London Interbank Offered Rate

The London Interbank Offered Rate (or LIBOR, pronounced /ˈlaɪbɔːr/) is a daily reference rate based on the interest rates at which banks borrow unsecured funds from other banks in the London wholesale money market (or interbank market). Alternatively, this can be seen from the point of view of the banks making the 'offers', as the interest rate the banks will lend to each other, that is 'offer' money in the form of a loan for various time periods (maturities) and in different currencies.

Introduction

In 1984 it became apparent that an increasing number of banks were trading actively in a variety of relatively new market instruments, notably interest rate swaps, foreign currency options and forward rate agreements. While recognizing that such instruments brought more business and greater depth to the London Interbank market, bankers worried that future growth could be inhibited unless a measure of uniformity was introduced. In October 1984 the British Bankers’ Association—working with other parties, such as the Bank of England—established various working parties, which eventually culminated in the production of the BBAIRS terms—the BBA standard for interest rate swaps. Part of this standard included the fixing of BBA interest-settlement rates, the predecessor of BBA LIBOR. From 2 September 1985 the BBAIRS terms became standard market practice.

BBA LIBOR fixings did not commence officially before 1 January 1986, although before that some rates were fixed for a trial period commencing in December 1984.

Member banks are international in scope, with more than sixty nations represented among its 223 members and 37 associated professional firms (as of 2008).

Scope

LIBOR rates are widely used as a reference rate for financial instruments such as

- forward rate agreements
- short-term-interest-rate futures contracts
- interest rate swaps
- inflation swaps
- floating rate notes
- syndicated loans
- variable rate mortgages[1]
- currencies, especially the US dollar (see also Eurodollar).

They thus provide the basis for some of the world's most liquid and active interest-rate markets.

For the Euro, however, the usual reference rates are the Euribor rates compiled by the European Banking Federation, from a larger bank panel. A Euro LIBOR does exist, but mainly for continuity purposes in swap contracts dating back to pre-EMU times. LIBOR is an estimate and not interred in the legally binding contracts of an LLC. It is however specifically mentioned as a reference rate in the market standard International Swaps and Derivatives Association documentation, which are used by parties wishing to transact in over-the-counter interest rate derivatives.

LIBOR is used by the Swiss National Bank as their reference rate for monetary policy[2]
**Technical features**

LIBOR is calculated and published by Thomson Reuters on behalf of the British Bankers' Association (BBA) after 11:00 am (and generally around 11:45 am) each day (London time). It is a trimmed average of inter-bank deposit rates offered by designated contributor banks, for maturities ranging from overnight to one year. LIBOR is calculated for 10 currencies. There are either eight, twelve or sixteen contributor banks on each currency panel and the reported interest is the mean of the middle values (the interquartile mean). The rates are a benchmark rather than a tradable rate, the actual rate at which banks will lend to one another continues to vary throughout the day.

LIBOR is often used as a rate of reference for Pound Sterling and other currencies, including US dollar, Euro, Japanese Yen, Swiss Franc, Canadian dollar, Australian Dollar, Swedish Krona, Danish Krone and New Zealand dollar.[3]

In the 1990s, Yen LIBOR rates were influenced by credit problems affecting some of the contributor banks.

For a precise definition of BBA LIBOR, see: The BBA LIBOR fixing & definition.[4]

Six-month USD LIBOR is used as an index for some US mortgages. In the UK, the three-month GBP LIBOR is used for some mortgages—especially for those with adverse credit history.

**Definition of LIBOR**

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 inter-bank offers in reasonable market size, just prior to 11.00 London time."

This definition is amplified as follows:-

- The rate at which each bank submits must be formed from that bank’s perception of its cost of funds in the interbank market.
- Contributions must represent rates formed in London and not elsewhere.
- Contributions must be for the currency concerned, not the cost of producing one currency by borrowing in another currency and accessing the required currency via the foreign exchange markets.
- The rates must be submitted by members of staff at a bank with primary responsibility for management of a bank’s cash, rather than a bank's derivative book.
- The definition of "funds" is: unsecured interbank cash or cash raised through primary issuance of interbank Certificates of Deposit.

**LIBOR-based derivatives**

**Eurodollar contracts**

The Chicago Mercantile Exchange's Eurodollar contracts are based on three-month US dollar LIBOR rates. They are the world's most heavily traded short term interest rate futures contracts and extend up to ten years. Shorter maturities trade on the Singapore Exchange in Asian time.

**Interest rate swaps**

Interest rate swaps based on short LIBOR rates currently trade on the interbank market for maturities up to 50 years. A "five year LIBOR" rate refers to the 5 year swap rate vs 3 or 6 month LIBOR. "LIBOR + x basis points", when talking about a bond, means that the bond's cash flows have to be discounted on the swaps' zero-coupon yield curve shifted by x basis points in order to equal the bond's actual market price. The day count convention for LIBOR rates in interest rate swaps is Actual/360.
Reliability

On Thursday, 29 May 2008 the Wall Street Journal released a controversial study suggesting that banks may have understated borrowing costs they reported for LIBOR during the 2008 credit crunch. Such underreporting could have created an impression that banks could borrow from other banks more cheaply than they could in reality. It could also have made the banking system or specific contributing bank appear healthier than it was during the 2008 credit crunch.

For example, the study found that rates at which one major bank "said it could borrow dollars for three months were about 0.87 percentage point lower than the rate calculated using default-insurance data."

In response to the study released by the WSJ, the British Bankers' Association announced that LIBOR continues to be reliable even in times of financial crisis. According to the British Bankers' Association, other proxies for financial health, such as the default-credit-insurance market, are not necessarily more sound than LIBOR at times of financial crisis, though they are more widely used in Latin America, especially the Ecuadorian and Bolivian markets.

Additionally, other authorities have contradicted the Wall Street Journal article. In their March 2008 Quarterly Review, The Bank for International Settlements have stated that "available data do not support the hypothesis that contributor banks manipulated their quotes to profit from positions based on fixings". Further, in October 2008 the International Monetary Fund published their regular Global Financial Stability Review which also found that "Although the integrity of the U.S. dollar LIBOR-fixing process has been questioned by some market participants and the financial press, it appears that U.S. dollar LIBOR remains an accurate measure of a typical creditworthy bank’s marginal cost of unsecured U.S. dollar term funding".

See also

- Euribor
- TIBOR
- Prime rate
- Ted spread
- Libor-OIS spread
- LIBID
- MIBOR
- JIBAR

References

Further reading


External links

- LIBORATED.COM (http://www.liborated.com), News, rates, education, opinion, calculator, graphs
- BBALIBOR.COM (http://www.bbabor.com), including historical worldwide rates, on the British Bankers' Association website
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