Reforming LIBOR and Other Financial Market Benchmarks

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Abstract

LIBOR is the London Interbank Offered Rate: a measure of the interest rate at which large banks can borrow from one another on an unsecured basis. LIBOR is often used as a benchmark rate—meaning that the interest rates that consumers and businesses pay on trillions of dollars in loans adjust up and down contractually based on movements in LIBOR. Investors also rely on the difference between LIBOR and various risk-free interest rates as a gauge of stress in the banking system. Benchmarks such as LIBOR therefore play a central role in modern financial markets. Thus, news reports in 2008 revealing widespread manipulation of LIBOR threatened the integrity of this benchmark and lowered trust in financial markets. We begin with a discussion of the economic role of benchmarks in reducing market frictions. We explain how manipulation occurs in practice, and illustrate how benchmark definitions and fixing methods can mitigate manipulation. We then turn to an overall policy approach for reducing the susceptibility of LIBOR to manipulation before focusing on the practical problems of how to make an orderly transition to alternative reference rates without raising undue legal risk.

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