

# ARNOLD & PORTER (UK) LLP

## CLIENT ADVISORY

### Credit Crunch: Method of calculating LIBOR under the spotlight

Pressure is growing on the British Bankers' Association (BBA) to overhaul the method of calculating the London Interbank Offered Rate or LIBOR, the primary benchmark for short term interest rates globally.

Banks often calculate their own LIBOR, but LIBOR as calculated by the BBA is viewed as the key benchmark for inter-bank lending. It is also used to calculate the interest rates for a range of financial instruments and derivatives worth a total of around US\$150 trillion.

#### WHAT IS LIBOR?

LIBOR aims to reflect the real rates of interest being used by the world's leading financial institutions when borrowing from each other. Central banks (such as the Bank of England, the US Federal Reserve and the European Central Bank) usually fix official base rates monthly, but LIBOR is calculated daily for 15 maturities (ranging from overnight to 12 months) and for 10 currencies including the dollar, euro and sterling.

#### HOW IS LIBOR CALCULATED?

For each of the major currencies and the 15 maturities, the BBA collates the interbank borrowing rates from a panel of 16 banks, takes the middle 50% of these rates and uses these to calculate an average, which then becomes that day's LIBOR rate. The BBA uses Reuters to fix and publish the data daily, usually before 12 noon UK time, to more than 300,000 trading screens around the world.

#### WHY IS THERE PRESSURE TO CHANGE THE METHOD OF CALCULATION?

In the search for information on the credit crunch, attention has turned to whether LIBOR reflects true inter-bank lending rates. In addition, despite the actions of the main central banks, the US Federal Reserve, the European Central Bank and the Bank of England, to boost liquidity in the financial markets, LIBOR rates have remained well above base rates. Before the credit crunch, dollar, euro and sterling LIBOR rates traded about 10 basis points above base rates. Now they are around 70 basis points above base rates. As a result, bankers and analysts have been questioning the validity of LIBOR as a credible market benchmark and have raised concerns over its method of calculation.

**MAY 2008**

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The concerns appear to be twofold: first, that the panel of reference banks used by the BBA may be too small and some banks may be submitting inaccurate information to the BBA. As the rates provided to the BBA by the reference banks are not the rates used in actual transactions, some have argued that banks have been understating rates for fear of appearing weakened by the credit crunch with the effect that LIBOR may not be reflecting real inter-bank lending rates. The second area of concern is that the benchmark does not accurately reflect conditions in the US markets. The dollar LIBOR rate is published before the US markets open and only three of the 16 reference banks for dollars are US-based institutions.

### **WILL THE BBA CHANGE THE WAY LIBOR IS CALCULATED?**

The LIBOR setting process is reviewed annually by the BBA's Foreign Exchange and Money Markets Committee, a group of 15 market practitioners who determine the membership of each panel (one for each of the 10 currencies covered) and review whether changes might be required in the setting process. The committee next meets on 30 May 2008. The BBA is clearly under pressure to propose some changes. However, as the benchmark is such an important barometer of risk in the financial markets, the BBA will want to avoid further volatility and uncertainty in the markets and will be reluctant to introduce major changes.

### **WHAT ARE THE POSSIBLE CHANGES TO THE CALCULATION OF LIBOR?**

LIBOR could be calculated on the basis of actual borrowing rates between banks, rather than from the information provided by the reference banks and the panel of reference banks could be expanded. More US institutions could be included as reference banks on the dollar panel and dollar LIBOR could be calculated and set at a time when the US markets are open.

### **ARE THERE ANY ALTERNATIVES TO LIBOR?**

Some London-based banks have already started using other independent points of reference for pricing syndicated loans, especially dollar loans, but LIBOR is such a fundamental point of reference that it is unlikely to be supplanted any time soon.

ICAP, the inter-dealer broker, is proposing to create a new reference rate to be called the "New York Funding Rate", or "NYFR", as an alternative to LIBOR. NYFR would be based on an anonymous daily survey of at least 24 banks, which would each estimate the cost of funding for one and three-month loans to a "representative" bank. NYFR would then be calculated using the quotes of the middle half of that group. However, other than including a more representative sample of reference banks, the NYFR rate would still be based on estimated, rather than actual, inter-bank lending rates. Furthermore, ICAP has not indicated when the new index will be implemented.

### **WHAT HAPPENS NEXT?**

If any changes are planned as to the method of calculating LIBOR, the BBA has said that it will announce any changes proposed by the Foreign Exchange and Money Markets Committee after its meeting on 30 May.

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*We hope that you find this brief summary helpful. If you would like more information, or assistance in addressing or commenting on the issues raised in this client advisory, please feel free to contact:*

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