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UK, US central bank chiefs urge markets to end reliance on Libor

By Jon Rees

The Bank of England and the Federal Reserve Bank of New York have urged global financial markets to accelerate their move away from scandal-hit Libor as a benchmark interest rate for contracts and move to more reliable alternatives.

Bank Governor Mark Carney said May 24 that global markets remain overly reliant on the London interbank lending rate, known as Libor, as a benchmark for interest rates and that Libor was not up to the task.

"Libor is a prime example of critical, hard, market infrastructure that has not kept up with market developments. Libor is meant to measure the short-term unsecured funding costs of banks. But the reality is that, since the financial crisis, Libor really has become the rate at which banks don't lend to each other," said Carney.

The rate underpins trillions of dollars of contracts but has been at the center of a long-running scandal after banks were found to have manipulated Libor to improve their results.

Banks including Barclays PLC, UBS Group AG, Royal Bank of Scotland Group PLC, Lloyds Banking Group PLC, and Deutsche Bank AG were fined billions of dollars in total from 2012 onwards while former UBS and Citigroup Inc. trader Tom Hayes was sentenced to 11 years in prison in 2015 after being convicted for rigging Libor.

"Aggressive action" needed

Bill Dudley, president of the Federal Reserve Bank of New York, said experience had shown that Libor was fundamentally flawed and "aggressive action" was needed to move to a more durable benchmark.

"The essential problem with Libor is the inherent fragility of its 'inverted pyramid' where the pricing of hundreds of trillions of dollars of financial instruments rests on the expert judgement of relatively few individuals, informed by a very small based of unsecured interbank transactions," he said.

He pointed out that new Libor-based contracts were still being written with an estimated $200 trillion of contracts based on Libor in existence today.

The Financial Conduct Authority will stop requiring banks to submit daily rates which are used to calculate Libor in 2021. Both the UK and U.S. authorities have announced the creation of benchmarks based on overnight lending transaction which are intended to be more reliable than Libor.

However, the authorities are concerned that markets around the world still rely heavily on Libor.

"Libor is overly reliant on expert judgement rather than actual transactions. And global markets remain overly reliant on Libor, a benchmark that may not exist beyond 2021. That reliance is neither desirable nor sustainable," said Carney.

He said banks no longer took sufficient short-term wholesale deposits to act as the basis for a transaction based Libor, so he urged markets to use the sterling overnight index average, or Sonia, which is based on actual transactions by banks and building societies and administered by the Bank of England instead.

In the U.S., Dudley noted, the Secured Overnight Financing Rate, or Sofr, is the preferred alternative to US-dollar Libor and said the underlying market on which the rate is based has a current daily volume of $700 billion.

Transition to Sonia

Carney noted that the Bank reformed Sonia in April to boost the volume of transactions captured to £50 billion a day.

"Market participants in every sector and market that use Libor now need to come together to identify and resolve issues, change business practices, and adopt alternative benchmarks," said Carney.

He said over 90 institutions, including banks, law firms, corporates, asset managers, trade associations and infrastructure firms, are directly involved in helping the transition from Libor to Sonia.

Dudley said it would be a "monumental and complicated effort — one that the industry has never undertaken." Nevertheless, he warned, "delay is not a viable option."

He said that the Chicago Mercantile Exchange Inc. began offering Sofr-based futures contracts earlier in May while Carney said the private sector would develop a wide range of products based on Sonia including floating rate notes and loans.

In the U.K., futures contracts based on the new benchmark are already available from commodity and currency exchanges.

Stuart Williams, president of ICE Futures Europe, the commodities and currency exchange, said one-month Sonia-based futures contracts launched in December last year were trading well, albeit in low volumes. The exchange will launch three month Sonia-based futures contracts on June 1.

"It is not a long time for futures contracts to gain traction particularly when there is an existing contract which provides the kind of liquidity that Libor-based short sterling contracts provide. You cannot make people trade using a particular benchmark, we are not here to force a particular benchmark over another, we are in the business of giving the customer choice … a lot will have to do with the appetite and the ability of the market to move to alternative rates, that will take a long time," he said.