

## THE WHEATLEY REVIEW OF LIBOR

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**Abstract:** This paper provides a salient review of suggestions by the Wheatley review, an assessment of the reforms recommended in the report in terms of making the setting of LIBOR more trustworthy and an assessment of how well the reforms deal with ethical issues in the setting of LIBOR rates.

### I. Introduction

The London Inter-Bank Offered Rate (LIBOR) is the most frequently utilized benchmark for interest rates globally.<sup>1</sup> Although estimates vary, LIBOR is referenced by contracts with an outstanding value of at least \$300 trillion.<sup>2</sup> LIBOR was established in the 1980s as a fair and standardized interest rate benchmark for loans.<sup>3</sup> The benchmark is an indication of the costs of unsecured borrowing in the London inter-bank markets, which in essence gauges the interest rate, credit premium, and liquidity premium that a lending bank would expect to be offered by another similar institution.<sup>4</sup>

LIBOR is currently calculated by Thomson Reuters on behalf of the British Bankers' Association (BBA).<sup>5</sup> LIBOR is currently calculated across ten currencies and fifteen tenors (borrowing periods).<sup>6</sup> Contributing banks are asked to submit a response to the following question for each currency and tenor: "At what rate could you borrow funds, were you to do so by asking for and then

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<sup>1</sup> *The Wheatley Review of LIBOR: Final Report*, at 75 (Sept. 2012), available at [http://cdn.hm-treasury.gov.uk/wheatley\\_review\\_libor\\_finalreport\\_280912.pdf](http://cdn.hm-treasury.gov.uk/wheatley_review_libor_finalreport_280912.pdf).

<sup>2</sup> *Id.* at 75–76 (pointing out that estimates range from \$300-800 trillion).

<sup>3</sup> *Id.* at 75.

<sup>4</sup> *Id.*

<sup>5</sup> *Id.* at 76.

<sup>6</sup> *Id.* at 5.

accepting inter-bank offers in a reasonable market size just prior to 11 am?”<sup>7</sup> The highest and lowest submissions, sometimes more, are discarded and the remaining submissions are averaged to create LIBOR for a given day using this ‘trimmed mean’ approach.<sup>8</sup> Submissions are received just prior to 11:00 am and LIBOR is published between 11:30 am and 12:00 pm every London business day, leaving only an hour for verification and calculation procedures.<sup>9</sup>

There is an incentive for banks, and individuals working for banks, to attempt to manipulate their submissions that compile LIBOR in order to either signal their perceived institutional creditworthiness or to support trading positions.<sup>10</sup> Contributing banks do not need to borrow at all maturities and in all currencies every day, so LIBOR submissions involve an element of judgment and inference on the part of contributors.<sup>11</sup> This necessity for judgment by LIBOR contributors involves a discretion which can be misused and creates a conflict of interest; contributing banks are contributors of the rate, users of the rate, and wider participants in the market.<sup>12</sup> “It is already clear that at least some serious misconduct has taken place relating to LIBOR submissions in recent years.”<sup>13</sup>

Concerns regarding attempts to manipulate LIBOR with inaccurate submissions have received a great deal of attention following publication of the Financial Services Authority’s (FSA’s) findings against Barclays Bank plc in June of 2012.<sup>14</sup> Barclays was fined £59.5 million, after a thirty percent discount from the original £85 million fine for agreeing to settle at an early stage, for multiple infractions.<sup>15</sup> These infractions included making LIBOR submissions which took into account requests made by the bank’s interest rate derivative traders who sought to benefit Barclay’s trading positions, making LIBOR submissions that took into account concerns over the negative credit-signaling (stigma) effect of the bank’s LIBOR submissions, and failing to have adequate risk management systems or effective controls in place to reduce the extent of such misconduct relating to the bank’s LIBOR submission processes.<sup>16</sup>

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<sup>7</sup> *Id.* at 76.

<sup>8</sup> *Id.*

<sup>9</sup> *Id.* at 65.

<sup>10</sup> *Id.* at 75.

<sup>11</sup> *Id.* at 79.

<sup>12</sup> *Id.*

<sup>13</sup> *Id.*

<sup>14</sup> *Id.* (noting that this is only the first of a number of investigations the FSA is carrying out into contributing banks).

<sup>15</sup> *Id.* at 81.

<sup>16</sup> *Id.* (noting the FSA findings also dealt with similar violations in Barclay’s EURIBOR submissions).

“The [Wheatley] Review does not consider any specific allegations against particular financial institutions or individuals regarding attempts to manipulate LIBOR or other benchmarks.”<sup>17</sup> Instead, the Review submits suggestions for reforming LIBOR in a way that reestablishes credibility in the benchmark while promoting market integrity, consumer protection, and effective competition.

