THE DEVIL IS IN THE DETAIL

Martin Wheatley's review of Libor shouldn't result in $300 trillion of contracts being torn up, but treasurers can't afford to ignore the fine print, warns Andrew Sawers

At first glance, it looks as though treasurers are getting what they wanted. The official report on how to fix the London Interbank Offered Rate (Libor) in the wake of the rate-rigging scandal has recognised that chaos would ensue in financial markets if it were to be scrapped or materially redefined. Nobody wanted to think about what would happen if $300 trillion of loans and derivatives contracts were suddenly frustrated by Libor being changed or dumped.

So far, so good. But the Wheatley Review, headed by Financial Services Authority (FSA) managing director Martin Wheatley, really only adds up to a statement of intent. The devil will be in the detail, and we haven't seen that yet.

In September, Wheatley produced a 10-point plan for restoring confidence in Libor, which was accepted by the UK government last month. It included suggestions for the introduction of statutory regulation of the Libor-setting process, bringing it under the FSA (and, post-FSA, the Financial Conduct Authority); institutional and governance recommendations for banks; and proposals for a new authority to take on oversight of Libor from the British Bankers' Association (BBA); as well as some other improvements that can be acted on straightaway. It also urged international coordination between the various global authorities and jurisdictions that are all looking at benchmark-setting arrangements.

The definition of Libor is still to be based on unsecured interbank lending rates. Not surprisingly, in light of the rate-rigging scandal, Wheatley wants Libor to be based, as far as possible, on actual transactions. But Wheatley recognised the need for some element of judgement, not least because at particular times of stress the number of transactions on which to base Libor can be pretty thin on the ground. He suggests, therefore, that transactions in other markets – such as certificates of deposit, commercial paper, overnight index swaps and repos – can be used "to support contributors' assessment of the market for interbank funding". Banks are going to have to keep – and reveal – many more records about the data and assumptions they use in making their submissions.

Wheatley also wants a broader range of banks to voluntarily submit rates for Libor – and if they don't volunteer, Wheatley intends to force them. He wants to tackle what he sees as a problem of 'free riders' – banks that use Libor as a reference rate, but don't do anything to contribute to it. Wheatley also argues that a greater number of bank submissions would reduce the scope for manipulation. "Libor," he said in his report launch speech, "is supposed to represent the market as a whole. [It] requires collective responsibility if it is to work effectively."

There are a couple of other notable technical changes. Firstly, instead of publishing individual banks' submissions straightaway – which Wheatley says exacerbated the problem in 2008 when Barclays didn't want to appear to be a credit risk by being at the top end of the range – there should be a delay of at least three months. Instead, a statistical report would be published weekly to give the market at least some guide as to what is underpinning Libor – details awaited.

Secondly, less frequently used currencies and tenors will be phased out. Australian dollar, Canadian dollar, New Zealand dollar, Danish kroner and Swedish kronor will, in all likelihood, go. So, too, will rates for the remaining currencies for four, five, seven, eight, 10 and 11 months. Neither is Wheatley convinced that one-week, two-week, two-month and nine-month rates should be retained. There is a big reduction in the hassle factor now that the number of permutations of currencies and rates will be reducing from 150 to 20, but the real problem has been that these rates are so illiquid there isn't much trade data to support them. Contracts with these currencies or tenors will, indeed, have a problem if they outlive the phase-out period, but Wheatley is hoping for

DAMAGING? OR JUST EMBARRASSING?

Given that the 'L' in Libor stands for London, is the rate-fixing scandal damaging for the City and the UK? Or is it all just a bit embarrassing?

"The 'L' is not the only benchmark that is facing scrutiny, so to that extent it is an issue that goes rather wider than London."

Karen Anderson, partner, financial services regulation, Herbert Smith Freehills

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DAMAGING? OR JUST EMBARRASSING?

"Getting this Wheatley report out so quickly and so thoroughly is a move to try and restore confidence. They want the international community to be comforted that with the sorts of changes that Wheatley recommends Libor will be, and be seen to be, fit for purpose."

Graham Smith, banking partner, Allen & Overy

"an orderly transition to alternative rates and arrangements".

The consensus, however, is that these changes do not add up to anything that will immediately frustrate contracts that use Libor. Well, up to a point. The ACT applauded the review, saying that it should achieve the aim of refining and improving Libor without jeopardising commercial contracts. John Grout, policy and technical director, says: "What Mr Wheatley has recommended could be implemented in such a way as to not disrupt all the outstanding contracts. We can't be sure until we have all the details."

