarking interest rates currently reflects mainly LIBOR based lending, raising technical loan pricing questions such as the definition of credit adjustment spreads and the identification of appropriate credit margins for new loans with interest calculated on the basis of a successor reference rate. As the new rates are typically overnight rates, the question of how to calculate term (e.g. 30 day, 90 day etc) rates also needs consideration.

Legal implications
LIBOR transition means that businesses need to look at the existing inter-company loan agreements already in place to understand the volume of loan agreements (as well as sale agreements, other commercial contracts, Ts&Cs and employee loans which commonly reference LIBOR too) which currently reference LIBOR and also to see what, if any, mechanisms already exist in those agreements for transition (e.g. existing fallback provisions).

It is not common for inter-company agreements to include fallbacks or other provisions setting out the process to identify a replacement rate if LIBOR is unavailable. If agreements are not replaced in their entirely, amendments to existing intra-group loan agreements will be necessary. The need for consent to replace or amend existing agreements from senior lenders, shareholders and other stakeholders should be considered. Associated hedging, security and guarantee arrangements will also need to be addressed. Existing template loan agreements will also need to be updated to include the new replacement rates.

Businesses will need to ensure an aligned transition from LIBOR across external debt facilities, external hedging and their intra-group arrangements to avoid mismatches, and we have many simplified legal solutions to help achieve this.

What do I need to do?
With less than 6 months to go until the LIBOR transition date for most currencies and tenors of LIBOR rate, it is important that businesses have a clear understanding of the transition, its impact on their business and its funding arrangements, and a clear plan to implement the necessary changes by the end of 2021. The interaction of these transfer pricing and legal questions with wider tax and accounting questions also needs to be taken into account, making prompt action key to managing the transition process successfully and efficiently.

Now	Q3 2021	31 December 2021
Target of no new GBP LIBOR loans Identification of LIBOR-linked loans maturing after 2021 Accelerate remediation of legacy GBP contacts New contracts to include terms facilitating conversion or new reference rate	Completion of active conversion of GBP LIBOR contracts where viable	No/limited publication of GBP LIBOR (and some other currencies) post 31 December 2021

Contacts
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For more information see our [LIBOR Transition for UK Corporates website]

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