## II. Wheatley Review Recommendations

The recommendations accepted by the UK government will be put forward in the Financial Services Bill that acts as the legislative vehicle.<sup>18</sup> I summarize the Wheatley Review’s main recommendations.

### A. Imposing Regulations and Sanctions

Currently, neither submitting to nor administration of LIBOR is a regulated activity under the Financial Services and Markets Act of 2000 (FSMA).<sup>19</sup> The Wheatley Review promotes regulating submissions to LIBOR as this is where the highest risk of misconduct exists. Regulation of LIBOR administration ensures the maintenance of proper systems and controls for identifying and investigating suspicious submissions.<sup>20</sup> Such regulation allows the FSA<sup>21</sup> (or to certify only fit and proper individuals are participating in controlled functions. The FSA ensures accountability by being able to impose a public censure or financial penalty in addition to imposing regulatory requirements on a firm or individual engaging in inappropriate conduct.<sup>22</sup> Any costs passed on to banks or individuals, in order for the relevant individuals to be approved as a LIBOR contributor, are proportionate to the benefits realized.<sup>23</sup>

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<sup>17</sup> *Id.* at 5.

<sup>18</sup> *Id.* at 9.

<sup>19</sup> *Id.* at 11.

<sup>20</sup> *Id.* at 12.

<sup>21</sup> As of April 1<sup>st</sup>, 2013, the FSA has been replaced by two successor organizations. The Prudential Regulation Authority (PRA) will ensure the stability of financial services firms and be part of the Bank of England. The Financial Conduct Authority (FCA) is now the City of London’s regulator. The Bank of England has direct supervision for the whole of the banking system through the Financial Policy Committee (FPC), which can instruct the two new regulators.

<sup>22</sup> *Id.* at 13.

<sup>23</sup> *Id.* at 14.

A well-developed civil market abuse regime exists in the UK, but the regime was designed to capture market abuse in relation to financial instruments rather than activities such as benchmark manipulation.<sup>24</sup> The Wheatley Review proposes the UK continue to assist in the finalization of legislation which, brings the submission of false or misleading information in connection with benchmarks within the scope of market abuse regulations.<sup>25</sup> Once benchmark manipulation is brought within the purview of market abuse, the penalties should remain at or above the level set forth in the Barclay's case discussed earlier in section I.<sup>26</sup>

The UK has the option of opting in to CS-MAD, a directive requiring the establishment of criminal offenses for the most serious cases of market abuse.<sup>27</sup> These serious cases of market abuse include intentionally transmitting false or misleading information, providing false or misleading inputs, and other similar activity which intentionally manipulates the calculation of a benchmark.<sup>28</sup> Should the UK elect to not opt-in to CS-MAD, it is suggested that changes be made to Section 397 of the Financial Services and Markets Act of 2000 to enable the FSA to prosecute manipulation or attempted manipulation of LIBOR.<sup>29</sup> The extension of FSA's criminal investigation powers will be limited to offenses connected with the financial markets to avoid any overextension of investigative powers.<sup>30</sup> By making LIBOR manipulation a criminal offense, the actions of others who attempt to persuade submitters to submit false figures, attempt to manipulate benchmarks through collusion, or conspiring with others to commit the offense also qualify as criminal offenses.<sup>31</sup>

There is broad support in favor of making LIBOR submissions a regulated activity.<sup>32</sup> By granting regulatory power over both the submissions to and oversight of LIBOR, there is greater assurance that LIBOR will be trustworthy. The regulations should serve to deter attempts at manipulating the benchmark as well as provide accountability for when individuals engage in such behavior.

Independent supervision of LIBOR assists in eliminating the ethical concern of conflicts of interest regarding benchmark oversight. In addition, false or misleading statements that will otherwise be submitted out of greed are deterred due to the potential civil, and possibly criminal, penalties that may be

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<sup>24</sup> *Id.* at 15.

<sup>25</sup> *Id.* at 15–16.

<sup>26</sup> *See id.* at 17.

<sup>27</sup> *Id.* at 15.

<sup>28</sup> *Id.* at 17.

<sup>29</sup> *Id.* at 18.

<sup>30</sup> *Id.*

<sup>31</sup> *Id.* at 19.

<sup>32</sup> *Id.* at 12.

imposed as a result. In turn, the implementation of regulations and sanctions promotes the credibility of LIBOR and hedges out unethical practices by LIBOR contributors.

