TREASURY, RISK AND FINANCE PROFESSIONALS
ACT

The Association of Corporate Treasurers

Comments in response to
The Wheatley Review of LIBOR: initial discussion paper
The Wheatley Review, HM treasury, August 2012

30 August 2012

The Association of Corporate Treasurers (ACT)

The ACT is a professional body for those working in corporate treasury, risk and corporate finance. Further information is provided at the back of these comments and on our website www.treasurers.org.

Contact details are also at the back of these comments.

We have canvassed the opinion of our members through our monthly e-newsletter to members and others, *The Treasurer* magazine, topic-specific working groups and our Policy and Technical Committee.

1 General

The ACT welcomes the opportunity to comment on the Initial Discussion Paper (IDP).

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We would be pleased to discuss any matter the subject of the Wheatley Review with the review team if that would be helpful.

2 General

2.1 The ACT regards the availability of reference rates such as BBA Libor and Euribor as very important and functioning as significant public goods.

2.2 For users the focus is on utility: reliable and representative rates available in a timely manner each business day. For non-financial corporates' main uses the rates need to have a reliable relationship with sovereign rates and the relative credit standing of representative high-quality banks and also to reflect market liquidity issues appropriately.

2.3 Following the 2008 British Bankers Association's review of BBA Libor governance, in 2009 the ACT and other representatives of users of BBA Libor agreed to become members of the Foreign Exchange and Money Market Committee that supervised the BBA Libor process for the BBA.

2.4 The views we, the ACT express here are consistent with those we conveyed to the review of BBA Libor started by the BBA in March 2012[1].

2.5 We, like others, have been very concerned at reported attempted manipulation of inputs to the BBA Libor calculation process. We are astonished that there was doubt about the legal position of attempted manipulation of market reference rates. We think that the mere fact of the existence of that doubt has cast a shadow over the UK as a place to do business. We have also been disappointed at the lack of good process within Barclays revealed by the authorities' reports into the case in the period covered by their investigation and suspected in other institutions the subject of the authorities' enquiries.

We have noted that the US CFTC's published report on Barclays included what it considers an appropriate protocol for Barclays to follow internally in arriving at its estimates. We take comfort from the statements from Lord Turner, FSA Chairman[2] that:

> [Libor] "has been pretty robust since 2009 and 2010". "People are trying to do it as honestly as they can." The regulator has advised banks on process for arriving at rates. Banks have had to formally attest to the quality of their Libor submission process to the regulator. "I would be very amazed if at the moment there is anything remotely like the problems of the past in terms of deliberate manipulation."

We hope and expect that the Wheatley Review will be an important step in maintaining such good order on which we all rely.

Note: We have used LIBOR when quoting the IDP or referring to it but Libor when referring to BBA Libor.

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1 http://www.bbalibor.com/news-releases/libor-update
2 Reuters, http://tiny.cc/eb6zhw, and oral evidence to the House of Commons Treasury Select Committee

3 Consultation questions

3.1 For convenience of reference, we have numbered serially the questions within each chapter.

3.2 Chapter 2: Issues and failings with LIBOR

Q.2.1 Do you agree with our analysis of the issues and failings of LIBOR?

A.2.1.1 Broadly, we agree but we would like to make some observations on judgement and the standing of the banks taken as the sample in a panel, based on the historical experience of our members. We also give more of a corporate borrower's view of the development of the rates.

A.2.1.2 Some of our members were involved in using predecessors to LIBOR from the arrival in Europe of syndicated loans to large corporates in the mid 1970s. This came from the increased activity of foreign banks, starting with US banks. It was the beginning here of bank lending based on market rates rather than base rate.

The rates were, initially, polled rates, surveying a panel of banks – the panel varied from loan to loan. The rate polled was that at which the bank believed it could borrow for the relevant period. Normally, a selection of the largest/highest standing banks in the syndicate constituted the panel for the particular loan[3].

