Proposed Libor Fixes May Open Door To New Benchmark

By Evan Weinberger
Law360, New York (September 28, 2012, 6:14 PM ET) -- The head of a U.K. panel put forward proposals Friday aimed at fixing the "broken" London Interbank Offered Rate following a rigging scandal, but observers say the short-term measures may also push banks and investors to find some new, more concrete alternative to the widely used benchmark.

Ever since Barclays PLC agreed in June to pay around $450 million to settle claims that it allegedly submitted artificially low borrowing costs to the panel that set Libor, regulators have searched for a new rate on which to base borrowing rates for trillions of dollars worth of financial transactions.

Martin Wheatley, the managing director of the U.K. Financial Services Authority, said Friday that such an agreed-upon rate did not currently exist, but new rules for the rate that he proposed could push banks to adopt a new rate based on real, observable transactions.

However, experts were skeptical that the proposed measures would reach beyond the short term, as they leave in place a fundamentally flawed Libor system.

“This might be a stopgap measure, but I don't think it's a long-term solution,” said Richard Grossman, an economics professor at Wesleyan University.

Wheatley, who will soon take over the reconstituted Financial Conduct Authority, unveiled a 10-point plan for fixing Libor in a final report on bid-rigging of the key rate.

Currently, 18 banks submit estimates of their borrowing costs to industry group the British Bankers' Association, which then averages them out to determine the key benchmark rate. The banks are not required to provide their actual borrowing costs, just daily estimates of how much a peer financial institution would charge them to borrow on a given day.

Under Wheatley's proposal, that responsibility would be taken away from the BBA and given to a new, private group approved by the FSA. He also proposed increasing FSA scrutiny of the process used to set Libor, including the approval of bank employees who submit borrowing estimates to the Libor panel and instituting civil and criminal penalties for manipulating the rate.

In addition, he said the FSA should set out rules governing the integrity of Libor submissions and banks' conduct, and that the number of banks that submit borrowing estimates to the Libor panel should expand.

During the financial crisis, lending between banks effectively stopped, meaning that banks needed to provide estimates in order to set Libor, which is used to set borrowing rates for everything from municipal securities to home mortgages and car loans. One of the allegations against Barclays was that
it artificially lowered its estimates in order to avoid looking weak in the marketplace.

Although there had been a growing cry from regulators in the U.S., in particular U.S. Commodity Futures Trading Commission Chairman Gary Gensler, for ditching Libor in favor of a benchmark rate based on actual transactions, Wheatley said Friday that there was not currently such an option available that could replace Libor.

Instead, he said that banks could submit borrowing estimates, but that there should be controls placed on them to make sure that they are based in reality.

"Some degree of judgment will have to be retained, because even in the more liquid markets there is not enough daily data available to have a system in place that is entirely based on market transactions, particularly in times of stress," he said.

There was wide agreement Friday that the steps taken by Wheatley were a good start at bringing trust back into Libor, and the financial markets generally.

"There was little option but to recommend a highly regulated approach to setting and governing Libor as anything less would not have answered the depth of public concern," Iwan Griffiths of auditing firm PricewaterhouseCoopers in the U.K. said in a statement.

But while having closer regulatory scrutiny and stiff penalties for manipulation could work to keep some honesty in the rate, it may not prevent rigging in all cases, added John A. James, the executive director of the Center for Global Governance, Reporting and Regulation at Pace University's Lubin School of Business.

"It brings the regulator closer to the action and it brings the number crunchers and threatens them with criminal penalties," he said.

Along with still relying on banks to submit their own borrowing costs, albeit with more supervision and controls, the Wheatley review highlighted the fundamental flaw within Libor: In stressed situations like the global financial crisis, banks do not lend to each other. That makes it impossible for banks to give firm borrowing costs and opens the door to manipulation as they put forward their estimates to the Libor panel, Grossman said.

"The self-reporting, it just creates so many problems that I don't think it's viable in the long run," he said.

Wheatley's reforms may only be needed in the short-term as markets move toward a new benchmark based on real transactions, Grossman said.

Gensler has been pushing for the use of global swap indexes, like one called the overnight index swap rate, but other new rate benchmarks could be used, Grossman said.

"If there's a market-based rate, there's not that much room for cheating," he said.

Libor itself was created by banks. As the markets process Wheatley's proposed changes to Libor, the lack of faith in bank estimates and the problems caused by a lack of interbank lending could push the market to migrate to a new standard, Griffiths said.
"This may encourage firms to seek out more robust solutions and move away from relying on Libor in the future," he said.

--Editing by Elizabeth Bowen and Katherine Rautenberg.