The Libor scandal was a headline-grabbing feature in the fallout from the financial crisis. The FSB itself has instigated moves to find a replacement, but how will that be implemented, and what will it mean for swap market participants?

Unsurprisingly the scandal around Libor fixing captured the public's imagination. Though one suspects many people would be hard pushed to explain the details, the affair encapsulated the image of devious bankers colluding to defraud the rest of us. For this reason, as well as other more practical ones, the Financial Stability Board (FSB)[1] instigated a review of benchmarks with the aim of putting them on a more sure and defensible footing. However the case for change is not as clearcut as might at first appear, nor is the mechanism of change straightforward.

The Rise of Libor. Like many things in financial markets the use of Libor as a reference rate was an organic thing, just as the emergence of the swap market was an experimental thing - many products and markets are tried, and many fail. The swap market started small in the 1980s between financial institutions, and required a rate which could be used as a benchmark for the fixed leg of swaps. The Libor rate, agreed daily between banks as the effective interbank lending rate, was proposed by the British Banker's Association as an ideal candidate. It was not known then that it would become a key componenent of a trillion dollar market, a market where reliance on a crudely aggregated rate based on the word of market participants was just accepted as the way things worked.

The case for change. Besides the fact that Libor is now viewed as suspect there are other issues which suggest it is best put out to grass. The interbank lending market has declined dramatically as a result of the crisis and now Libor often doesn't even represent figures of the rate at which banks are actually lending, but is only an estimate of the rate they would apply were they to lend. In addition the rates which are used for what interbank lending still occurs contain credit risk reflecting the increased concern banks have for the soundness of their peers. This effect is dampened by the low interest rate environment, but this credit risk insurance premium incorporated in swap prices will become more prominent as rates rise.

It is worth noting that if Libor manipulation were a real concern one might expect a market-driven change to adopt a new benchmark without the instigation of the regulators. However, no such shift has occurred and the market has continued to willingly trade Libor-referenced derivatives, albeit with a more robust fixing process designed to remove the opportunity for fraud. The primary driver for change given by the FSB is not manipulation but the lack of liquidity in the interbank market, which threatens the reliability of Libor. In addition some banks are withdrawing from the Libor setting group as the task is not deemed worth the effort and associated risks.

It is also not a given that a replacement rate based on more liquid and transparent traded rates will be more immune to tampering. As other cases such as FX fixing have shown, trading around designated fixing times can be used to shift the rate that is set. Ironically it is end-users that favour fixing as it gives certainty and removes choice, while banks dislike the risk it introduces.

[1] The FSB was established in April 2009 as the successor to the Financial Stability Forum (FSF). At the Pittsburgh Summit, the Heads of State and Government of the Group of Twenty endorsed the FSB's original Charter of 25 September 2009 which set out the FSB's objectives and mandate, and organisational structure The FSB has assumed a key role in promoting the reform of international financial regulation.

Obstacles to change. The introduction of a new reference rate is not going to be plain sailing, as a number of difficulties must be overcome. For example, will the new rate be applied retrospectively to all existing contracts, requiring complicated and time-consuming conversions of contracts, or will it only be used in new contracts? How will market participants be persuaded to the new rate? For all it's faults Libor is familiar and its use embedded in procedures, so initial use of an alternative will be thin and this lack of liquidity will make spreads unattractive.

Proposals for change. The FSB set up a number of regional bodies to assess potential candidates for their respective currencies, with committees of market participants providing input to these bodies. Recommendations have been requested for new reference rates, and for methods of implementation.

The list of potential replacement rates has been reduced to either an unsecured overnight index or a secured overnight index based on the repo market. In the case of the former some reform of existing rates may be required, while the latter would require development of a new rate. A final decision on the selection is expected in 2017.

The strategy for conversion to the new rate would involve it's incorporation into the OIS market - and therefore for discounting and collateral interest – across the entire yield curve. There is no suggestion of coercion, with the focus rather on 'encouraging' adoption of the new rate. Conversion of legacy contracts will also be incentivised if economically viable. However the regulators recognise that some market participants will prefer to continue to use Libor.

Consequences of change. The effect of the proposed change will vary for different types of end user. It will generally be welcomed financial institutions, removing as it does bank credit risk and therefore more appropriate for hedging general interest rate risk. Meanwhile, corporates looking to hedge loans may prefer to continue using Libor as a reference, happy to pay the premium for continuing protection against rising bank funding costs. However given that banks will likely push to use the new rate both for lending rates and for swap hedges in the market, there may be pressure on corporates to accept the new reference rate. More prosaically any change will require changes to systems, procedures and the expertise of operational staff.

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