There was no governance mechanism surrounding the rate contributions. However, large companies had regular dialogue with the discount houses at the time as part of their use of the sterling acceptance market[4]. They would also regularly receive (directly or through brokers) quotations for short-term loans from banks to lend to them as bare loans without formal standing loan agreements. This gave companies good knowledge of market rates and very competitive alternatives if they did not like polled average indicated by the Agent bank for a proposed draw-down. Over time, bank margins over LIBOR came down for investment grade borrowers to perhaps one fifth (or even less) of what they were in the mid 1970s. The treasurer's machismo apart, non-financial companies were not really bothered by the last basis point as the impact on the firm's weighted cost of capital would be very small. Margins started to go up again from 2008,of course.

It is important to note that from early on the reference rate was related to:

[3] A similar mechanism is retained in most loans based on Loan Market Association draft documents as a standby rate setting mechanism. It would today be an unacceptable mechanism for LIBOR in view of the lack of governance and controls around the rate setting process and, given the numbers of loans involved there would be practical difficulties.

[4] Some large companies, having had the bank accept the bill for the acceptance fee, required the bank to hold the bill to the company's order for eventual delivery at a time and to a discount house of the company's choice, rather than allowing the bank itself to discount the bill it had accepted. Large companies would also deposit funds with discount houses against the security of a "parcel" of bills.

- panel banks' estimate ("judgement") of their own likely borrowing costs, the estimate made in light of the transactions they had been entering into and their knowledge of the market; and
- the selected panel banks were the syndicate members of the highest credit standing – what we would probably today recognise as "too big to fail".

A.2.1.3 The growth of the number of syndicated loans, the desire to base even bilateral loans (loans from a single bank) on market rates and to have standard reference rates for interest rate derivatives (starting with forward rate agreements) led eventually to the predecessors of BBA Libor and to BBA Libor itself.

Development of foreign currency (and indeed of multi-currency) facilities led to the introduction of similar rates for other currencies.

Standardisation eventually provided the opportunity to introduce some element of governance provisions into the rate setting arrangements. However, the idea of a judgemental input from a fairly small set of banks selected to be large banks of high credit standing was preserved in Libor.

A.2.1.4 The decline in the discount market in the decade after 1986 and then the desire of banks to reduce their balance sheets following the events after 2008 have made the governance aspects of rate contributions much more important as borrowers' comparators/alternatives for this type of financing became fewer. Any abandonment of a Libor style reference rate and a reversion to panel banks specified deal by deal would be wholly unwelcome to wholesale borrowers. The lack of independence, governance and regulation on that old style of rate setting was a significant weakness. In the 1970s when such panels were used, the arrival of aggressive foreign banks meant there was market discipline on bank behaviour towards large corporates. Today, with banks reducing their balance sheets and some foreign banks withdrawing back to their home territory, market discipline would be much less. A medium sized or small company would be even less able to challenge rates a bank was contributing.

A.2.1.5 It is noteworthy that, with the rise of the Euro, it was chosen that Euribor settings would use a larger number of contributing banks such as to include banks that would not meet the Libor criteria – but, to compensate, asked them to contribute rates relative to their view of a theoretical superior-standing bank. This introduced a further layer of judgement and remoteness from its own transactions in each bank's input. It makes internal (or external) review of the input rates much more theoretical and less concrete.

A.2.1.6 At the end of 2.24 of the IDP, reference is made to the relatively small panel sizes of Libor panels. It is important that the BBA Libor rates are intended to be representative of the top banks in the particular market – not of banks as whole. Smaller banks and those with lower perceived credit standing are likely to expect to pay higher rates. So the panel size will always be relatively limited. This is more important with the perceived growth in deviation in credit standings among banks.

As noted above, Euribor gets round this problem for their larger and more inclusive panels by asking the contributors to guess what a high-standing bank might expect to pay.

3.3 Chapter 3: Strengthening LIBOR

Q.3.1 Can LIBOR be strengthened is such a way that it can remain a credible benchmark?

A.3.1.1 Generally, yes. We consider that a rate informed by actual transactions by an institution and its knowledge of other transactions and market conditions can be valid. Given the lack of inter-bank transactions a widening of the basis to take in the costs of a bank's unsecured wholesale market funding would be helpful, rather than being limited to inter-bank funding. We think that two basic criteria must be met:

A.3.1.2 First, we believe that the kind of protocols internal to the contributing bank such as set out by the CFTC and referred to by Lord Turner, including the involvement of the bank's compliance function, record keeping, etc. is essential and practical. An appropriate regulatory and supervisory structure is needed to give external confidence.

