Market Concerns Regarding LIBOR

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Elevated LIBOR-OIS Spreads Since Aug 2007

Heightened counterparty credit risk and liquidity risk since Aug 2007:
- LIBOR-OIS spreads widened across maturities (dollar, sterling, and euro)
- Extensive credit tiering and name-specific lending
Potential USD LIBOR Misreporting

Allegations of misreporting, designed to avoid stigma, picked up in mid-April:
- Comparisons to Eurodollar deposit rates, FX basis swaps, CDS spreads
- Broker claims that panel banks were bidding above LIBOR quotes

These claims are difficult to evaluate:
- Credit tiering, intraday variation, “reasonable market size”, little trading activity
- However, large re-pricing in 3-month LIBOR following WSJ article on April 16
Suggestions to Enhance LIBOR’s Credibility

Market participants point to several problematic features of LIBOR:
• Quoted rates are self-referencing and published
• US sources of liquidity are not in the market at 11am GMT
• USD LIBOR panel is heavily orientated towards European institutions
• Ambiguity in quote size and limited trading activity leads to subjectivity
• Insufficient governance and policing of quotes by the BBA

A number of potential changes have been suggested:
• Make quotes anonymous, or change the definition of the quoted rate
• Changing the time of the fixing, or add a second fixing during the NY session
• Increase the size of the panel and/or include more US banks
• Specify transaction size and/or reduce the number of maturities quoted
• Agree and publish best-practices, and enhance governance of the process
The BBA’s and Financial Market’s Reaction

The BBA announced results of its annual review on May 30:
• No changes made to the composition of any LIBOR panels
• Recent developments in LIBOR discussed at the meeting
• Details of an enhanced policing mechanism to be provided “in due course”

Broker ICAP proposed New York Funding Rate (NYFR) on May 2:
• NYFR expected to “provide more useful adjunct to LIBOR” rather than “to replace the more transparent, established LIBOR”
• No additional news regarding NYFR since May 14 when ICAP announced that is has no “concrete timetable” for its release

Market impact on trading and hedging activity:
• Limiting exposure to LIBOR – fed funds futures vs. Eurodollar futures
• Complications in pricing and netting swaps contracts
• Possible increase in indexing to alternatives going forward – e.g., OIS
Appendix
Appendix: Overview of BBA LIBOR

LIBOR is a survey-based measure of representative interbank deposit rates in the London market at 11am GMT:

- Banks report rate at which “could borrow funds, were (they) to do so by asking for and accepting inter-bank offers in reasonable market size just prior to 11am.”

- Quotes in 15 maturities, from overnight to 1-year, and across 10 currencies

- LIBOR "fix" is the interquartile mean in each tenor and currency

- All individual quotes – names and rates – are published, even those not within the middle 50 percent

- Membership of each LIBOR panel is reviewed annually by a group of 13 active market practitioners – the “FX & MM Committee”
Appendix: Why LIBOR Matters

Gauge conditions in wholesale unsecured bank funding markets:
- Spread to overnight index swaps (which measure policy expectations)

Referenced by a broad spectrum and enormous volume of contracts:
- Interest rate swaps/futures, consumer mortgages, corporate loans, etc.
- E.g., $100 trillion (notional) interest rate swaps reference USD LIBOR

Used to price many assets, even if not contractually linked
Appendix: USD LIBOR Panel Members

- **US**: Bank of America, Citibank, JP Morgan

- **Japanese**: Bank of Tokyo – Mitsubishi UFJ, Norinchukin

- **European**: Barclays, Credit Suisse, Deutsche Bank, HBOS, HSBC, Lloyds, Rabobank, RBS, UBS, West LB

- **Canadian**: RBC
Appendix: ICAP’s NYFR

According to ICAP, NYFR will be constructed in the following manner:

- Respondents will be asked to estimate the rate at which a representative $A_1/P_1$ bank would be likely to obtain unsecured funds, rather than the rates at which they themselves could borrow (note: not just interbank)

- Rates will be collected at 9:30am ET, for the 1-month and 3-month tenors; rates will be published around 10am ET

- The number of contributors will vary from day to day, and will be at least 24 and perhaps as high as 40

- NYFR will be calculated as the trimmed mean of all responses, with the 6 top and bottom responses dropped

- Individual rates and names of individual contributors will not be published