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MARKETS

Scandal-Hit Libor to Be Phased Out

U.K. regulator lays out five-year plan for alternative benchmarks

Andrew Bailey, chief executive officer of the Financial Conduct Authority, on Thursday. He said work will begin to plan for a transition to alternate benchmarks by the end of 2021. PHOTO: SIMON DAWSON/BLOOMBERG NEWS

By Max Colchester

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In five years, Libor could be no more.

On Thursday, a top U.K. regulator said it would phase out the London interbank offered rate, a scandal-plagued benchmark that is used to set the price of trillions of dollars of loans and derivatives across the world.

Andrew Bailey, the chief executive of the U.K.'s Financial Conduct Authority, which regulates Libor, said that work would begin to plan for a transition to alternate benchmarks by the end of 2021. "We do not think markets can rely on Libor continuing to be available indefinitely," he said.

Libor is calculated every working day by polling major banks on their estimated borrowing costs. Its integrity was called into question following a rate-rigging scandal where traders at numerous banks were able to nudge it up or down by submitting false data. Banks were fined billions of dollars and several traders were sent to prison.

LIBOR: WHAT YOU NEED TO KNOW

What it is: Libor—the London interbank offered rate benchmark—is supposed to measure the interest rates at which banks borrow from one another. It is based on data reported daily by banks. Other interest rate indexes, like the Euribor (euro interbank offered rate) and the Tibor (Tokyo interbank offered rate), function in a similar way.

Why it's important: Hundreds of trillions of dollars of securities and loans are linked to the Libor, including auto and home loans, according to the Commodity Futures Trading Commission. Even small movements—or inaccuracies—in the Libor affect investment returns and borrowing costs, for individuals, companies and professional investors.

Over the past five years, regulators have tried to find ways to tie Libor submissions to actual trades, as opposed to estimates. But in several cases that proved impossible because interbank lending has hugely diminished, Mr. Bailey said.

The push to ditch Libor creates a headache for authorities who have to drum up alternative benchmarks and banks that face having to rewrite trillions of dollars' worth of contacts. In financial markets, Libor is ubiquitous, used to price financial products ranging from mortgages to complex derivatives. Industry bodies have yet to agree on fallback rates that can be inserted into existing contracts if Libor suddenly ceases to exist.

THE FALL OF LIBOR

- 1986: First Libor rates published.
- 2008: WSJ articles show concerns with Libor. Regulators begin probes.
- 2012: Barclays becomes first bank to settle Libor-rigging allegations. U.K. regulator pledges to reform the benchmark.
- 2014: Intercontinental Exchange takes control of administering Libor.
- 2015: Trader Tom Hayes gets 14-year prison sentence after Libor trial.
- 2017: U.K. regulator plans to phase in Libor alternatives over five years.

Libor, created in the early 1980s, was previously overseen by a British banking lobby group. During the financial crisis, lenders' submissions in the rate-setting process were closely watched as a gauge of their health. The less a bank said other lenders charged it to borrow, the safer the institution was deemed to be. The problem: Bank lending largely froze up, so the Libor rate was based on guesses and in some cases on deliberately skewed data.

Following the rate-rigging scandal, the bank lobby was stripped of its control of the benchmark. In 2014, the ICE Benchmark Administration, a subsidiary of Intercontinental Exchange Inc., became the new administrator of Libor. The IBA implemented a series of changes—including putting in a surveillance team that evaluates the data coming out of the banks—to ensure that the lenders' submissions are more accurate.

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But interbank lending has dried up. In one case, banks setting the Libor rate for one version of the benchmark executed just 15 transactions in that currency and duration for the whole of 2016, Mr. Bailey said. The U.K. regulator has the power to compel banks to submit data to calculate the benchmark. "But we do not think it right to ask, or to require, that panel banks continue to submit expert judgments indefinitely," he said, adding that many banks felt "discomfort" at the current set up. The FCA recently launched an exercise to gather data from 49 banks to see which institutions are most active in the interbank lending market.

Mr. Bailey didn't set out exactly what a potential replacement for Libor might look like, but a group within the Bank of England is already working on potential replacements.

However, any shift will have to be phased in slowly.

Some £30 trillion ($39.4 trillion) of over-the-counter derivatives reference the rate, while dollar Libor contracts run to the hundreds of trillions, according to the central bank. After 2021, IBA could choose to keep Libor running, but the U.K. regulator would no longer compel banks to submit data for the benchmark. The IBA said in a statement that Libor "has a long-term sustainable future."

Regulators have already been working with banks for several years to find alternatives to Libor.

Last month, the U.S.'s Alternative Reference Rates Committee, which is made up of a group of big banks and sponsored by the Federal Reserve, voted to use a benchmark based on short-term loans known as repurchase agreements or "repo" trades, backed by Treasury securities, to replace U.S.

dollar Libor. The new rate is expected to be phased in starting next year, and transition will be voluntary.

"It is now clear that market participants can no longer avoid facing up to Libor's structural challenges," said Fed governor Jerome Powell in statement Thursday. "The FCA's action today gives market participants the time they need to transition from Libor to a more durable reference rate in a careful and considered way."

In the U.K., one potential replacement is the Sterling Overnight Index Average, which is calculated using banks' overnight funding rates in the sterling unsecured market. This rate is currently being reformed by the Bank of England. The euro's overnight interbank lending rate, Eonia, could also be a possible Libor replacement, said the FCA's Mr. Bailey. Both these rates are administered by central banks.

A major unknown is how existing contacts written using Libor will be amended and what rate will replace the current benchmark. The Financial Stability Board, a global standards setter, is currently working with groups including the International Swaps and Derivatives Association to define a fallback rate to use if Libor suddenly disappears. Regulators could then have to enforce rules that push financial groups to simultaneously amend vast numbers of contracts.

—Katy Burne contributed to this article.

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