Is Libor dead? On this and the facing page leading borrowers and bankers assess the future for this benchmark rate.

It's just a question of protection against risk

AMONG THE great discoveries of nature and insights into the secrets of life, Libor (the London Interbank Offered Rate) doubtless will be fondly remembered—particularly by investment and commercial bankers. The use of Libor as the virtual universal benchmark for the pricing of dollar-denominated interest rate sensitive debt outside the U.S. was inevitable and understandable. It satisfied almost everyone. The reasons for its success are transparent.

The fact is Libor-based lending permitted commercial banks to relax—not to worry about credit distinctions or mismatches between funding costs and return on assets. Banks were not about to fall into the trap of taking on interest rate sensitive liabilities while deploying them on fixed rate loans. And, if in some countries home owners were as yet unwilling to take on the volatility of floating or adjustable rate mortgages, there was no shortage of sovereign governments prepared to do just that.

From the borrowers perspective, Libor-based instruments were described as "long term." "Long Term" became synonymous with certainty. Again, there was little concern with volatility although as matters later developed the uncertainty of the cost of servicing may have been an appropriate price to pay as compared to the certainty of the perpetual nature of the maturity. But that is another story.

Libor had other attractions. It did not discriminate between not-so-good banks, careful banks or aggressive banks. The funding costs of banks, except in a few isolated situations, did not distinguish fully the better capitalised or more cautious banks from their less-endowed competitors.

Libor did not penalise, generally, banks on the basis of the quality of their assets or the rate of return on those assets. It was and is a sort of lowest common denominator pricing. Not exactly a comfortable benchmark for the highest credit standing issuers in the world.

Similarly, the spreads paid by issuers or debtors "over" or "under" Libor seemed driven, at any given time, primarily by a desire for market share, the slope of the yield curve, the proliferation of offices in London, the extent of consumer loan demand back home, and more generally the capacity of the lead manager to exercise discipline over its co-underwriters and thereby diffuse risk.

There was hardly any room to distinguish, on the basis of spreads, India from China from Korea from Mexico from France from Sweden. The credit standing of the issurer got lost in the rounding.

Everyone used it: banks; issuers, debtors, rich countries; poor countries; traders and arbitrageurs. Clearly, if the largest and best of the brightest banks in the world lent money to each other at Libor, should not that rate provide the base for Sweden and France and the World Bank?

Libor also proved wonderfully unstable against the U.S. Treasury Bill, unpredictably ratcheting up rates for all banks when any one bank (or country) had publicised problems. Not unexpectedly, the volatility created the opportunity even the necessity for hedging, arbitrage, swaps—a process still continuing.

Libor also provided a cost benchmark for pricing loans based on the marginally highest cost of funds—a particularly useful characteristic for banks with a diversified source of funding—even more so if they were a natural dollar-based deposit-taking institution. That aspect, however, did not help issuers.

Perhaps most relevant, Libor pricing did not require an external customer base. The ultimate investor could just as well be the under-writing bank.

For the World Bank, all this was a puzzlement. We had come but lately onto the scene, borrowing for the first time in 1982 through interest rate sensitive instruments in the U.S. domestic short-term market—and even then by means of day-to-day pricing strictly based on the prevailing yields for short-dated U.S. government obligations and typically at 10-15 basis points over the yield for those instruments.

Over the last 30 years, our fixed rate bonds were consistently priced on the basis of the yield on fixed rate government obligations. We were accustomed to depositing our liquidity in commercial banks particularly when Libor escalated to 300-400 basis points over U.S. Treasury Bills.

The idea that the World Bank should price its bonds on the basis of those rates was anomalous at best and innovative to say the least. The development expected and fair, which brought Libor-based instruments to the U.S. simply provided a successful test of the quality of the World Bank credit.

The very success and the reasons for Libor acceptance increased our anxiety about its wisdom for us. We had the luxury of waiting. The first T-Bill FRN in Europe was brought to market with the World Bank name by Bankers Trust. Only a partial success—but, nonetheless, it represented an attempt by reasonable and motivated bankers to test the market outside the banking system—in a favourable environment when Libor-Bill spreads were quite narrow.

