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RBI NOTIFIES TRANSITION TO ITS BENCHMARK RATES FROM OVERSEAS BORROWINGS

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Background

With the imminent discontinuation of the publication of the London Interbank Offered Rate (LIBOR) by the end of 2021 for most currencies, the Reserve Bank of India (RBI) by its circular dated 8 December 2021 (Circular) amended the RBI's Master Direction - External Commercial Borrowings, Trade Credits and Structured Obligations dated 26 March 2019 (ECB Master Directions) to provide for a risk free benchmark rate as an alternative to the LIBOR (which has been used since inception for majority foreign currency borrowings).

LIBOR has been a preferred benchmark rate for the syndicated loan markets and as a pricing source by financial markets globally and in India for a wide array of financial instruments including loans and derivative products. In view of the cessation of publication of LIBOR, the RBI in August 2020 had indicated to all the banks and the financial institutions to frame a board-approved plan, outlining an assessment of exposures linked to the LIBOR and the steps to be taken to address risks arising from the cessation of LIBOR, including preparation for the adoption of the Alternative Reference Rates (ARR) and putting in place a framework to mitigate risks arising from such exposures on account of transitional issues including valuation and contractual clauses.

The amendments to the ECB Master Directions introduced by the Circular are as follows:

- **Revision to the definition of benchmark rate:** The benchmark rate for foreign currency external commercial borrowing (FCY ECBs) / trade credit (TC) which was previously pegged to 6- months LIBOR rate of different currencies or any other 6-month interbank interest rate applicable to the currency of borrowing, has now been changed to any widely accepted interbank rate or the ARR of 6-month tenor, applicable to the currency of borrowing. There is no change to the benchmark rate in case of Rupee denominated ECB/TC which continues to be linked to the prevailing yield of the Government of India securities of corresponding maturity.

- **Increase in all-in-cost ceiling for existing ECBs which are affected by the LIBOR transition**: For all the existing FCY ECBs and TCs, where benchmarks are modified to ARRs pursuant to LIBOR transition, a one-time adjustment for only such ECBs and TCs has been provided for the all-in cost ceiling with an increase of spread by 100 basis points. The revised all-in-cost ceiling limit for the existing

FCY ECBs and TCs will now be 550 basis points and 350 basis points, respectively over the benchmark rate.

The all-in-cost ceiling for Rupee denominated ECB/TC has been maintained at 450 basis points above the benchmark rate.

- **Increase in all-in-cost ceiling for new ECBs:** For any new FCY ECBs and TCs which will be using the ARR (benchmark rates other than LIBOR), the all-in-cost ceiling has been increased to 500 basis points and 300 basis points, respectively, above the benchmark rate to bridge the gap between LIBOR and ARRs in terms of credit risk and term premia.

Comments

The amendments to the ECB Master Directions provide much-needed clarity to the financial institutions, hedge providers and borrowers on the new applicable alternative reference rates for external commercial borrowings and encourage them to use any widely accepted ARRs as soon as practicable in lieu of the cessation of LIBOR from December 2021. The amendments provide a framework to the financial institutions for a smooth transition ensuring that the risks arising from such exposures on account of transitional issues including valuation and contractual clauses are mitigated well in time. The market participants have already migrated to alternate benchmark rates depending on the currency of lending including the Secured Overnight Financing Rate (SOFR), Sterling Overnight Indexed Average (SONIA), Swiss Average Overnight (SARON) for Swiss Francs, Tokyo Overnight Average Rate (TONAR) and have been including fallback provisions by way of amendments. It will be interesting to watch the development of other reliable benchmark rates that will provide much needed stability to international trade now that LIBOR will be discontinued.

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