A.3.1.3 Second, and a much bigger obstacle we feel, is the willingness of banks – now and in the future and not just the current banks but others too – to make rate submissions where good faith judgements are necessary in arriving at the rate to be contributed. The legal and reputational risks arising from bad faith and compliance failure are demonstrably very large. "Look-back" risk when evaluating a judgement, even one made reasonably, after proper process, is always a concern for anyone involved.
This makes confidence in the internal processes and any external review important.
It also means that a very clear and robust legal framework is required to give banks the confidence that they are not needlessly running high risks not only under normal criminal law but under financial regulations and competition law. In the absence of that – in all affected jurisdictions – we would fear early collapse of the reference rate creation mechanisms. Indeed, we believe that, to avoid such collapse, contribution to reference rate compilation should be a requirement on relevant banks asked so to contribute, provided that an appropriate legal framework has been created.

A.3.1.4 We note that the signalling effect of publishing promptly, by institution, rate submissions about an individual bank's view of its own borrowing cost can give rise to de-stabilising credit-signalling. We believe that that can be dealt with in several ways. Delaying the public disclosure of individual submitted rates would help here and, usefully, also make collusion between banks to influence the final rate improperly more difficult for those colluding to check on their partners-in-crime. Such delay should not apply to disclosures to the authorities. After the delay (two months or a quarter, perhaps) rates contributed may be disclosed, by the bank or anonymously.

Q.3.2 Could a hybrid methodology for calculating LIBOR work effectively?

Note: The word "hybrid" is only used in the IDP in this question. We have interpreted it to refer to LIBOR contributions being determined not only by actual transactions of the institution but in part estimates informed by such transactions and other (legitimate) information as in 3.8 of the IDP.

A.3.2.1 We think that the current system is roughly hybrid. That is to say we understand that a bank informs its estimate from transactions it has undertaken (maybe in the run up to rate submission but possibly earlier in the day or even in the previous day) and those it has considered and information it has gleaned from market conversations, brokers, transactions in other time zones, etc. Thus it can interpolate between maturity points where it has better information for points where it has worse. The balance likely varies between days.

A.3.3.2 Given the potential effects of a changing mix from day to day or maturity to maturity of different types of transaction that may be taken into account can introduce novel and incremental volatility, we believe that a (good faith) judgement based rate is greatly to be preferred to one that requires actual transactions (that may be in different time-slots) always to be used where available.

This is conditional on contributors making appropriate, reviewable, notes on how their estimates were arrived at and keeping records of the information that informed those estimates and on appropriate compliance/supervision.

Although use of expert judgement may appear to make submissions vulnerable to manipulation we agree with the point in IDP paragraph 3.6 that transaction data is not immune from manipulation – particularly at times of low transaction volume. Indeed challenging actual data could be more difficult than challenging judgements such that a system based mechanically only on actual trades would in our view be inferior.

When volumes are low the most recent deals could have been executed several hours before the 11.00am rate fixing and be out of date. Alternatively transactions could be dealt at unusually high or unusually low rates due to a special relationship with the counterparty and not be truly representative of the going market rate.

Adjusting for this is part of the judgement required of the contributor. If relevant rates are widened to include broader money market transactions such as with non-bank wholesale depositors, this effect would be greater. We would regard volatility introduced by failing to adjust for non-representativeness of transaction rates as undesirable.

A.3.3.3 Paragraph 3.6 of the IDP hints that the time of setting of LIBOR could be changed or it might become an average of rates over two calendar days. These changes, while possible, would change the nature of the rate. At present trends during a morning are picked up, rather than the final rate being a lagged indicator of average rates over a longer period. And, at least for sterling transactions, LIBOR is used for same day value transactions and this would be more difficult with later rate availability. In both cases these comments are from the point of view of a party using LIBOR for loan pricing (or hedging such costs) which happens at draw-downs and roll-overs. The perceived difficulties here may be less apparent to a dealer in the derivatives markets where either a measure

of rate movements in the economy is needed or market anomalies may drive trading and (to exaggerate) any daily available rate would be satisfactory.

Q.3.3 Is an alternative governance body for LIBOR required in the short term?

