LIBOR recommendations

Timothy Geithner to: mervyn.king 06/01/2008 05:00 PM
Sent by: Marlene Williams
Cc: Paul.Tucker
Bcc: Michael Silva

Please see message below which was sent last Tuesday, but you might not have received. Sorry for any inconvenience this delay might have caused.

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Mervyn:

We spoke briefly in Basel about the BBA's LIBOR regime, and you said you would welcome some suggestions.

I have attached a list of recommendations prepared by my staff. We would welcome a chance to discuss these and would be grateful if you would give us some sense of what changes are possible.

With best wishes.

Tim

LIBOR Recommendations_052708.pdf

May 27, 2008

Recommendations for Enhancing the Credibility of LIBOR
FRBNY Markets and Research and Statistics Groups

1. Strengthen governance and establish a credible reporting procedure

To improve the integrity and transparency of the rate-setting process, we recommend the BBA work with LIBOR panel banks to establish and publish best practices for calculating and reporting rates, including procedures designed to prevent accidental or deliberate misreporting. The BBA could require that a reporting bank's internal and external auditors confirm adherence to these best practices and attest to the accuracy of banks' LIBOR rates.

To further enhance perceptions of the BBA as an objective intermediary in the rate-setting process, we recommend greater transparency with respect to the financial relationships between the BBA and the panel banks, and around the BBA's financial interests in LIBOR.

2. Increase the size and broaden the composition of the USD panel

The BBA should increase both the size and the proportion of US banks on the USD panel. Currently, the only US banks on the panel are Bank of America, Citibank, and JPMorgan, but there are several other US banks active in this market and potentially eligible for inclusion in the panel, including Wachovia, State Street, Northern Trust, and BoNY. Subject to maintaining the panel's credit quality, the inclusion of more active US banks would produce a fixing that is more representative of the London interbank market and less susceptible to the specific funding issues of institutions that do not have a broad USD funding base.

3. Add a second USD LIBOR fixing for the U.S. market

The BBA should consider adding a second USD fixing to capture rates for transactions that occur when the US market is active. LIBOR rates for all ten currencies are currently published at 11am GMT, and this common timing is important to many participants in the FX swaps and other financial markets. However, the fixings occur prior to the opening of the New York market, and prevailing rates can change considerably once US-based sources of dollar liquidity arrive. A second fixing, during the New York trading session, would provide an additional benchmark rate more indicative of conditions during those hours of market activity.

For this second fixing, we recommend polling all the banks that participate in the 11am GMT panel, as well as any additional banks necessary to get an accurate representation of the USD funding market during the New York session. The BBA might emphasize that the introduction of a second fixing is being undertaken in tandem with efforts to enhance the credibility of the first fixing, and thus the second is intended to complement rather than replace the first.

4. Specify transaction size

Banks currently quote the rate at which they could borrow in "reasonable market size." To eliminate some of the ambiguity that comes with this definition, we recommend that the BBA provide more specific guidance as to the size of the transaction being referenced in the reported quoted rates. In addition, to reflect the fact that actual transaction sizes can fluctuate markedly with changes in market conditions, the BBA should consider allowing the transaction size it specifies to adjust flexibly over time, with these adjustments occurring either at a regular frequency or in response to significant changes in market conditions.

5. Only report the LIBOR maturities for which there is a net benefit

We recommend that, in consultation with panel banks, the BBA adopt guidance on consistent methods for determining quotes across the range of maturities of LIBOR. In addition, we recommend that the BBA consider reducing the number of maturities for which it solicits quotes and publishes rates. For tenors such as the 3-month tenor, LIBOR quotes provide valuable information to the public because of the volume of activity occurring at that tenor, while quotes for tenors at which little or no trading occurs, such as the 11-month, are less indicative and therefore less valuable. The current practice of soliciting rate quotes across 15 tenors, when only a subset of those tenors reflect meaningful market activity, likely leads to more subjective and formulaic responses across all tenors. By asking banks to quote fewer rates, the BBA may solicit higher quality responses for those more informative tenors, with relatively little value lost by excluding less informative tenors.

6. Eliminate incentive to misreport

If the combination of best practices and audit recommendations in (1) above seems unlikely to be sufficiently effective in ensuring accurate reporting, a complimentary approach might be to adopt the following process for collecting, calculating, and publishing LIBOR rates. The BBA could collect quotes from all members of the expanded panel, and then randomly select a subset of 16 banks from which the trimmed mean would be calculated. The names and quotes for the 8 banks whose rates are averaged to calculate the LIBOR fixing would be published. The banks' whose reports fall above or below the midrange would not be publicly identified, nor would the level of their outlying rates. This random sampling from an expanded panel would lessen the likelihood that the market would draw a negative inference regarding a particular bank's continued absence from the list of published quotes.[1]

[1] One potential drawback of this process is that it may introduce, or be expected to introduce, additional volatility into the LIBOR fixings. However, simulations based on historical LIBOR quotes suggest that a process of this sort would not dramatically affect the volatility or level of the fixing. We find that rates computed using this random process differ from the actual LIBOR fixings by, on average, by less than 0.2 basis points in the 3-month tenor.