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Statement of the Shadow Financial Regulatory Committee on

LIBOR Reform

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The recent settlement by the U.K's Barclays bank over its manipulation of its LIBOR (London Inter-Bank Offered Rate) submissions to the British Bankers Association (BBA) reflects a problem that has festered for several years. The current problem emerged most recently in 2008, but has yet to be addressed adequately. The LIBOR index, as currently constructed, is clearly flawed. It is not a transaction rate and is vulnerable to incentive conflicts that should have been addressed long ago by regulators and the British Bankers Association that sponsors the index.

Questions about LIBOR manipulations are of two types. One relates to allegations that groups of derivatives traders at Barclays and several large international banks attempted to influence LIBOR submissions so as to either increase profits or reduce losses on their derivatives exposures. The second involved allegations that Barclays, and many other banks, submitted intentionally low estimates of their borrowing costs during the financial crisis so as to suggest that they would be perceived in the market as less risky than they actually were.

LIBOR rates submitted by participants in the British Bankers Association's LIBOR indices do not reflect actual transactions. Indeed, according to the definition contained on the BBA's website, LIBOR is defined as the answer to the following question:

"At what rate could you borrow funds, were you to do so by asking for and then accepting inter-bank offers in a reasonable market size just prior to 11 am (London time)?"

For such a definition to lead to a credible index, submitting institutions must submit honestly their best estimates. However, as the recent revelations imply, submitting institutions may be inherently conflicted and a trade group like the BBA is not necessarily in a strong position to either police or correct the behavior of its members.

Both banking regulators and the BBA bear a heavy responsibility for the current problems given that evidence on questionable behavior in the submission process has existed since the early 2000s. The regulators in the UK, US and elsewhere are clearly at fault for not acting more promptly, especially since there is evidence that misconduct was widespread and involved bank staffs in New York, London, and Tokyo, among other cities. To be sure, investigations have been finally initiated in at least seven countries and involve more than ten regulatory bodies including the Department of Justice, Securities and Exchange Commission, and Commodities Futures Trading Commission in the US.

The Shadow Financial Regulatory Committee believes that the LIBOR index should be redesigned and done so promptly. The restructured index should have two key features. It should be market based and reflect actual transactions that can be verified. These supervisors should require that institutions subject to their jurisdiction promptly to reconstitute or replace the current LIBOR rate with market based rates together with pre-defined protocols for interpolating rates across the term structure that will apply in the event of gaps in rate submissions on different maturities or market disruptions. Furthermore, any attempts to manipulate the rate should be subject to severe criminal penalties.

It has been suggested that a government regulatory agency should become involved in the construction and maintenance of a redesigned index and Federal Reserve Chairman Ben Bernanke has recently discussed several alternatives in Congressional testimony. The Committee believes that index design should be the banking industry’s responsibility since bankers are in the best position to construct the index that best fits the needs of the contracts they are offering. The index (or indices) should be subject to approval and oversight by the responsible regulatory agencies. All institutions that participate in the LIBOR survey are subject to extensive regulation by their bank supervisors and should be required to submit reliable rates. Finally, banking supervisors should work actively with both market regulators, such as the SEC and CFTC, and criminal authorities to provide appropriate penalties and redress where there is evidence of manipulation.