A.3.3.1 We recognise weaknesses in the current governance arrangements. In particular we regret the UK authorities' reluctance routinely (or at all) to attend the FX&MM Committee or take a greater part as recent disclosure of e-mails by the Bank of England has revealed that the BBA suggested to them in the review of 2008.

A.3.3.2 In the longer run (and as soon as possible) we would prefer an appropriate authority (whether the FSA or Bank of England) to be responsible for the LIBOR setting process, with a suitably constituted advisory board involving staff from the authorities and contributors and users carrying out most of the functions of the FX&MM Committee. The advisory board could "own" the kind of LIBOR code discussed in the IDP. We do not think a trade body such as the BBA can be in a position potentially to wield appropriate sanctions where the stakes are so high for individual members of the trade body.

A.3.3.3 In the short term, if responsibility for LIBOR remains with the BBA (through one vehicle or another), at the very least, the FSA and the Bank of England should attend FX&MM Committee meetings as observers formally reporting back within the respective authority and actually conveying views back to the Committee as appropriate.

A.3.3.4 There seems to be no reason for the existing FX&MM Committee not to adopt forthwith the kind of Libor Code discussed in the IDP.

Q.3.4 Should the setting of and/or the submission to LIBOR be regulated activities?

A.3.4.1 Broadly, yes. And we would extend that idea to all widely used reference rates.

Q.3.5 Should the regulator be provided with specific powers of criminal investigation and prosecution in relation to attempted manipulation and manipulation of LIBOR?

A.3.5.1 Someone needs such powers. We leave it to legal experts to suggest the best location of such powers. From a naive point of view, however, the regulator should have such powers and reserve powers should be retained by the normal criminal authorities.

Q.3.6 What role should authorities play in reforming the mechanism and governance of LIBOR?

A.3.6.1 We were disappointed that the institutional arrangements discussed in 3.37 of the IDP refer only to a representative body or a commercial body as taking responsibility for governance and oversight. We do not believe that either would be seen as appropriately (or even remotely) competent

in any system reliant on judgement rather than on collection and processing of mere transaction data.
As commented above the “institution” with responsibility for governance and oversight would be the FSA or the Bank of England. We doubt the credibility of any other proposal.

A.3.6.2 It may be noted that the only sanction available to the current FX&MM Committee is to ask a bank to stop contributing rates to a panel. Given that that would stop for that bank the future reputational and legal etc. risks from contributing rates, that is no sanction but rather a bonus. And, it is unlikely that any new bank would volunteer to replace the leaver on a panel: so the only sanction available leads eventually to the demise of Libor.

Q.3.7 Which types of financial contract, if any, would be particularly affected by the risks of a transition from LIBOR?

A.3.7.1 Of course the effects would vary according to what the transition was to. However, we see a divide between uses of Libor for loan (and related hedging) purposes and for more general interest rate hedging or speculation.

A.3.7.2 For loan-related activity a new rate would show new characteristics that would transfer value between parties for existing transactions – commonly with an initial life of 5 years, perhaps longer. The swapping of long-term bonds to floating rates would, with longer maturities, potentially transfer more value. Some companies will be concerned that linkages enabling hedge accounting may be broken if loan and derivative relationships are changed. A small change in accounting treatment could have a disproportionate impact on companies that are operating close to the covenant limits required by their lenders.

A.3.7.3 For derivatives themselves, the mechanics for change under ISDA arrangements would function eventually to provide transition.

Q.3.8 Could the number of maturities and currencies currently covered by the LIBOR benchmark be reduced? (This question is in the Chapter at Box 3.A but not the listing of questions in Appendix C.)

A.3.8.1 Broadly, and being quite tough about it, yes from our point of view on maturities. The majority of corporate users use the shorter-term rates plus 3 and 6 months (“the reduced set”). Some users, for example in the travel industry, use all maturities. Some companies also use 12 months for internal purposes. But inconvenience would be limited if rate issue of the reduced set of maturities continued with confidence.

A.3.8.2 On currencies, use of BBA Libor for some currencies is small and, if the price of preserving LIBOR at all is to drop some of the lowest-volume currencies, it would be a price worth paying.

