Finance Watch

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Answer to the questionnaire for the public consultation on "MARKET MANIPULATION: LESSONS AND REFORM POST LIBOR/EURIBOR" by ECON Vice President and Rapporteur – Arlene McCarthy MEP

Response by Finance Watch

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PRELIMINARY REMARKS: Comparing LIBOR and EURIBOR

In order to answer the questions asked by this consultation, it is essential to establish first the similarities and the differences between LIBOR and EURIBOR.

The similarities relate to the fact that both LIBOR and EURIBOR are established by averaging contributions made by a panel of participating banks, they are not effective rates (they do not reflect actual transactions) and both benchmarks' governance is organised by a professional banking association (British Bankers Association and European Banking Federation respectively).

The differences relate to the definitions of LIBOR and EURIBOR (official definitions to be found respectively on http://www.bbalibor.com and on http://www.euribor-ebf.eu):

- **LIBOR** is defined as: *"The rate at which an individual contributor panel bank could borrow funds, were it to do so by asking for and then accepting interbank offers in reasonable market size, just prior to 11.00am London time."*
- **EURIBOR** *is the rate at which euro interbank term deposits are being offered by one prime bank to another within the EMU zone*.

As can be seen, the main two differences between the two rates are 1) that LIBOR reflects a cost of borrowing whereas EURIBOR reflects a price of lending (even though a bank's cost of lending in the interbank market is by definition another bank's cost of borrowing) and 2) a LIBOR contribution reflects the estimated cost of borrowing for the bank contributing whilst a EURIBOR contribution reflects the contributing bank's conviction about the cost at which a prime bank (i.e. not necessarily the contributing bank) would offer term deposit to another prime bank (this has the implication that some banks contributing to the EURIBOR panel and which do not consider themselves as prime banks notoriously contribute, without going against the definition of EURIBOR, a rate different from the rate at which they would themselves offer funding in the market).

These differences will lead us to make distinctions between LIBOR and EURIBOR in our answers to some of this questionnaire's questions.

Concerning the EURIBOR definition, it must be noted that it does not define what a prime bank is. By the same token, the relevance of the contributions not necessarily reflecting the contributing banks' position could also be questioned.

These differences in definition probably explain also the significant difference between the number of banks contributing to USD LIBOR (18) and to EURO EURIBOR (44): on the one hand it could be argued that LIBOR's definition is more demanding and its selection criteria for contributing banks stricter but on the other hand it could be argued that having a much broader base of contributing banks makes EURIBOR less prone to manipulations. In any case, both rates reflect different realities with their respective strengths and weaknesses.

The reality is that these differences, which are not widely understood outside of specialised circles but have important consequences, reflect the fact that both rates are controlled by professional organisations with a mission of promoting private and often competing interests.

Finance Watch suggests that either/both BIS, as part of the mission given by the Economic Consultative Committee to the group of senior officials to examine reference rates used in

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financial markets as announced on 10 September 2012[1], or/and IOSCO, as part of the global policy guidance and principles for benchmark-related activities that will be realised by the Board Level Task Force on Financial Market Benchmarks announced on 14 September 2012[2], look into the opportunity of bringing the definitions and the methodologies of LIBOR and EURIBOR (and possibly other benchmarks such as TIBOR) closer to each other in order to **have truly comparable benchmarks**. This, in Finance Watch's view, is important not only because those benchmarks are massively used by professionals for activities ranging from banks' funding to interest rate swaps trading but, as importantly, because they are used as a reference for multiple retail financial products ranging from money market funds to mortgage related loans. The inconsistency of definitions between benchmarks that are used for broadly similar purposes has far reaching consequences, makes the whole debate more opaque and, in any case, can only lead to an ever increasing mistrust of financial markets and financial activity from the broader public.

