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No catch-all 'Swiss army knife' solution to replace Libor benchmark, says BIS

By Jon Rees

Libor, the interest rate benchmark that underpins trillions of dollars of financial contracts, may be reformed to co-exist alongside single, all-purpose alternatives, said economists at the Bank for International Settlements.

The London interbank offered rate is likely to cease being published in 2021 following a series of scandals in which bankers tried to manipulate the rate. However, about $400 trillion of financial contracts are still underpinned by Libor in one of the major currencies, according to the BIS.

Financial regulators around the world want Libor to be phased out and more accurate, overnight risk-free rates linked to the interest rates that large banks use to borrow and lend from one another to supersede them. The U.K.'s Financial Conduct Authority, for instance, has said it will no longer "persuade or compel" banks to submit the rates required to calculate Libor after 2021, while it is promoting the sterling overnight index average, or Sonia, published by the Bank of England, as an alternative.

Former Citi and UBS trader Tom Hayes was sentenced to 11 years in prison in 2015 for manipulating Libor. Here he is seen arriving at London's Southwark Crown Court during his trial.

Source: Associated Press

'**Surgery on a pumping heart**'

But Libor may never be replaced by a single alternative benchmark, according to BIS economists, who describe the process of switching benchmarks to carrying out surgery on the pumping heart of the financial system.

"A 'Swiss army knife' solution for benchmark rates does not exist. That is, an all-purpose, all-in-one benchmark may be neither feasible nor desirable," said Andreas Schrimpf and Vladyslav Sushko in a paper published as part of the BIS' March quarterly update.

Risk-free rates are less liable to manipulation than Libor, which is set following a survey of a small set of banks that report nonbinding quotes rather than the interest rates used in actual transactions.

It was this process that allowed some bankers to manipulate the system by persuading banks to submit rates to the panel overseeing Libor that suited themselves rather than the actual rates used. A number of bankers were jailed as a result and some banks paid billions of dollars in fines.

However, despite the development of risk-free reference rates, traditional interbank offered rates are still the dominant interest rate benchmarks in many market segments. The paper quoted a 2017 survey conducted by a Libor panel bank which showed that 80% of respondents indicated they would prefer Libor to remain in some form.

"Issuance of securities linked to Libor is still considerably greater than that linked to the new benchmarks," said the economists.

Though risk-free rates are suitable for many financial transactions, banks still lack a benchmark that adequately reflects their marginal funding costs as a substitute for Libor. The move away from Libor is likely to be particularly difficult for cash instruments like business and consumer loans due to their bespoke nature, while there is no body that could help co-ordinate an overarching industry-wide solution.

The amount of business loans, consumer loans, securitized products and bonds referencing U.S. dollar Libor with a maturity date

after 2022 exceeds $2 trillion, according to asset manager BlackRock.

Possible solutions

The authors suggest a move away from Libor could be helped by converting floating-rate cash instruments to fixed-rate contracts while Libor-linked debt instruments could be recalled and replace with those linked to new benchmarks.

In some jurisdictions, such as Japan, authorities have opted to complement risk-free rates with a reformed local interbank offered rate while in the euro area there is a continuing effort to reform the euro interbank offered rate, Euribor, to complement the euro short-term rate, Ester.

Intercontinental Exchange Inc.'s ICE Benchmark Administration, which administers Libor, recently published a paper setting out its plans for an alternative, called the U.S. dollar ICE Bank Yield Index, which it is proposing to introduce in 2020.

"Different benchmarks could emerge that are better fit for individual purposes than the 'Swiss army knife approach' implicit in a single benchmark," the paper's authors concluded.

"It is hence possible either that reformed benchmarks suitable for such purposes will retain market share or that new market solutions will emerge."