## **B. Reorganization, Internal Governance, and Oversight**

The BBA acted as the lobbying organization for the same submitting banks that it oversees.<sup>33</sup> This creates a conflict of interest precluding strong and credible governance of LIBOR.<sup>34</sup> The Wheatley Review recommends that the role of future administration and governance of LIBOR be passed to a private organization demonstrating greater independence, specific oversight processes, transparency, and a firm commitment to providing access to the benchmark on fair and non-discriminatory terms.<sup>35</sup> The membership of this new committee should include an independent chairperson and representatives from the Government and FSA, the BBA, and a variety of other market participants.<sup>36</sup> This committee will, in turn, make a recommendation as to the preferred candidate to take ownership of LIBOR, and the BBA will be expected to transfer ownership and responsibility to such candidate.<sup>37</sup>

The new framework entails a benchmark administrator responsible for the day-to-day management of LIBOR, public relations responsibilities, pre-publication verification checks (to avoid manifest errors in submissions) and post-publication scrutiny of submissions from contributing banks, defining procedures and criteria for banks to become members of LIBOR panels and setting out the responsibilities and notice period for banks considering leaving the LIBOR panels, and determining technical and operational procedures for submitting rates to LIBOR.<sup>38</sup> An independent and powerful oversight committee is included in the framework to oversee many of the decision-making and technical discussions as well as enforce low-level sanctions with respect to participating banks.<sup>39</sup> Meanwhile, all other breaches are referred to the FSA for supervisory review.<sup>40</sup>

Again, this restructuring aims to curtail conflicts of interest, a main ethical concern with the current structure of LIBOR. Taking oversight out of the hands of the submitting banks' lobbying institution and placing it under the power of an

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<sup>33</sup> *Id.* at 21.

<sup>34</sup> *Id.*

<sup>35</sup> *Id.* at 22.

<sup>36</sup> *Id.* at 23.

<sup>37</sup> *Id.*

<sup>38</sup> *Id.* at 24.

<sup>39</sup> *Id.* at 25.

<sup>40</sup> *Id.*

independent administrator and oversight committee, establishes more effective and structurally reasonable system. The incentive to forego regulation of questionable LIBOR submission is removed as the same conflicts of interest will no longer exist. This leads to greater enforcement of existing and future market rules and principles.

### **C. Corroboration of LIBOR Submissions with Transaction Data**

“LIBOR submissions should be explicitly and transparently supported by transaction data.”<sup>41</sup> The Wheatley Review suggests the LIBOR administrator, through the oversight committee, draft a code of conduct that serves as a manual for the internal governance and organization of LIBOR submissions.<sup>42</sup>

This code of conduct should cover the following:

1. The role and explicit use of transaction data
2. A requirement to keep accurate and accessible internal records of all transactions in the inter-bank deposit market and other relevant markets
3. Validation and corroboration procedures
4. Policies for the training of LIBOR submitters
5. A requirement for all institutions to have in place suspicious submission reporting procedures to the rate administrator and oversight committee for review
6. An outline of personal responsibilities within each firm that includes internal reporting lines and accountability
7. Implementing disciplinary and/or whistle-blower procedures for manipulation attempts or failure to report manipulation attempts
8. Installation of effective conflicts of interest management procedures and communication controls to avoid inappropriate external influence
9. Retention of records related to the submission process
10. Requirements for an annual internal audit and regular compliance reviews
11. Requirements for a less common external audit.<sup>43</sup>

Presently, submitting banks do not have to record the trade data used to support their LIBOR submissions.<sup>44</sup> Requiring expert judgment to be corroborated by

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<sup>41</sup> *Id.* at 27.

<sup>42</sup> *Id.* at 30.

<sup>43</sup> *Id.* at 31–32.

transaction records will facilitate oversight and assurance that LIBOR submissions are not arbitrary attempts to manipulate the benchmark. It is true that transaction data will not be available for all currencies and tenors. However, LIBOR contributors should still be able to record data supporting their expert judgment by way of:

1. Observations of third party transactions in the same markets
2. Quotes by third parties offered to contributing banks in the same markets
3. Techniques for interpolation or extrapolation from available data
4. Changes in relative credit standing of the contributor banks and other market participants and other similar information.<sup>45</sup>

This requirement of some corroboration would assist in preventing dishonesty by increasing accountability and detection of false LIBOR submissions.

#### **D. Reducing the Number of Currencies and Tenors of LIBOR**

LIBOR was originally published for only three currencies.<sup>46</sup> This number increased to ten currencies.<sup>47</sup> The number of maturities published under LIBOR has likewise increased from twelve to fifteen.<sup>48</sup> Three and six month tenors are used the most often in contracts, while the use of others is very limited.<sup>49</sup> The three originally published currencies (U.S. dollar, yen, and sterling) continue to be, by far, the most widely used.<sup>50</sup> Due to the lack of regular transactions for many of the currencies and tenors for which LIBOR is calculated, there is more room for discretion in submissions.<sup>51</sup> A lack of transparency may result in reliance upon an arbitrary benchmark based on these types of submissions, since the submissions are being given legitimacy despite a lack of transaction data to corroborate the rate submissions. Improved transparency allows LIBOR users to see the volumes of the inter-bank transactions that underpin the benchmark and allow them to understand the extent to which expert judgment was used for a given LIBOR benchmark.<sup>52</sup> The Wheatley Review supports a reduction of LIBOR benchmarks published daily from 150 to 20, eliminating benchmarks that

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<sup>44</sup> *Id.* at 33.