Comparative summary of the main characteristics of LIBOR and EURIBOR

	LIBOR		**EURIBOR**	
	LIBOR €	LIBOR USD	EURIBOR €	EURIBOR USD
Nb of members in the panel	15	18	44	19
Nature of contribution	estimation daily mandatory*		estimation daily discretionary**	
Ownership and governance of the rate	BBA (private - banking association)		EBF (private - association of banking associations)	
Nature of contribution	**Indication of the average rate at which a leading bank can obtain unsecured funding in the London interbank market for a given period, in a given currency** > i.e. cost of borrowing for the contributor > i.e. lowest perceived rate in the London market		**Rate that each panel bank believes one prime bank*** is quoting to another prime bank** for interbank term deposits within the euro zone > i.e. cost of lending for any bank of the panel	
Calculation method	**Exclude the highest and lowest 25%** of submissions Remaining contributions are then averaged		**Exclude the highest and lowest 15%** of submissions Remaining contributions are then averaged	
Quorum			At least 50% of the Panel Banks must quote to establish Euribor. In the event that less than 50% of Panel Banks are able to quote, Euribor is established as soon as it can collect quotes from at least 12 panel banks in at least 3 different countries.	

* not specified on BBA documents but suggested (panel banks "will contribute" their rates...)

** no strict onligation to contribution, but processes in place, set-up as incentives for panel banks to contribute

*** definition of a prime bank is not strict but understood as the leading banks operating on the market

[1] See Bank for International Settlements : http://www.bis.org/press/p120910.htm
[2] See IOSCO media release: http://www.iosco.org/news/pdf/IOSCONEWS250.pdf

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TOPIC 1: TACKLING THE CULTURE OF MANIPULATION

Q1: How widespread is the problem? Are there other financial instruments, markets and/or benchmarks vulnerable to potential manipulation? What action should be taken to ensure these forms of market abuse are tackled?

There exist two families of financial indices or benchmarks:

1. Indices / benchmarks whose value formation is based on transactions (e.g. equity indices such as DAX, MIB, FTSE100, CAC40, AEX, etc…).
2. Indices / benchmarks whose value formation is based on indications given by market professionals that have accepted to contribute (e.g. LIBOR, EURIBOR, credit related indices, commodity indices…)

Even though both types of benchmarks can be the subject of manipulations, the second category is by definition particularly fragile in that respect. The reason for this is easy to understand: notwithstanding the safeguards brought by governance, technical standards, surveillance and, hopefully in most cases, personal integrity of market operators, **manipulating an indication is by definition far easier than manipulating a real transaction**. It is relatively easy and therefore tempting for an operator to move an indication if it serves his / her interest whilst moving a benchmark calculated on real transactions requires by definition to commit capital. Manipulating actual transactions is not only more difficult but also of a different nature: reporting made on actual transactions reflect by definition a "real" price (not precluding the fact that this price can also be manipulated).

In the case of **LIBOR / EURIBOR**, the problem is compounded by the fact that **the banks contributing to the benchmarks both trade books of financial instruments (e.g. interest rate swaps…) whose value is linked to those benchmarks and fund themselves, at least for short maturities, at a cost linked to those benchmarks**. This means that, depending on their actual market positions, a different level of LIBOR or EURIBOR will mean more or less profits for the contributing banks. In a nutshell, contributing banks have a **dual role of judge and jury** and giving a person or an institution the dual role of judge and jury creates by definition conflicts of interest regardless of the quality of the Governance put in place and of the level of personal integrity of operators.

In Finance Watch's opinion, situations with built-in conflicts of interest create a particularly perverse situation when **a small concentrated group of private interests** (panel contributors) **controlled by a private interest body** (industry-linked organisations and in some cases such as, for example, credit or commodity indices, for-profit organisations) **has a considerable impact on the global financial system and therefore an enormous impact on public interest**. This situation is inherently unhealthy.

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With a view of avoiding situations with built-in conflicts of interest that constitute a particularly fertile land for potential market abuses, situations that have a (very large) impact on public interest should be **controlled or at the very least closely supervised by a public authority and not by a private entity**. **This principle should hold true on the entire private interest / public interest chain when it comes to financial services**. Failing this, the conditions for the fraction of dishonest operators, which are inevitably to be found in any industry, will be in place for those operators to successfully conduct their deeds going against public interest.

Q2: What action should be taken to ensure the integrity and quality of all benchmarks, financial instruments and markets?

