WILMERHALE

The likely replacement for Libor may be just as prone to abuse

SEPTEMBER 11, 2017

N*OTE: This article originally appeared on City.A.M. on September 7, 2017.*

Following the investigations into alleged manipulation of the London Interbank Offered Rate (Libor), in July the head of the Financial Conduct Authority (FCA), Andrew Bailey, announced plans to abandon this “unsustainable” benchmark, and transition to an alternative rate.

The plan is clear, but will this transition assist the FCA in its efforts to tackle benchmark manipulation?

Libor was developed in 1984 in response to calls for a universal rate for new financial instruments. It became widely used as a reference rate across a variety of financial contracts.

The methodology for calculating Libor has developed over time, but key elements have remained consistent.

At 11am each day, a panel of banks submit rates at which they, in their judgment, consider they could borrow funds in the interbank market. The top and bottom 25 per cent of rates are disregarded, and the average from the remaining banks forms the published rate.

Investigations beginning in 2012 led to allegations that some banks had manipulated their Libor submissions in order to move the published rate, and thereby generate profit.

In light of these allegations, both the FCA and panel banks have devoted considerable expense and resource to strengthening systems and controls around Libor.

Notwithstanding these efforts, the FCA now considers that it is “not only unsustainable, but also undesirable” to continue using Libor.

There are several reasons for this, but a key concern is the element of subjectivity and judgment inherent in the Libor definition, which, according to Bailey, leads to a “greater vulnerability to manipulation”.

However, with hundreds of trillions of dollars' worth of financial contracts pegged to Libor, the rate cannot simply be abandoned overnight. A suitably low-risk alternative must be found.

The most likely candidate for the sterling benchmark is the Sterling Over Night Index Average (Sonia) – although other jurisdictions are looking at different ways of producing a benchmark.

Unlike Libor, Sonia is calculated on a quasi-automatic basis, with no subjective judgment involved.

Given its controversial history, the FCA's efforts to move on from Libor are understandable. However, in terms of preventing future manipulation, transitioning to a different benchmark may not be quite the panacea the FCA would have us believe.

For all its flaws, the subjective nature of the Libor-setting process allows submitters to take a holistic view of the market in deciding on an appropriate rate to set.

In doing so, a submitter may consider that a movement in the market can be written off as unsubstantiated hype at best, or at worst, a more sinister attempt to manipulate or spoof the underlying market.

In transitioning to a rate automatically generated from transaction data, such as Sonia, the FCA removes the ability to differentiate between legitimate and questionable market behaviour.

Unexpected movements in the underlying market could automatically be reflected in the resulting rate without checks or balances – a system which on paper seems inherently vulnerable.

Bailey himself has said that Sonia does not "involve expert judgment". In the fog of concern about allowing any subjectivity into the rate-setting process, the FCA has failed to acknowledge the benefits that this "expert judgment" can bring.

Of course, it is far easier to criticise the FCA's proposed solution than it is to suggest a perfect alternative.

By replacing Libor with Sonia, the FCA would certainly be making it difficult to recreate the specific misconduct demonstrated in the Libor investigations.

The question is whether, in the process, the door is left open for manipulation of a new and unexpected kind.