The Death of LIBOR?

July 2012

Richard Nadeau, Esq.

Robert Diamond's resignation today as CEO of Barclays PLC is the direct result of the bank's deliberate submission of artificially low reports of its borrowing costs from 2005 to 2009. These reports were used by the British Bankers' Association in compiling data from major banks and using that data in determining the London Interbank Offered Rate ("LIBOR"). At least a dozen other banks, including Citigroup, Deutsche Bank, HSBC and UBS, are being investigated to determine if they likewise submitted false reports of their borrowing costs to the British Bankers' Association.

One important take-away from the current controversy is that LIBOR is likely to cease being relied upon by banks in setting interest rates on commercial loans and other financial contracts. Banks are now looking for the most credible replacement for LIBOR available in the market today.

Some large international banks are testing the use of rates linked to the market for repurchase agreements, or "repos." Such rates avoid the main flaw inherent in LIBOR, which is that it is set based on what banks report as their estimated borrowing costs for various lengths of time rather than on the banks' actual borrowing costs. Rates mentioned as successors to LIBOR include the General Collateral Finance Repurchase Agreements (GCF Repo) Index, the Fed Funds Effective rate, and T bill rates; at this point the leader in the clubhouse appears to be the GCF Repo index.

The GCF Repo Index is an attractive potential successor to LIBOR. Depository Trust & Clearing Corp., the company that clears and settles financial contracts worldwide, sets the GCF Repo Index. The major advantage of the GCF Repo Index is that it is based on actual rates paid for repurchase agreements, which are a crucial source of short-term funding for many banks. Accordingly, the GCF Repo Index is a better, more accurate indicator of interest rates than LIBOR has turned out to be.

Some bankers argue that the GCF Repo Index is not a suitable substitute for LIBOR because most repos involve collateral of some sort, and thus are riskier than loans tied to LIBOR. Although true, the solution may be simply to increase the premium over the Index in order to account for the added risk.

Nonetheless, regardless of which index becomes commonly used in the international finance markets, it seems clear that LIBOR as it is now calculated is too prone to manipulation to serve its purpose for much longer.