TRANSFER PRICING ASPECTS OF FINANCIAL TRANSACTIONS - REPLACING LIBOR AND HIGH FX RISKS AND IMPACT

I. The LIBOR is replaced at the end of 2021

The London Interbank Offered Rate (LIBOR) is the global benchmark for financial transactions with an estimated volume of USD 370 trillion. The discontinuation of LIBOR at the end of 2021 requires market participants to use alternative key interest rates from 1.1.2022 at the latest.

This amendment affects the transfer pricing systems of multinational enterprises (MNEs) that have entered into intercompany financing agreements on the basis of LIBOR. Stakeholders should assess the impact on existing intra-group transactions and policies in a timely manner and develop a transition scenario that takes into account the likely impact of discontinuing LIBOR.

Alternatives to LIBOR

Alternative interest rates have emerged in various countries, but their characteristics differ significantly from LIBOR according to region, currency, maturity and basis.

In the USA, the Secured Overnight Financing Rate (SOFR) introduced by the Federal Reserve in 2018 is establishing itself. The SOFR is based on the interest rate for banks that borrow overnight in the market for repurchase agreements, where lenders such as money market funds grant short-term loans to bond brokers, often using government bonds as collateral. The alternatives in the UK, the Reformed Sterling Overnight Index Average (SONIA) and in Europe, the Euro Short-Term Rate (ESTER) are unsecured rates. The Swiss average rate (SARON), a rate secured overnight, is based on a mixture of transaction and survey data.

Possible alternatives to the various LIBOR rates are:

LIBOR rate	Proposed alternative benchmark
EUR LIBOR	Euro short-term rate (ESTER)
USD LIBOR	Secured overnight financing rate (SOFR)
GBP LIBOR	Reformed Sterling overnight index average (SONIA)
CHF LIBOR	Swiss average rate overnight (SARON)
JPY LIBOR	Tokyo overnight average rate (TONAR)

Companies that price intra-group financing transactions or have financing structures (e.g. in-house banks, cash pools and back-to-back loan agreements) based on LIBOR must switch to an alternative interest rate from 1.1.2022 at the latest.

Effects on Transfer Pricing

i. Intercompany loans

For intercompany loans that use LIBOR as the base interest rate and mature after 2021, an amendment to the agreements should be considered in good time and any necessary measures and timetables for the changeover should be supplemented.

Companies that conclude new intercompany loans by the end of 2021 should consider including recidivism clauses.

ii. Transfer pricing policy

According to the generally applicable transfer pricing rules, intra-group loans must be priced at arm's length conditions. The information contained in LIBOR and the proposed new reference rates may differ more or less in their comparability. Companies should therefore review their transfer pricing policies at this point, revalue them if necessary and redefine rules for comparability if necessary.

iii. Hedging transactions

MNEs often enter into hedging transactions as part of their risk management or to limit currency risks. These are often linked to the LIBOR. Treasury departments and house banks should therefore plan the effects of the discontinuation of LIBOR on existing intercompany financing and hedging structures.

Recommendations

There is still some time until the end of 2021, but the impact on a transfer pricing policy of discontinuing LIBOR requires careful analysis and planning of adjustments. In order to ensure a smooth transition, it is advisable to identify the transactions and structures concerned in good time and to develop transition scenarios in order to counter the abolition of LIBOR appropriately.

II. Foreign exchange management and transfer pricing

As a part of increasing international tension on trade flows recently, Foreign exchange ("FX") positions became more volatile. As a result, FX management which has always been an integral element in transfer pricing, has become increasingly more important, as it plays a part in determining arm's length remuneration for an intercompany transaction. Further, in the post BEPS world and also considering the OECD BEPS actions 8-10 financial-transactions discussion draft, 2018, the measures that have been taken to mitigate the FX risk are also now under scrutiny like never before. In this regard, some of the issues that we have come across in respect of FX management that require an examination to be made by treasury teams of an MNE are listed below:

- Functional profile and absorption of foreign exchange risk are not aligned for an entity in an intercompany transaction;

- Foreign exchange rates not being regularly updated in MNEs;
- Inconsistent foreign exchange policy being applied in MNEs;
- No treasury function managing F/X risks centrally or central treasury function not aligned with local treasury function;
- Treasury policy and TP policy are not aligned.

Ways to mitigate currency risks

When setting up a transfer pricing policy, keep in mind the following three important points:

i. MNE should have a consistent treasury policy to reflect the remuneration for FX management;
ii. Arm's length remuneration has to be provided to treasury hub for negotiating a hedging contract. Thus, the spread margin should include compensation for cost of hedging.
iii. The contractual arrangements should be aligned with the transfer pricing policy to showcase the remuneration of FX management.
iv. The treasury guidelines should be updated regularly to showcase the applicable transfer pricing policy.
v. Advance pricing agreements should have a provision for regular amendments to be made to reflect the FX movements which impact the arm's length remuneration.

In case of any questions, feel free to approach each of the experts directly or contact the TPA Global team:

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