<sup>45</sup> *See id.* at 28.

<sup>46</sup> *Id.* at 76.

<sup>47</sup> *Id.*

<sup>48</sup> *Id.*

<sup>49</sup> *Id.* at 79.

<sup>50</sup> *Id.*

<sup>51</sup> *See id.* at 36.

<sup>52</sup> *Id.* at 40.

are both difficult to support using trade data and are not heavily used by market participants.<sup>53</sup> Benchmarks to be eliminated include all LIBORs for Australian Dollars, Canadian Dollars, Danish Kroner, New Zealand Dollars, Swedish Kronor, and tenors of four, five, seven, eight, ten, and eleven months for all remaining currencies.<sup>54</sup>

The remaining rates will be more easily supported by trade data and are heavily used by market participants.<sup>55</sup> As mentioned, there are over \$300 trillion in contracts referencing LIBOR. Any elimination of particular LIBOR rates will need to be preceded by a significant and public notice period to allow for an orderly transition to alternative rates and arrangements.<sup>56</sup>

Elimination of arbitrarily-set LIBOR submissions due to a lack of transactional data regarding certain currencies and tenors, in and of itself does not eliminate ethical issues surrounding the setting of LIBOR. What the ridding of arbitrary LIBOR submissions achieves is to eliminate the need for speculation, which in turn reduces the opportunity to manipulate benchmarks. When the transaction data is simply not there, it is reasonable to rely on currency benchmarks calculated in domestic jurisdictions where there is greater liquidity of transactions in the domestic markets compared with LIBOR.<sup>57</sup> This creates more representative benchmarks to rely upon by parties referencing the benchmark and decreases the incentive to speculate in ways that attempt to manipulate the benchmarks with misleading submissions.

#### **E. Increasing Participation in LIBOR Panels**

The Wheatley Review encourages banks to participate as widely as possible in the LIBOR compilation process.<sup>58</sup> LIBOR will lack sufficient submissions to be an accurate reflection of bank borrowing costs and will eventually fail in the absence of participating banks.<sup>59</sup> Larger panels increase the overall representativeness of LIBOR benchmarks as well as ensure that each individual submission has a limited impact on the published benchmark thus, discouraging attempts to manipulate LIBOR.<sup>60</sup> At this point, the Wheatley Review encourages bank participation in LIBOR panels and recommends the

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<sup>53</sup> *Id.* at 36–37.

<sup>54</sup> *Id.* at 37.

<sup>55</sup> *Id.*

<sup>56</sup> *Id.* (suggesting a 12-month transition period).

<sup>57</sup> *Id.* at 36.

<sup>58</sup> *Id.* at 35.

<sup>59</sup> *Id.* at 38.

<sup>60</sup> *Id.*



government legislate to provide FSA with an express reserve power to compel LIBOR submissions by banks, as this compulsion might be necessary in the future.<sup>61</sup>

An increase in the number of submissions results in a larger pool of data upon which submissions attempting to manipulate the benchmark will have less of an effect. This discourages unethical misrepresentations and possibly fraud. This may be a secondary impact, with the primary interest being an increase in the overall representativeness of the LIBOR benchmark. Even if the impact on ethical violations may be insignificant, an increase in participation by banks serves to strengthen the credibility of LIBOR.

### III. CONCLUSION

LIBOR, in its current state, leaves contributing banks with opportunity and motive to attempt to manipulate benchmarks with their submissions. This behavior both undermines the credibility of LIBOR and illustrates ethical concerns in the benchmark's framework. Allowing LIBOR contributors to speculate on rates, without corroboration using transaction data, creates individual conflicts of interest. Additionally, placing LIBOR oversight responsibilities in the BBA is indicative of institutionally-mandated conflicts of interest. It is no surprise, then, that serious misconduct has taken place relating to LIBOR submissions in recent years. The credibility of LIBOR is undermined. Reform is necessary to resolve the unethical behaviors surrounding the setting of LIBOR and resurrect trust in the most frequently utilized benchmark for interest rates globally. Adoption of the Wheatley Review's recommendations set out in the final report, outlined in this paper, serves as a starting point to deal with unethical attempts by contributing banks to manipulate LIBOR benchmarks. Such reform makes the setting of LIBOR more trustworthy.

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<sup>61</sup> *Id.* at 39.