How to mend the Libor process

Barclays' settlement of Libor-rigging claims has sparked a full-scale financial scandal and exposed the conflicts inherent in the rate-setting process. There is a better way to organise it, says ***David Rowe***

Perhaps the first point to make about the Libor rigging scandal is that concerns about the Libor determination process are not new. There was a flurry of interest in the topic when Libor diverged so dramatically from other benchmark rates in 2008 – but as long ago as 1998, observers had warned that the polling process used to set Libor was susceptible to misreporting, whether intentional or accidental.[1]

Those familiar with the process have always recognised Libor is not based on actual transactions. It is the result of a self-assessment poll conducted among a panel of major banks active in the London interbank money market. The specific question posed to the panel daily is: "At what rate could you borrow funds, were you to do so by asking for and then accepting interbank offers in a reasonable market size just prior to 11am?" The central point is that these inputs are subjective estimates. They are neither rates at which actual transactions have occurred or commitments to undertake any transaction in the future.

The most inflammatory aspect of this story is that traders were apparently actively involved in the process of determining the Libor rate submissions at Barclays and possibly at other banks. Assuming this to be true, it is a breathtaking lapse in sound governance. Traders should never be allowed anywhere near the process of setting the rates or prices used to value their positions. Failing to follow this commonsense principle – even when, as here, any one bank's submission can have only a small influence on the result – is simply unacceptable.

The second aspect of the scandal is more subtle but potentially more significant. It concerns the inherent weakness of a rate-setting process based on commitment-free self-assessments. When Libor originated in the mid-1980s, the dispersion in credit spreads among major money-centre banks was modest and the interbank lending market was deep and active. This left little room for fiddling the rate submissions and a polling process conducted by an industry association – in this case the British Bankers' Association – seemed perfectly acceptable.

The financial crisis that unfolded in 2007 and 2008 strained this clubby rate determination process to the breaking point. Individual bank spreads began to diverge as credit markets looked aggressively at which banks could be in serious trouble. Worse still, the interbank money market froze up almost completely for some periods and, even today, it remains a shadow of its former self. How can a bank respond to a question that begins "At what rate could you borrow funds..." if it is effectively shut out of borrowing at all? But answer they did, even in the worst of the unsecured funding market's deep freeze. Furthermore, the inherent self-interest in minimising one's own reported borrowing rate to avoid adverse market reaction is obvious.

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How could the inherent conflicts of interest in the Libor determination process be corrected? The essential problem is that the rates currently reported represent what a bank claims it would have to pay as a borrower – but submissions carry no obligation to undertake any actual transactions. That is to say, no bank is obliged to lend to the submitting bank at its self-proclaimed cost of borrowing. A far more objective approach would be to have each member of the panel submit multiple rates at which they would be prepared to lend to the other individual members of the panel. This process could incorporate elements of an auction. For example, submitters of the two lowest rates for lending to an individual bank could be required to enter into transactions of a fixed size – $25 million dollars, for example – for the stated term. This would immediately convert the submissions from obligation-free self-assessments into potentially binding commitments. It would also change the process from a self-assessment to a peer-review system. It would be prudent for such a system to be operated by regulatory authorities and for the actual individual rate submissions to be confidential rather than public, given the potential for destructive feedback based on details of the submissions.

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I am aware the system I propose would result in quite different behaviour of the interbank lending rate over time than is produced by the present arrangements, especially in times of stress. Given the pervasive implications of Libor, however, a major overhaul of the rate determination process is essential. Something other than obligation-free – and potentially self-serving – estimates is clearly required. ■

[1] *See Berkowitz J, 1998,* Dealer polling in the presence of possibly noisy reporting, *Federal Reserve Board, available at www.federalreserve.gov/pubs/feds/1998/199833/199833pap.pdf*