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Will Wheatley's recommendations fix the LIBOR?

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Last Friday, Martin Wheatley, the incoming chief executive of the Financial Conduct Authority, issued his final recommendations on how to fix the LIBOR — the scandal-ridden rate set by the British Banking Association based on submissions from a small group of large banks. Many of the recommendations are in line with what we had proposed in our submission to the Wheatley Review. Wheatley's key recommended changes are as follows.

- LIBOR will be cured rather than killed because eliminating it would create too much upheaval, uncertainty, and litigation as a result of the fact that the LIBOR rate is embedded in contracts with hundreds of trillions of dollars of notional value.

- Administration of the LIBOR will be moved to a private entity selected through tender by a committee consisting of many stakeholders and reporting to a regulator.

- Moving forward, LIBOR quotes will have to be related to actual transactions rather than mere representations by submitting banks as it has been.

- Efforts will be made to expand the number of banks submitting data on rates thereby increasing the accuracy of LIBOR and reducing the possibility of manipulation and collusion.

- Information identifying the rates submitted by banks won't be released for three months to reduce the ability to use the LIBOR as a facilitating device.

Wheatley has accomplished a great deal in a short time. However, we continue to believe that several aspects of our proposal would result in a more accurate, reliable and transparent LIBOR — goals we share with the Wheatley Review — than his final recommendations. Our proposal had three elements.

1. Banks that participate in the rate setting process would have to submit bid and ask quotes for interbank lending and commit that they would conduct transactions within that range. If they traded outside of those ranges they would have to justify and face a penalty. This leads to the CLIBOR—for "committed" LIBOR.

2. All large banks would have to submit interbank transactions including rates to a data-clearing house. The data-clearing house would use the actual

transactions to verify the commitment of the banks to the submitted rates. It would also report aggregate transaction data, keeping the actual identities of the trading parties anonymous, with a necessary time delay.

3. A governing body would be established from the CLIBOR participating banks, representatives of CLIBOR users, and other independent parties such as academics. That governing body would enter into a long-term contract, based on competitive solicitation, with a private sector entity to supervise the CLIBOR, operate the data-clearing house, and disseminate information.

The Wheatley Review adopted recommendation (3) more or less as we had proposed.

Instead of adopting recommendation (2), however, the Wheatley Review proposes requiring banks to document where possible transactions that support their submissions. In our view, their recommendations turn the daily determination of the submitted rates into a cumbersome and heavy process, supervised by lawyers and compliance officers worried about satisfying the regulations and covering their rears, rather than one designed to do what the LIBOR is needed for — establishing accurate rates that market participants can rely on. The risk aversion that will clearly and understandably dominate the minds of compliance officers and corporate lawyers who will be involved in LIBOR setting for their banks, will reduce the power of LIBOR to adjust to predicted changes in cost of borrowing for today which were not present at the time that the last transactions took place. As a consequence, this will not only reduce the LIBOR ability to vary over time in response to new and predicted market changes, but also affect its reliability as the prime indicator of the day's expected interbank lending cost.

The Wheatley Review seems to agree that our proposal for a committed LIBOR should be explored in the longer term, but raise two shorter-term concerns.

The principal concern over our recommendation (1) for committed quotes is that banks will not want to participate in this process. That may be true but the Wheatley Review has already indicated that banks might not want to participate in the revised LIBOR process they propose either, and may need to be compelled to do so by regulation. Unfortunately, given the litigation exposure the banks have created for themselves and the resulting proposal for criminal sanctions, the only way to preserve the LIBOR, and avoid market disruption, is to compel banks to contribute.

The other concern raised by the Wheatley Review relates to potentially undesirable increases in balance sheets by the banks, if they are forced to submit quotes for all currencies at all maturities and have to commit to transact on these – they face the risk of actually finding counterparties for all of these submitted quotes and having to transact. Though it is true that this would be a possibility, the way to remediate it is to 1) have a larger number of banks in the panels as recommended; 2) reduce the number of currencies and maturities for which LIBOR is calculated as Wheatley recommend; and 3) not require every bank to submit daily committed quotes to all of the remaining LIBOR. As long as there is a large enough group of banks, one may always expect that bids and asks will exist, particularly since we would be focusing only on currencies and maturities for which a large enough number of transactions tends to exist anyway.

The first two pillars of our recommendation would lead to a more accurate, reliable, and transparent LIBOR than what the Wheatley Review has proposed.

First, by forcing banks to commit to their quotes—actually trade at them when given the opportunity — banks need only make an honest market determination. They only need their army of lawyers when for some reason, on a given day, they decide they want to make a trade outside of the range they've quoted. This is a parsimonious method for ensuring accurate and reliable quotes.

Second, by having a data-clearing house the market will learn anonymous transactions quickly. That will provide an almost immediate way to detect anomalies in the LIBOR and provide the source for alternative benchmarks albeit not ones based on daily data. Adopting a TRACE-like system, that compels the submission of interbank lending and borrowing transactions by a large number of banks, is the surest road to transparency.

The key difference between our proposal and Wheatley's is that our proposal relies on setting up the incentives for the banks to freely submit quotes which are representative of their actual borrowing costs, while the Wheatley's recommendations will force banks to provide quotes according to particular guidelines set out by regulators and which, at the end of the day, may well reduce the incentive to provide the most accurate quotes, and replace those with "the least risky quotes."

Nevertheless, and fortunately, the Wheatley Review provides an excellent foundation for considering proposals such as our own for reforming LIBOR and similar benchmarks around the world.

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