3.4 Chapter 4: Alternatives to LIBOR

Q.4.1 Are there credible alternative benchmarks that could replace LIBOR’s role in the financial markets?

A.4.1.1 We do not see currently available rates that would carry out the loan related aspects of Libor use in this time zone or at all. In particular the unsecured bank credit risk nature of Libor (and similar rates) is important to preserve, particularly given the wider spreads of bank from sovereign risk and the greater tiering of rates between higher credit standing banks such as contribute to Libor and smaller or weaker banks.

A.4.1.2 If banks change their perceived cost-base for incremental corporate lending as being from, say repo transactions, they may want to start to propose to borrowers that a margin over repo rate (rather than LIBOR) may be used as a reference rate for a loan. The BBA's sterling repo rate and the EBA's Eurepo come to mind for sterling and for the Euro. These latter rates are polled rates similar to BBA Libor and Euribor.

A.4.1.3 There are some other rates or indexes that may be suitable for hedging changes in general interest rate changes in the economy or for speculative purposes.

Q.4.2 Should an alternative benchmark fully replace LIBOR, or should it substitute for LIBOR in particular circumstances?

A.4.2.1 If LIBOR can be "improved" within the definitions commonly used in contracts this would be the best outcome of the current concerns. If a new rate not compatible with the LIBOR commonly used in contracts were introduced alongside the improved LIBOR they could surely coexist. Perhaps the new rate may be preferred for speculative and general economy rate hedging transactions and the improved rate be preferred for loan related transactions. Perhaps, over enough time, one rate would fade away. This should not be pre-determined.

A.4.2.2 If only a new rate not compatible with current contractual definitions of LIBOR were available (with other existing or new rates, of course) and "LIBOR" ceased to be published this would be disruptive, of course. The new LIBOR basis could lead to a significant transfer of value between the parties or would necessitate a renegotiation of all relevant contacts, so a transition period and process would be required to reduce disruption.

Q.4.3 Should particular benchmarks be mandated for specific activities?

A.4.3.1 We do not think that regulators or authorities should generally seek to mandate or to limit the use of particular reference rates. Needs of users are various and willingness of counterparties vary according to a number of factors. Authorities should allow the market to work in these matters.

Q.4.4 Over what time period could an alternative to LIBOR be introduced?

A.4.4.1 Broadly, if an improved Libor, fitting within the current contractual definitions and the current definition of LIBOR itself were introduced only a limited transition period would be needed before "old LIBOR" might be dropped – perhaps 15 months to allow two year ends given that there can be temporary distortions to the markets at year ends when financial institutions and companies manage their liquidity more tightly. If a

replacement for LIBOR altogether (e.g. a secured rate or a rate derived from sovereign rates or CDS prices and so on) a longer transition would be needed. Companies plan their interest rate risk management over long periods so due consideration should be made of any significant accounting or tax implications that would arise from any radical change to LIBOR, In any case we would expect to see a number of new reference rates being experimented with from time to time.

Q.4.5 What role should authorities play in developing and promoting alternatives to LIBOR?

A.4.5.1 We believe that governance approval and a supervisory role for all reference rates should apply. Where judgement is involved rather than data collection and calculation from the collected data, the authorities' role should be more because the opportunity for manipulation is greater.

3.5 Chapter 5: Potential implications on other benchmarks

Q.5.1 Are there other important markets or benchmarks that could face similar issues to those identified relating to LIBOR?

A.5.1.1 We are not aware of more to add. However, all polled rates asking banks to estimate a rate may face many similar issues. Polled rates include repo indexes such as BBA Repo, Eurepo, and swap indexes such as the EONIA Swap index. We hope that in due course a uniform approach internationally to the governance and competitions law issues from rates requiring estimates to be made will help reinforce the credibility of reference rates.

Q.5.2 Should there be an overarching framework for key international reference rates?

A.5.2.1 International support is necessary if banks are going to be willing in future to supply rates involving judgement.

A.5.2.2 Particularly in smaller market centres, use of special reference rates can lead to poor levels of competition and opportunities for rent by the financial services sector from the non-financial – whether extracted in inefficiencies, higher profitability or staff remuneration levels. So an internationally accepted set of reference rates than can be traded widely and in large centres is a public good to be cherished.

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The Association of Corporate Treasurers

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