Q2.a. Do both benchmarks and those entities that input into the setting of the benchmark need to be regulated?

Yes, without any doubt, along the principles described in the answer to Q1 above: as the setting of those two benchmarks has a very large impact on public interest (the economy and society in general), they need to be regulated.

Q2.b. Are traded rates as opposed to offered rates a better basis for input? Or should a 'hybrid' approach be adopted?

As explained in the answer to Q1, compared to contributions based on an estimate, **traded rates have the dual merit of:**

1. **Reflecting a financial reality** (by definition, money was borrowed/lent at that rate and therefore that rate reflects a real financial transaction) ;
2. **Making cheating more difficult** as cheating with traded rates requests the ability to move real transactions to the level desired by the cheater, which is obviously much more difficult than to simply say “I think the market is at that point”.

In theory, there should be no difficulty to set benchmarks on traded rates. **In practice however a distinction between LIBOR and EURIBOR must be made and a number of difficulties may arise:**

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→ **Concerning LIBOR:**

The actual volume of transactions traded on the different tenors and across the different currencies varies greatly, with a limited number of tenors concentrating the bulk of volume. For instance, in the case of LIBOR, 6 tenors involving 3 currencies only out of a total of 40 tenors across 10 currencies concentrate 97.3% of LIBOR references for interest rate swaps and floating rate notes (underlying notional amount of transactions using LIBOR as a reference for those instruments being circa $ 200 trillion). Those 6 tenors are: USD 1 and 3 months, GBP 3 and 6 months, JPY 3 and 6 months (with USD LIBOR 3 months taking 52.8% and JPY 6 months 23.5% respectively)[3].

Facing such a reality, **a distinction should be made between traded tenors and non-traded tenors**. By definition, founding LIBOR rate setting on actual transactions for traded tenors should not be a difficulty. However, the situation is more difficult for non-traded (or little-traded) tenors.

An argument against founding LIBOR setting on actual transactions is that contributing banks should not be forced to take on their balance sheet **unnecessary liquidity or credit risk.** Given the very large amounts of transactions realised on traded tenors, it can be easily demonstrated that the **liquidity argument does not hold for traded tenors**. However, the liquidity argument does **hold true for little traded tenors and should be considered on those**.

Another point is that the **credit risk argument** is a **valid concern of banks contributing to LIBOR setting**: managing credit risk is a delicate exercise for all banks and it would make no technical sense to force banks to take unwanted credit risk on board.

All those parameters being taken into account and with the absolute conviction that in the world of finance a price that does not reflect a transaction can quickly become meaningless, **two solutions can be contemplated that would have almost identical results** although they would represent different constraints for banks:

Solution n°1:

On the tenors representing the overwhelming majority of transactions, base LIBOR setting on **actual transactions**. As those tenors are actively traded, this will not induce unwanted liquidity nor credit risk for the contributing banking institutions as they are by definition already trading those tenors actively (and if they are not, it can be questioned what the meaning of their contribution is).

On the little traded tenors, **the current contribution system based on indications only could be kept under a newly organised supervisory regime.** Even though this solution keeps, by definition, the flaws described above that are inherent to a non-transaction based contribution system, this downside is greatly mitigated by the fact that the tenors for which the contributions are indications only represent little, if any, volume of actual transactions, thus representing little impact on the economy and public interest.

[3] Source : Wheatley review, Chart 2.C, page 13

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Solution n°1 has nonetheless the **downside** of **not having a consistent system between traded and non-traded tenors** and, incidentally, has the difficulty of **deciding "where to draw the line"** (what is the legal definition of a traded or a non-traded tenor? How do we deal with formerly non-traded tenors that become traded or vice versa? Etc…).

Solution n°2:

On all tenors (whether actively traded or not), **keep the current system of non-transaction based indications, but force the bank(s) that contributed the lowest rate to lend a significant albeit reasonable amount at that rate plus a justifiable bid-offer spread fixed by supervisors and the bank(s) who contributed the highest rate to borrow a significant albeit reasonable amount at that rate** (this, outside of the 25% highest / lowest contributions excluded under current rules).

