Law360 A LexisNexis® Company

Regulators Push Reform Agenda Through UBS Libor Deal
By Liz Hoffman

The UBS AG Libor-rigging settlement announced Wednesday includes new compliance requirements for the bank that accomplish many of the objectives identified by Britain's Financial Service Authority in its proposals to bring the benchmark interest rate — called the most important number in the world — under tighter oversight.

As part of its settlement with five American, British and Swiss regulators, UBS agreed to use more objective data to calculate the borrowing rates it submits to Libor, implement firewalls between submitters and traders, prepare certain documents, track emails and other communications, meet with the U.S. Commodity Futures Trading Commission every four months, and develop more rigorous standards to protect Libor and other benchmark rates.

These requirements may pale in comparison to the massive fine, criminal charges against a Japanese subsidiary and two individual traders, or the flood of civil litigation UBS is likely to face, but they are largely in line with existing proposals to reform the benchmark — a self-reported, unchecked number that many experts say is far too susceptible to manipulation for profit.

"There are a lot of policy levers at regulators' disposal, and they seem prepared to pull at least a few of them," said Andrew Verstein, a financial regulatory expert at Yale Law School. "There's a lot of overlap between the settlement and some of the proposals on the table."

Verstein warned that there's "no such thing as a perfect index" and that tweaking certain aspects of the popular Libor may open up other areas for concern. But the rate-rigging scandal has threatened the integrity of Libor, which underpins millions of contracts, from residential mortgages to billion-dollar merger financings, and regulators are playing tough.

Britain's Financial Services Authority released a report in September calling for 10 specific reforms to Libor, several of which are part of the UBS settlement. The European Commission has weighed in as well, warning in July that it may consider regulating Libor and Euribor, a continent wide survey of 40 banks, though details have been scarce.

"There is little question that both [regulators] will take interest rate setting out of the industry's hands as much as possible," said John A. James, a Pace University expert on European banking governance. "Self-policing died with Lehman Brothers, and benchmarks is the next place it's coming."

Changes to the system will likely try to reform Libor, rather than replace it, experts said. Some $300 trillion in outstanding contracts are estimated to be tied to the index, and scrapping it could do more harm than good to the market, according to a September review of Libor led by FSA Director Martin Wheatley.

“The issues identified with Libor, while serious, can be rectified through a comprehensive and far-reaching program of reform,” the report said. “Transition to a new benchmark or benchmarks would pose an unacceptably high risk of significant financial instability, and risk large-scale litigation between parties holding contracts that reference Libor.”

And the benchmark has proven remarkably popular since it was introduced in 1986. It is consistently the interest rate market of choice, despite plenty of government-regulated alternatives exist like the Consumer Price Index, the federal prime rate or the TED spread, which tracks the gap between interbank interest rates and what the U.S. government pays on short-term debt, Verstein said.

Libor is free to use and widely understood by analysts, which makes it a popular tool for corporate financings. Big investment banks like to see it in transactions because they have a voice in setting it. And ironically, many in the industry have relied on Libor instead of benchmarks like the CPI because of some concern that government indexes might be susceptible to manipulation for political purposes, Verstein said.

“There's been a lot of grumbling [to replace Libor], but the Wheatley report didn't make that move, the UBS settlement doesn't make that move and I haven't seen migration in the market,” Verstein said. “Libor could disappear from use, certainly, but I don't see this as a turning point.”

Not everyone agrees. Richard Grossman, an economics professor at Wesleyan University, says self-reported data is always susceptible to corruption, and as long as the market relies heavily on its own participants to set interest rates, it risks losing the confidence of lenders and borrowers.

“This is what financial regulators are there to do — protect the integrity of the market,” he said. “This is a moment for them to be aggressive, and I worry they're stopping short because to go further would be too hard.” Proposals on the table include:

Using Objective Data

Banks are not required to provide their actual borrowing costs to Libor, but rather daily estimates of how much a peer financial institution would charge them to borrow on a given day a certain currency for a certain time period — say, Swiss francs for three months.

But as part of Wednesday's settlement, UBS will have to use more objective data in determining those rates, including actual transactions the bank has made that day: certificates of deposit, commercial paper and transactions in swaps, foreign currency forwards and other future-looking transactions. The bank will have to show documents supporting their Libor submissions.

The Wheatley report called for similar reforms, suggesting that "judgment be removed from submitting banks, with submissions instead relying entirely on transaction data or committed quotes." If UBS was forced to report its actual borrowing costs today instead of predicting tomorrow's, it would remove the most obvious opportunity for rate-rigging.

But Verstein said it creates another problem: What happens if there isn't enough data? Most banks do enough business every day in six-month U.S. dollar trades, but what about Danish kroner or the Swiss franc? There are 10 currencies and 15 maturities currently tracked by Libor, and without enough data points, the rates might be meaningless, experts warned.

"If you made banks supply objective data, what happens when the market is very thin?" Verstein said. "If you want to have a rate every day, [you] have to be able to produce data every day, and that may require people to exercise judgment."

One possible solution has already been floated. Last month, the British Bankers Association, the trade group that administers Libor, said it was considering narrowing its offered rates from 150 to 30.

Less Transparency

There aren't many corners of financial regulation where less transparency is a plus, but Libor reporting might be one. Currently, the BBA publishes the data with the name of the bank that reports it. If UBS thinks it can borrow yen for 59 basis points over three months — as it did on March 30, 2009, when regulators now say it was lying at the request of a trader on the Japanese desk — everybody knows it.

That creates incentives for banks to lie, Verstein said. High borrowing costs suggest the market has lost faith in a bank. In the days before its collapse, Lehman Brothers saw its cost to borrow money overnight skyrocket, and it was widely seen as a sign of weakness. Shielding the identity of banks could encourage them to report their true borrowing costs, rather than worry about taking a market hit.

The Wheatley report suggests a middle ground. The names of reporting banks would be kept separate from their data for three months. "It lets banks report accurately for a time without worrying about their day-to-day reputation," Verstein said.

Chinese Walls and Tougher Reporting

The BBA did not require submitters of Libor data to have a Chinese wall separating people who submit rates to Libor and the traders who might benefit from its movement.

And at UBS, efforts from individual employees to submit phony Libor numbers for personal gain appear to have been rampant. The FSA complaint against UBS says that there were more than 800 requests for the yen Libor alone — most of the allegations against UBS center on its Japanese securities unit — and 115 for Libors in other currencies.

The Swiss bank will now be required to implement firewalls between different departments. It must also conduct internal audits of their Libor submissions every six months and submit to an annual independent audit.

“At the very least, you need real separation between the people making the trades and the people setting the rates,” Grossman said. "These things are a first step, but should be just that — a first step."