Cruden: Is Libor a trustworthy index?

Futures & Options World
15 October 2012

Insch Capital Management's Christopher Cruden examines whether Libor is still a reliable index for market participants.

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According to some politicians it isn't. (Can we trust politicians?)

The issue came into question after last summer's scandal, when banks' were caught red-handed misreporting submissions for the calculation of the Libor indices. Two reasons were behind the large banks' violations of Libor's integrity, both seemingly confirmed: 1. To make banks look healthier 2. To reap insider trading profits.

The first violation occurred under the supervision by central banks and apparently, with their knowledge. This violation was embedded in the Libor calculation: Banks were asked to rate their own worthiness. (Car drivers tend to rate their driving abilities "above average".)

Libor is structurally prone to manipulation: The British Bankers' Association asks a panel of banks to provide the rates at which they *could* borrow, *unsecured,* at *reasonable* rates. Strategic misrepresentation**[1]** was made possible by basing Libor on non-binding quotes rather than on actual transactions.

This probably had a beneficial effect on the state of a financial system in turmoil, by making banks look less risky and reducing the billion dollar losses they posted quarterly. (Some may call this "monetary policy".)

Benchmarks such as Libor are critical for efficient pricing, beyond their use in contracting. For example, the increase in the spread between LIBOR and OIS**[2]** rates was used as a thermometer in judging systemic health. In that sense, Libor fixing may well have prevented further bailouts.

Nowadays we see proposals for "cleaning" Libor by changing the way it is calculated from a reported rate to an observable, market-based rate, derived from real transactions. On Sep. 25 BBA signaled that it would surrender oversight of Libor to regulators and proposals were made for the calculation of transaction-based rates. However, there are problems with this solution as well: the resulting Libor may become more volatile and thus increase risk premia once more**[3]** (As if the financial system were in need of an additional layer of risk.)

And there are more issues: Libor averages interest rates paid for unsecured debt – a sector that has virtually dried up in the interbank lending market – therefore losing further of its relevance. In addition, dominance by a small group of banks in setting Libor may fail to reflect the systemic borrowing costs and risks because borrowing costs can diverge dramatically in a financial crisis.

Recommendations have been made for the TARP**[4]** to stop using Libor in its transactions. Furthermore, a flood of law suits is in the offing. To say the least, Libor is losing friends.

But are there better, more reliable benchmarks around? Some investors use T-bills, repo, or commercial rates. However, the risks embedded in these benchmarks are non-constant, not easily predicted, and sometimes hidden. The fact is, any change in the calculation of Libor or its replacement would likely be disruptive for borrowers, lenders and traders everywhere.

In future, we may opt for avoiding basing contracts on Libor ourselves… or not, depending on the alternatives. There may not be a better benchmark when the time comes.

Efficiency in pricing is a goner, but when has efficiency been other than a myth? One positive takeout is that once a problem has been pinned down, there are hopes for solving it.

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[1] BIS Quarterly Review, March 2008, pgs. 47-72. In this issue the possibility of LIBOR fixing is put forward with clarity. Of course, one would have to read past page 15…

[2] Overnight index swaps, the most liquid interest rate instrument.

[3] More volatile payoffs, leading to riskier hedging.

[4] Troubled Asset Relief Program