In order to avoid any (otherwise legitimate) concerns from banks about taking on unwanted credit risk, **the transactions imposed upon the banks having contributed the lowest and the highest rates should be realised with the European Central Bank (ECB).** This would not only **eliminate all credit risk** for contributing banks on those transactions but would also be consistent with the supervisory role that we will propose to give, along with a European Supervisory Authority, to the ECB on the setting of those benchmarks.

The **liquidity implications** of solution n°2 can be easily dealt with in the following manner: the **ECB would determine and revise on a regular basis (quarterly?) the exact size of the transactions that would be forced** upon the lowest and the highest contributors in order to **make the size of those transactions compatible with current market conditions**. This size would then go from relatively small to much larger depending on the tenor contemplated. In case a tenor never trades, thereby creating for banks a great difficulty to take or give liquidity, it could be asked what the usefulness of having a non-traded tenor is. Alternatively, it could be asked what the actual economic ability and credibility of a bank to indicate a rate on a tenor that never trades is. In any case, legislators and regulators should not fall short of fixing the issue of rate rigging for the sake of having the right solution in place on tenors that never trade and have therefore no or little economic importance.

→ **Concerning EURIBOR:**

Given the definition of EURIBOR ("rate at which euro interbank term deposits are being offered by one prime bank to another, cf. preliminary remarks), it would not make sense to base EURIBOR fixing on actual transactions. As previously noted, it is notorious that some banks contributing to the EURIBOR panel contribute a rate different from the rate at which they would really offer funding in the market. This does not go, strictly speaking, against the definition of EURIBOR and therefore cannot be considered as rate rigging but is an implicit statement by those banks that they do not consider themselves as prime banks.

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However, it could be argued that this reflects an intrinsic weakness in the definition of EURIBOR. A solution to strengthen the definition of EURIBOR and therefore its economic meaningfulness could be for banks contributing to the EURIBOR panel to declare formally whether they consider themselves as prime banks or not. If they do, the reasoning developed above for founding LIBOR on traded rates could be applied to them.

Alternatively, BIS' group of senior officials appointed to examine reference rates used in financial markets and/or IOSCO's Board Level Task Force on Financial Market Benchmarks could work on the improvement of all benchmarks' definitions and on improving the consistency of different benchmarks' definitions with each other.

Q2.c. Should the posters of rates be granted anonymity? What would be the potential downside to such an approach? Would such a status add or diminish the integrity of prices?

Here again, given the difference of definitions between LIBOR and EURIBOR, a distinction must be made between those two rates in order to answer the question of anonymity.

→ **Concerning LIBOR:**

Absence of anonymity has been identified as one of the reasons why some banks have been incentivised to submit artificially low LIBOR rates in the past. The objective, so the explanation goes, seems to have been for those banks not to reveal their strained cost of raising liquidity in the market. The concern from banks not to show to the market a possibly strained cost of funding is understandable and should be given attention. In that context, anonymity towards the outside world makes sense and seems to have very little downside as long as the outside world has trust that the rates provided reflect the exact economic reality of the true cost of funding of banks**. In turn, in order for the trust in LIBOR to be founded on strong ground, the condition is that anonymity should be towards the outside world only but not towards the public authority supervising the rate setting mechanism**. Such a mechanism would combine the best of both worlds as one of the possible reasons for banks to rig the rate setting mechanism would disappear whilst public confidence would be restored as the process would be supervised by a public authority.

At the risk of repeating ourselves, it has to be emphasized that this can only work if anonymity is kept for the outside world only: **anonymity vis-à-vis supervisors should not even be contemplated**.

→ **Concerning EURIBOR:**

As the current EURIBOR definition does ask that contributing banks disclose not their own cost of lending but the cost of lending of a somewhat theoretical "prime bank", it would make no sense to grant posters of EURIBOR rates anonymity (anonymity would actually decrease the credibility of EURIBOR in that context).

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However, if the definition of EURIBOR were to evolve on that point, the reasoning on anonymity given above for LIBOR could be applied.

