Reader reaction: your views on the news

Is Libor and unreliable index?

Chris Cruden, Insch Capital

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 was made possible by basing Libor on non-binding quotes rather than on actual transactions.

On September 25 BBA signalled 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 premium once more.

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. 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 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 the fact is, any change in the calculation of Libor or its replacement would likely be disruptive for borrowers, lenders and traders everywhere.

Rohan Douglas, Quantifi

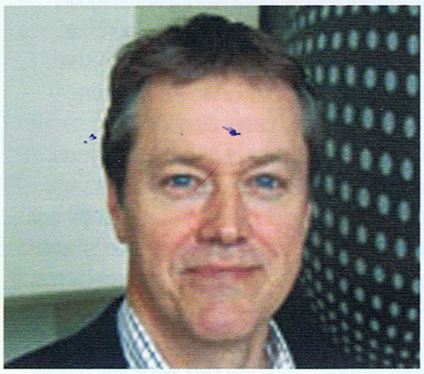
Reference indices like Libor play a very useful role for end users of interest rate products. Consumers need an independent, unbiased reference to structure interest rate trades based on rates that are shorter than the maturity of the trade. These trades exist because they more closely match the risks of the consumer.

The need for indices like Libor is clear. However, Libor is broken and fails the basic tests for a good reference index. It should be noted that is broken is not impossible to correct and both regulators and the market have little choice other than to incrementally improve how Libor is set given the entrenched nature of the index in the market as well as the large body of existing trades.

Libor will continue and be more transparent. Hopefully lessons have been learned by both the regulators as well as the industry to more proactively address the causes of Libor's failure.

> Hopefully lessons have been learned by both the regulators as well as the industry to more proactively address the causes of Libor's failure

Robin Belec, In Touch Capital Markets



Since the amount traded in Libor has reduced to almost nothing, the question on what level Libor should be fixing becomes a big can of worms. Fixing is therefore whatever the bank says it is.

With regards to the accuracy of Libor, at this time it's more of an estimated guess and the more this crisis continues the less trading takes place in the interbank market.

Is it being manipulated? I can't say that, I assume that people are making that decision on the back of the information that they have, the only problem is that as we get closer to zero that information becomes less and less valuable because there's fewer and fewer trades taking place.

Also its important to remember that with Libor there seems to be a herd mentality, the idea is that you want to be part of the herd, if you're too low or too high relative to the others then questions may be asked.

So therefore the mentality is such that as the quoting drifts lower and lower the tendency is to follow the herd, not because you may believe that that is what your funding costs may be, but because it would be a little be awkward to admit that you're not seeing the same type of reduction in rates to everybody else. No one wants to be left behind.

Quote of the month...

"The fact that market participants are fleeing the Commission's swap regulations is proof that the Commission has not developed clear and cost-effective rules." CFTC Commissioner Scott O'Malia