Box D

Interbank Reference Rates

Many financial contracts, including those governing derivatives and debt securities, reference interbank interest rates. The process by which these reference rates are set has been called into question by the recent findings of authorities in the UK and US that Barclays Bank attempted to manipulate the rate fixings within the London and European markets. A number of other financial institutions are also being investigated for similar misconduct.

Reference rates for term borrowing and lending are usually compiled by industry associations and are not taken from actual market transactions. As such, the credibility of these surveys is largely dependent upon the liquidity and transparency of the market they are referencing. In contrast, overnight reference rates are usually compiled by the central bank as a weighted average of rates transacted within the interbank market. For example, to compile the Australian dollar cash rate, the Reserve Bank surveys 25 banks each day on the details of their overnight borrowing and lending.

In the London market, the British Bankers' Association (BBA) publishes interbank borrowing rates for 10 currencies, including the Australian dollar. These rates, which extend to 12-month maturities, are known as London Interbank Offered Rates (LIBOR).

For each currency, the BBA appoints a panel who submit the rates at which they could borrow unsecured funds in the interbank market. Specifically, the respondents are asked: 'At what rate could you borrow funds, were you to do so by asking for and then accepting interbank offers in a reasonable market size just prior to 11 am?' The integrity of the LIBOR fix therefore relies upon the respondents submitting accurate data about their own (actual or potential) borrowings. The panellists' individual contributions are published by the BBA each day.

While LIBOR fixings are commonly used as reference rates in British pounds, Swiss francs and US dollars, they do not have a similar status in the other currencies for which LIBOR fixings are available. The comparable reference rates for euros are Euribor (Euro Interbank Offered Rates), as published by the European Banking Federation (EBF). The EBF's panel of contributors currently has 43 members, whose credit ratings range from AA to CCC. However, the EBF defines Euribor as the rate at which '… euro interbank term deposits are offered by one prime bank to another prime bank'. Consequently, unlike the BBA survey, the EBF is not asking respondent banks where they themselves could borrow, but are asking for an assessment of where a representative bank could borrow.

To mitigate the influence of an individual contributor, the survey responses for LIBOR and Euribor are both trimmed of a set number of top and bottom respondents before being averaged.

The findings of the UK and US authorities were that, on repeated occasions between 2005 and 2009, Barclays Bank submitted rates to the BBA and EBF that were false and that were designed to benefit the derivative positions held by Barclays. In some instances, Barclays also appeared to accommodate requests from traders at other firms when making its submissions, and traders employed by Barclays were found to have sought to influence the submissions made by other contributing banks.

The UK and US authorities also found that some of the LIBOR submissions made by Barclays were influenced by a desire to avoid negative perceptions about the relative funding position of the bank. From mid 2007, term (unsecured) money market activity was curtailed in many currencies, making it difficult for LIBOR panellists to determine the correct rates to submit to the BBA. On various occasions, Barclays was found to have set its submissions so that its borrowing costs did not appear too high relative to other contributing banks.

Only a small number of financial contracts are referenced to Australian dollar LIBOR. Instead, the market convention is to reference Australian dollar derivatives and floating rate debt securities against the bank bill swap reference rates (BBSW) published by the Australian Financial Markets Association (AFMA).

To compile BBSW, AFMA surveys 14 banks operating in the domestic market. These banks report where prime bank bills were priced at 10 am for each monthly maturity out to six months. A trimmed mean is then calculated and published as BBSW, with the individual survey responses also published.

Hence, unlike the BBA's LIBOR survey, AFMA is not surveying the respondents about their own borrowing costs. AFMA's survey is more akin to the EBF's Euribor survey in that it is surveying respondents on prime banks' borrowing costs. However, unlike the EBF, AFMA specifically designates who the prime banks are.

In a process overseen by AFMA, money market participants select the prime banks each year, subject to minimum credit rating and issuance size criteria. The purpose is to ensure that buyers of prime bank bills and certificates of deposits (CDs) in the interbank market will be indifferent between receiving securities issued by any of the prime banks. This significantly enhances the liquidity of the market. At the present time, only the four major Australian banks are designated as prime banks. In earlier years, certain foreign banks active in the Australian market had been selected as prime; however, these banks no longer meet the minimum criteria.

Interbank trading in prime bank bills and CDs is concentrated around 10 am and is mostly conducted over broker screens, imparting a great deal of transparency to the market. The most actively traded bills and CDs are those with one, three and six months to maturity.[1] (Contributions for two, four and five months often need to be imputed by respondents, however. This is possible because of the close price points at one, three and six months.)

1 To aid liquidity, bill and CD maturities are grouped into half-month periods ('early' and 'late' month). Consequently, a 3-month bill purchased on 1 August could mature on any date between 1 November and 15 November and could be sold as a 3-month bill up until 15 August.