Andrew Roberts, partner, debt capital markets with law firm Herbert Smith Freehills, says: "I would expect that 'high-90s per cent' of transactions won't be a problem." But it is, he says, necessary to check loan and derivatives contracts "to make sure that the Libor definitions are unaffected". The problem is that the way Libor is referred to in contracts is nowhere near as standardised and boilerplate as one might have thought. Contracts that use documentation from the International Swaps and Derivatives Association (ISDA) define sterling Libor as the rate that appears on Reuters page LIBOR01. Loan Market Association documents refer to Libor as "the British Bankers' Association Interest Settlement Rate". But, as Graham Smith, banking partner at law firm Allen & Overy, points out, the loan market "is not a market that's as homogeneous as the swaps market, which predominantly follows ISDA documentation. We've got far more variety in our documents."

"If you have a definition in your documents that talks about Libor, for example, being the rate calculated in accordance with the BBA rules, then that could become a bit of an issue," Roberts says. While often there is a fallback clause that, in essence, allows for the parties to phone some banks for comparable rates, that's not always the case. "Then you will have to see, what will the parties agree as an alternate," Roberts says.

Virgin Media group treasurer Rick Martin is keeping an eye on the debate. Contracts that define Libor by its Reuters page may not be strong enough if, as he colourfully puts it, the means of calculating the numbers on that page have changed significantly: "Like *Star Trek*: It's Libor, Jim, but not as we know it." Wheatley's proposal to expand the pool of banks may be a problem, Martin thinks. "I get where Wheatley is coming from, but I query whether that is going to introduce an overall strengthening or weakening of the banks [on the panel]. More banks could mean weaker banks, so Libor could be higher. If your borrowing cost is higher, you won't be pleased. The reverse will be true if expanding the pool of banks makes the overall credit quality stronger."

There is one intriguing aspect of Wheatley's report. While it might have been perfectly reasonable to say that markets may well decide to move to alternative rates rather than Libor in future contracts, his report positively encourages market players "to consider and evaluate their use of Libor, including a consideration of whether Libor is the most appropriate benchmark for the transactions they undertake."

"Let a thousand flowers bloom," says Grout, poetically. "People will invent new rates or find existing rates that they like for their contracts. Libor was invented for a particular purpose. It's stupid that people who are just trying to hedge increases in rates in the economy as a whole are actually hedging the cost of funding to banks, which might not be what's affecting them at all."

But other rates can behave differently. Because Libor is supposed to represent unsecured lending rates between banks, it spiked very sharply during the financial crisis compared with, say, overnight index swap rates, which don't carry counterparty credit risk in the principal, just the interest. "I'm fairly relaxed if we switch to a different benchmark other than Libor, but I want to understand the pros and the cons before I do so," says Martin. "It's not like I'm pounding the table for the continued use of Libor."

Andrew Sawers is a freelance business and financial journalist

RULE BREAKERS AND RULE MAKERS

- As *The Treasurer* went to press, Barclays was the only bank that had agreed a settlement with regulators over manipulation of Libor, costing it $450m in fines. Other banks have yet to settle with the FSA and the US Commodity Futures Trading Commission (CFTC). Authorities around the world are in the midst of their own investigations. RBS is said to have been trying to agree 'a collective deal', but the authorities are all working to different timescales and agendas, Reuters reported. Although the behaviour of Libor banks is now surely beyond reproach, Barclays appears to have been forced to quit the rate-setting panel for United Arab Emirates dirhams – Emirates Interbank Offered Rate (Eibor).
- The ACT's John Grout says regulatory action must be carefully coordinated. "We have to hope that there are no agreements with major regulators that would stop banks contributing rates to Libor and Euro Interbank Offered Rate (Euribor)." He notes that Wheatley will be co-chairing a task force with CFTC chairman Gary Gensler.
- These regulatory pronouncements strengthen the hand of litigants. Class action suits are already under way (some predate the Barclays announcement), but lawyers are clear that it will still be difficult to prove that manipulation of a rate by a trader generated an actual loss.
- Virgin Media's Rick Martin says: "Sort it out. If you have to, do it on the court house steps – but sort it out."

DAMAGING? OR JUST EMBARRASSING?

"The global community generally wants to see people tackle problems when they exist and the fact we're doing that is respected and recognised."

Martin Wheatley, managing director, Financial Services Authority