Eugene H. Rotberg, Vice-President and Treasurer of the International Bank for Reconstruction and Development

Later First Boston, then Salomon Brothers, again, this time in the U.S. domestic market found a niche—customers who wanted a high quality credit other than a commercial bank—which would provide a return over T-Bills. Someone, we concluded, must be purchasing Treasury Bills. After all, there are $250bn outstanding with a maturity six months or less. Central banks clearly were and are not the only non-U.S. holders.

Morgan Guaranty then restructured the "traditional" T-Bill-based issue by creating an instrument which provided (a) immediate liquidity, (b) a take-out at Par, (c) a return higher than the three month T-Bill, (d) an assurance of funding for a reasonable time for the Bank. Investors therefore had choices—puts, secondary market liquidity, and/or protection against capital loss. Five hundred million dollars. A diversified customer base—institutional and corporate.

The prospects remain bright. After all if it is mainly the open-ended risk of the T-Bill Libor spread going berserk, one would think there might be ways to hedge that risk, lock in spreads, and protect oneself. The thought occurs, if one were to fix the spread to say 25 per cent of the difference between T-Bill and Libor and guarantee a minimum decent spread over the T-Bill, what would an issuer (or underwriter) do and for how much to protect against an escalation of rates?

I suspect someone will work it out. After all, there's nothing "wrong" with Libor. It's just a question of protection against risk. Like carrying an umbrella.

Eugene H. Rotberg

Not necessarily appropriate basis for one-in-one lending

SWEDEN'S borrowings at floating interest rates were originally done in the syndicated credit market and it was natural that these credits were priced off a cost-of-funds-related base rate, such as Libor.

It is, however, important to recognise that Libor can vary as between groups and classes of banks. This tiering can also vary over time.

Normally this means that a Libor-related rate would provide a higher effective return, in relation to cost of funds, to the largest, more creditworthy and dollar-based banks than to the smaller, peripheral or non-dollar-based banks.

This would suggest that large, widely-syndicated international bank credits will continue to be Libor-based, but also that the leading banks should pay more attention to the distribution of fees so as to achieve a more equitable treatment of the majority of banks in the syndicate. Otherwise the market for broad syndication might continue to shrink, to the detriment of banks and borrowers alike.

This also means that Libor is not necessarily the appropriate basis for one-in-one lending by the large dollar-based banks for which Libor is not relevant as a measure of their cost of funds.

This diversification, designed to come closer to the banks' cost of funds, has already taken place in the U.S., where pricing in relation to the CD (Certificate of Deposit) rate has become more usual and is replacing the use of the prime rate as a reference rate.

The floating rate note (FRN) market developed initially as an extension of the credit market and, when banks were the principal investors, it was natural that Libor became the principal reference rate. However, as the investor base widened away from commercial banks and to the extent that FRNs develop into highly traded and liquid instruments, the argument for Libor as a base rate quickly erodes. This has been shown by the increasing use of Limean and Libid as reference rates in this market.

For instruments that are primarily designed for non-bank investors, Libor should be irrelevant as a reference rate, unless commercial banks are regarded as "investors of last resort." The latter role can, however, be better performed through various back-stop facilities.

FRNs that are widely traded and thus have a high degree of liquidity and, even more so, short-term Euronotes should be priced on the basis of alternative investment vehicles.

These might be Treasury bills, commercial papers, bankers' acceptances, CDs, etc. The notional base rate should be the rate for the least risky and most liquid instrument, which is usually the Treasury bill.

As AAA-rated paper by sovereign borrowers obviously represents a higher quality paper than bank CDs, the former should carry a lower interest rate than the latter. Since the CD rate is normally below Libor, this also means that there is no reason to use Libor as a reference rate.

As the Euronote market develops further into a parallel with the commercial paper market in the U.S., it is likely that the rate structure will develop more fully based on credit risk, in which case Libor will become of reduced significance. As such instruments will appeal to the treasuries of corporations, institutions, commercial banks and to central banks, they will develop their own rate structure without reference to Libor.

In this area the dollar markets are likely to lead, but the same fundamental argument holds for other currencies. That development is, however, hampered in those countries where the authorities do not permit foreign borrowers in the short markets. Such restrictive policies will continue to preserve the domestic banks' ability to maintain artificially high lending rates.

Peter Engstrom

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