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London ' s Rate-Setting Is Raising Doubts

Critics Contend Yen Libor Is Distorted by Japanese Banks' High Quotes
By Michael R. Sesit

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LONDON -- About $5 trillion of derivative contracts and loans may currently be based on a questionable interest rate set by London bankers.

The situation is **raising doubts** about investors' ability to reliably use the contracts to hedge interest-rate and currency risk. At risk: hedge funds, big investment dealers and multinational banks and corporations.

Some bankers contend that if the problem isn't cleaned up soon, **London ' s** reputation as Europe's premier financial center could be damaged at a time when Continental cities are launching a serious challenge.

The culprit is the yen London interbank offered rate, or Libor -- the interest rate at which banks in London lend money to one another. It is also the benchmark off which everything from yen loans to yen-derivative contracts are priced.

Each day, the British Bankers Association asks 16 banks for the interest rate at which they could borrow yen for periods of a week to a year. The BBA then tosses out the four highest and four lowest quotes and averages the rest to get a single Libor.

While eight of the banks (seven Western and one Chinese) are quoting rates of zero to 0.06% for three-month loans, another eight -- all Japanese -- are quoting 0.66% to 0.84%. As a consequence, the resulting average Libor -- 0.39% on Tuesday -- is way above what some people think it should be, by as much as 0.25 to 0.30 of a percentage point.

"The average exists in this empty zone and is close to no contributor (bank)," says William Campbell, an analyst at J.P. Morgan & Co. in Tokyo. "Normally, the average is close to everybody (and) representative of something, whereas here it is a mathematical abstraction."

The wide gap between the rates quoted by Japan's banks and the others has created "a dysfunctional market," says Ravi Bulchandani, an economist at Morgan Stanley, Dean Witter & Co. "One assumption of functioning markets is that the transacting agents -- in this case banks -- are a relatively homogeneous group; but right now that's been called into question."

The distortion, explains Mr. Campbell, "impacts any transaction that uses yen-Libor as a reference rate." That includes $4.6 trillion of interest-rate swaps, as of the end of 1997, according to the International Swaps and Derivatives Association, and another $823.6 billion of loans and bonds, according to Capital Data Ltd. (Swaps involve an exchange of payment streams over time, based on preset terms. In a common interest-rate swap, one party agrees to pay a fixed interest rate in return for receiving a floating rate from another party.)

Traders say the distortion is also creating unnecessary volatility in the so-called basis-swap market where payments based on yen Libor are exchanged for those based on Libor denominated in other currencies, such as dollars and marks. That in turn is making it harder for investors and companies to hedge against adverse interest-rate and currency movements.

Who gets the short end of the stick depends on which side of the equation is being looked at. "If you are a lender (of yen), you are getting a higher return than you ought to; if you are a borrower, you are paying more than you should," says the head of risk management at a big U.S. insurance company. "People are winning or losing based on an improper index" that includes Japanese banks that are quoting rates way out of line with other institutions, this person adds.

Because hedge funds have borrowed hundreds of billions of yen at Libor and invested the proceeds in other markets, they "have gotten completely beaten up by this," says the head trader for a big fund in Bermuda. Bankers add that big Western banks, investment banks and insurance companies also put on similar long-term trades starting earlier in the decade, before the Libor problem popped up.

Companies that have taken out loans or sold bonds priced off yen Libor include U.S.-based Morgan Stanley, Dean Witter, Merrill Lynch & Co. and BankAmerica Corp., Britain's Barclays Bank, Deutsche Bank of Germany, Australia's Westpac Banking Corp., Canadian Imperial Bank of Commerce, Societe Generale of France, the Netherlands' ABN Amro Bank NV and the U.S. and offshore financing units of scores of Japanese companies, according to Capital Data. The list of borrowers also includes national and local governments or state-owned companies from Italy, Sweden, Norway, India, Australia, Canada, Finland and South Korea.

On the other hand, an investor who purchased bonds issued by these governments or companies is getting paid more money than if the Japanese banks weren't part of the Libor calculation.

Why the mess? Max Whatmore, head of fixed-income derivative trading at Merrill Lynch in London, says the high rates quoted by Japanese banks reflect their own high funding costs, which in turn "reflects the poor state of Japanese banks and the Japanese economy generally." Others say it also indicates Western banks' reluctance to deal with Japanese banks near year end.

Still others, especially hedge-fund managers, accuse the Japanese banks of pushing up London lending rates to make extra money from customers who have borrowed at Libor. These skeptics argue that Japanese banks' real funding costs are lower than the rates quoted in international markets, because Japan's central bank is lending them money at effectively no cost. An executive at Sanwa Bank in Tokyo says the eight Japanese banks' Libor quotes mostly reflect the "premium" they must pay for funds in global markets, but concedes that "everybody doesn't quote their real funding rate."

Many traders and bankers argue that low-rated Japanese banks -- four are rated triple-B -- have no right being in the BBA's Libor sample. They also contend that the BBA created a nightmare by changing the definition of Libor on Oct. 1. Each of the 16 contributor banks is asked to quote a rate at which it could borrow funds "in reasonable market size." Before October, they were asked to judge what a "prime bank" could borrow at, which many U.S. and European bankers define as one rated no lower than single-A.

Libor "isn't as representative as it used to be, especially in yen," says Rudolf Enderli of UBS AG in Zurich.

Western bankers say the solution is to stop asking Japanese banks for quotes until they get more respect, and some are betting several Japanese banks will be removed from the contributor panel following a study now under way by the BBA. For its part, the BBA is mum. "People are always talking to us about the composition of the yen Libor panel," says Simon Hills, a BBA director.

Money managers and bankers warn that if the BBA doesn't move fast, it and London risk losing the ability to control what on Jan. 1 will become Europe's key interest-rate benchmark -- that based on the euro, Europe's planned new common currency. Already, the European Banking Federation is advocating its own Euribor, based on quotes from mostly Continental banks.

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