LIBOR, Part II: What Can Be Done

Simon Johnson explains that LIBOR must be changed from a hypothetical to a real rate but that problems could arise from relying on it in a financial crisis like the one in 2008.

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Steve Weisman: This is Steve Weisman at the Peterson Institute for International Economics with Simon Johnson, my colleague, Senior Fellow here and also a professor at MIT, talking about the Libor scandal. We've just discussed the scope of the scandal and the significance and a little bit of the technical aspects of how it worked. Let's talk now about what should be done in the wake of this scandal.

Simon Johnson: The main problem is that Libor is not based on actual transactions. It's based on people saying and reporting—supposedly honestly reporting—the rate at which they could have borrowed at 11 AM in a particular currency at a particular maturity in London. The London Interbank Offered Rate, and the problem with the system is clearly, first of all, people are not honest.

Secondly, they have a massive incentive not to be honest. Thirdly, the ability of the institutions where they work to control their honesty is broken or demonstrated to be completely incapable of having them report honestly. So you have to move away from the hypothetical reporting they do now towards using actual transaction data.

Steve Weisman: The banks argue that these transactions have to be notional because they don't actually do the trading that they're being asked to say what the numbers would be for that trading.

Simon Johnson: I think you raise an interesting question, which is whether there is some trading at some maturities in some currencies that you could use as a benchmark on a daily basis, and I think there is.

Steve Weisman: Is there?

Simon Johnson: Because I think overnight dollars -- three-month dollars for example -- these are pretty big markets in ordinary times. There may be other currencies and other maturities that are relatively less traded and I think those should not be used in that case as references for securities.

This may cause some inconvenience and certainly this is a question of how to unwind the current position. But using as a benchmark anything that must by its nature be hypothetical isn't going to work. Mervyn King, the Governor of the Bank of England, said it very well recently, "'My word is my Libor' is dead." I think that's exactly what you've got to move away from.

Steve Weisman: It's remarkable.

Simon Johnson: Look, it is at one level astonishing and astounding and confirms many of the criticisms of the financial sector. At the same time, many people who have been in the financial sector, who

have worked around these markets for a long time, say, "Yes, it's been going on there. It's been going on—we've had it. We've known this was out and about for many years." To which my reaction is well, first of all, thanks for telling us earlier and secondly, this has to stop.

Steve Weisman: Going from a hypothetical to a real set of numbers can be accomplished. What other structural changes should be made?

Simon Johnson: I think the caveat on moving to actual transaction data is: what happens in a crisis? Let's say that three-month Libor is always traded in good times, but we face some sort of liquidity crisis or some sort of concern about the sovereignty of banks as we faced in the fall of 2008, for example.

Steve Weisman: Right.

Simon Johnson: Then Libor may dry up. Then the question is what rate should you use as a reference?

Steve Weisman: To determine spreads or …

Simon Johnson: The pricing of derivatives would be a key thing.

Steve Weisman: I see.

Simon Johnson: Other products where the interest rate is Libor-plus or some basis points.

Steve Weisman: What's your solution?

Simon Johnson: I think that's a pretty hard question. You have to look for example, at alternatives like the Federal Funds Rate, which of course is the rate in the United States, a rate much more directly under the control of the Federal Reserve System. The origin of Libor, if you go back to the eurodollar market in the '60s and '70s -- the idea was to escape a rate, move away from a rate that the U.S. could control, particularly when you're worried about inflation. The Federal Funds Rate could be held down, for example, by a central bank that wasn't concerned about inflation. Libor could rise. Libor was the market rate, and I think that's a legitimate concern, and a reasonable protection for people entering into credit transactions. But this entire structure of the problem now has to be reassessed.

Steve Weisman: Is there some kind of global Libor that could be created that is somehow broader than the current Libor, but not dominated by the United States? What might such a solution look like?

Simon Johnson: You have to base it on actual transactions, on what banks are actually doing and—at least at the moment—the Global Offshore Dollar Market is the biggest market. There are certainly transactions going on in that market on a daily, hourly basis. The problem is: what would happen in a crisis? What does the future look like? That's very hard to say. What are you going to do if there are no actual transactions? That is a problem that needs to be addressed.

Steve Weisman: Looking at the regulatory structure in London and the United States, what needs to happen—more intrusive monitoring by the government in these institutions, more institional accountability enforced in some way?

Simon Johnson: There certainly needs to be more disclosure, more transparency. You need to see the amounts actually borrowed. That has to be a reported number available in real time to people in the markets. These have been much more behind closed doors kinds of transactions in the past. And the financial sector as a whole has to open up about this.

I would not say, oh well, have the regulators come in and keep an eye on this. They will be captured again as they have always been captured in the history of regulation. So, I think that having the market be able to see actual transactions and observe the terms of those transactions, that's what we have in the stock market.

We don't base indices, stock market indices, around hypotheticals or what a regulator says that somebody could have sold one share of GM at. It's actual transactions. We watch that and we worry about manipulation, by the way. In those markets, we worry about high-speed trading. We worry about other issues for sure, but we see the transactions.

Steve Weisman: What does this tell us about the nature of the derivatives market?

Simon Johnson: I think it confirms or offers further evidence in support of the position that having opaque, over-the-counter markets is potentially dangerous. We want more out in the open. We want more transparency in terms of the accounting around derivatives.

We should be moving away from the U.S. preferred system, where you allow a lot of netting of derivatives, which shows a smaller position on the balance sheet of big banks, towards what the Europeans use under the IFRS, international financial accounting standards, where you are less generous to the banks in terms of their netting. That shows you more accurately, I would argue, the true potential downside losses of banks when derivative markets turn against them.

Steve Weisman: Is that likely to lead to fewer derivatives transactions or just more clarity?

Simon Johnson: It would lead to more clarity. It would increase the pressure for the big banks to strengthen their equity positions relative to the total balance sheets. In that context I would not be surprised if the total amount of derivatives traded declined.

Steve Weisman: Thank you, Simon.

Simon Johnson: Thanks a lot.