Q2.d. What kind of powers should regulators of the financial sector be given to set and introduce criminal sanctions for attempted or actual manipulation of benchmarks?

At regulators' level, the following powers should be given in order to avoid further manipulation of benchmarks:

1. The **rate setting and calculation process should be monitored and supervised by regulators** and not by organisations representing private interests. This is an important point and it has to be emphasised that **even an improved Governance mechanism in the private associations currently controlling the process will not be a sufficient game changer** in that respect. A simple principle should be that a public authority should systematically be granted supervisory power upon any process that has implications on the public interest.
2. When it comes to deciding **which authority should supervise the process**, two fundamental principles must be respected:
   a. **that authority must have as little proximity as possible with the supervised contributors** as proximity has proven over and over again to be hardly compatible with a strict and non-complacent control;
   b. **that authority should not have a national dimension (should be supra-national)** as national authorities always have a tendency to include in the set of parameters feeding their thinking the commercial interest of the financial market place they have the responsibility of supervising.

   It has to be understood here **that if European political leaders want to restore confidence in the financial sector, the supervisory mechanism cannot be based on arguments around international competition between financial centres: what is at stake here is whether financial markets can still serve society**, something that requires that trust is restored. EU political leaders are in that respect in a unique position to come up with the right solution given the EU broad mandate they hold. In the EU context, the two obvious possible supra-national authorities are a relevant European Supervisory Authority and the European Central Bank and it could be considered whether it would be worth involving the two authorities in the process.
3. The regulator in charge of supervising the process should be given the following power:
   a. Control / supervise the process (including calculation) on a daily basis. Check the consistency of rates provided.

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b. In the case of LIBOR, enforce (if adopted) the rule stating that the contributor of the lowest rate has to lend at the rate contributed (+ a normal bid-offer spread) and the contributor of the highest rate has to borrow at the rate contributed (solution n°2 described above).

c. Be able to investigate all alleged misbehaviours.

d. If necessary, engage civil responsibility of banks after investigation.

e. If necessary, engage personal responsibility of operators after investigation.

f. If necessary, engage personal responsibility of banks managers after investigation.

TOPIC 2: ESTABLISHING INTEGRITY AND TRUST POST LIBOR/EURIBOR

Q3: What specific measures should be taken at European/Global level to improve investor confidence?

The key to restoring investor confidence is linked both to **holding banks accountable for past misbehaviour** and **ensuring in a transparent and highly controlled way that the same phenomenon cannot happen again**.

Holding banks responsible for past action:

A full and complete enquiry into what happened on the alleged manipulations should be conducted and the result of the enquiries should be published in a completely transparent manner. The enquiry should describe not only the process by which a manipulation happened at certain banks for a certain period of time but should also quantify the extent of the manipulation and indicate the amount of undue profits generated by those banks to the detriment of investors, corporations and consumers.

Holding operators responsible for past action:

A full and complete enquiry into who did what on the alleged manipulations should be conducted and the result of the enquiries should be published in a completely transparent manner. When applicable law allows, operators should be held personally responsible for their action.

Holding banks' managers responsible for past action:

A full and complete enquiry into management structures and into the chain of responsibilities in the banks convicted of having manipulated (or attempted to manipulate) the benchmarks should be conducted and the result of the enquiries should be published in a completely transparent

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manner. When applicable law allows, banks' managers should be held personally responsible for the misbehaviour of the operators they were responsible for as the manipulations could only result either from complicity between the managers and the operators who manipulated the benchmark(s) or from managers having grossly neglected their duty of controlling the operations of the banks they are responsible for.

Q3. (continued) How can cooperation between global regulators be improved?

It is in the nature of national regulators to also have a tendency to protect their local market vis-à-vis foreign competition on top of ensuring the integrity of the market place and the protection of banks' customers, investors and corporations.

In that context, BIS' and IOSCO's involvement in the process of thinking, organising, coordinating and controlling a consistent benchmark setting process should be seen as going in the right direction.

On the issue of controlling benchmarks on a daily basis, we would like to emphasize again that the further away from local considerations the authority in charge of controlling benchmarks is the better.

Q3. (continued/end) How can legislators ensure continuity between existing contracts which rely on LIBOR/EURIBOR (some $500 trillion of contracts) and future contracts?

The link to LIBOR/EURIBOR should not be changed for existing contracts as the enormity of the task and the implications of such a process (market disruption, possible triggering of early termination clauses) would make it a highly adventurous and probably unrealistic solution. **Future contracts could continue being based on LIBOR/EURIBOR provided the right remedies have been put in place, as described in Finance Watch's response to this questionnaire**:

1. public supervision of the process;
2. use of effective rates or revised definitions as applicable (see above);
3. personal responsibility of both operators and banks' managers.

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Q4: What specific measures could be taken to enhance transparency and information quality in the financial sector?

As a rule, **transparency and information quality must follow the following rules** in order to be complete, avoid suspicion of collusion and serve the purpose of developing trust in the financial sector:

1. **Enquiries should be systematic** (it seems for instance that in the case of LIBOR/EURIBOR different national authorities have adopted different policies in terms of enquiries, a situation that can only lead to an increased level of distrust of customers vis-à-vis the financial sector);
2. **Enquiries should be conducted by authorities that are far from the banks being investigated and that have no mandate to defend even partially common interests** (such as, for instance, the commercial interest of a particular financial centre);
3. **The result of all enquiries should be published and include a quantification of the cost of misbehaviours for customers**;

Such enquiries should be conducted today systematically on **LIBOR** and **EURIBOR** for a significant period of time extending further than the periods currently under investigation (past ten years?) and across all relevant jurisdictions.

It would also be worth considering with a view of enhancing transparency and information quality in the financial sector, if similar enquiries should be launched on other benchmark setting processes: even without any suspicion of past manipulation, this would definitely be the best way to restore trust and transparency in the market.

Extending enquiries to other benchmarks beyond the specific case of LIBOR/EURIBOR is consistent with the set-up of a group of senior officials at BIS to work on reference rates used in financial markets and the remit of IOSCO's Board Level Task Force on Financial Market Benchmarks to identify the relevant policies and principles for benchmark-related activities.

Q5: What future action could be taken to achieve better governance in order to prevent future manipulation and establish integrity, trust and fairness in the financial services industry?

As a rule, establishing integrity, trust and fairness in the financial services industry and avoiding manipulation will require **to reform, or supervise closely, the situations where one of the following factors (or several) can be encountered**:

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1. **Situations where an entity is both judge and jury**: e.g. banks contributing to LIBOR/EURIBOR, credit rating agencies (cf. Finance Watch contribution to Credit Agencies Hearing given to ECON Committee of the European Parliament on January 24th 2012), etc…
2. **Situations where moral hazard can be encountered**: e.g. position of traders vis-à-vis the banks employing them, position of banks vis-à-vis society due to "too big to fail", etc…
3. **Situations where a (generally small) group of private interests controls a process that has (often large) consequences on the public interest**. Several examples of such situations can be found (non-exhaustive list):
   a. LIBOR;
   b. EURIBOR;
   c. credit related and CDS related indices and benchmarks;
   d. commodity indices and benchmarks;
   e. others…

These principles hold true for the entire financial sector beyond the issue of benchmark setting.

To conclude on the specific issue of benchmark setting, Finance Watch welcomes BIS and IOSCO initiatives respectively on Reference Rates used in Financial Markets and on Financial Market Benchmarks, and looks forward to the conclusion they will come up with, in particular on:

- exercising appropriate regulatory oversight of the process of benchmarking,
- having in place robust processes and procedures for benchmark calculation, and constructing credible governance structures, to address conflict of interests in the benchmark setting process,
- and ensuring transparency and openness in the benchmarking process;

Finance Watch is nonetheless concerned that the mandate for the IOSCO Task Force includes the development of "global policy guidance and principles, including those related to effective self-regulation" as **"effective self-regulation" has proven over and over again to be an oxymoron when it comes to financial services and is not the way to restore a profoundly shaken trust of the greater public in the fairness of financial activities**.

END

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