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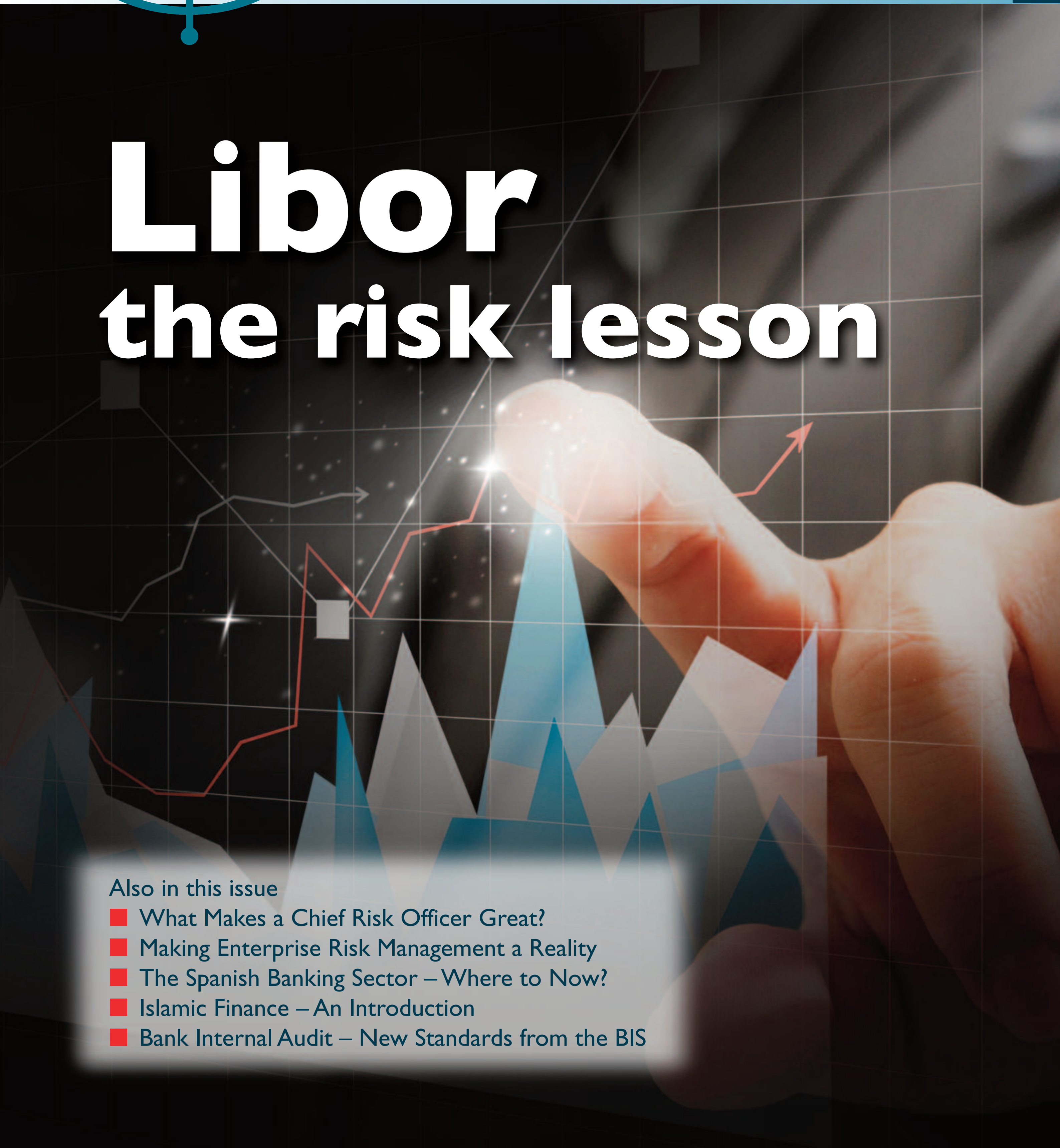
The quarterly independent risk review for banks and financial institutions worldwide

10 Years and Growing

AUGUST 2012



Libor the risk lesson

Also in this issue

- What Makes a Chief Risk Officer Great?
- Making Enterprise Risk Management a Reality
- The Spanish Banking Sector – Where to Now?
- Islamic Finance – An Introduction
- Bank Internal Audit – New Standards from the BIS

Libor – the Risk Lesson

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The banking world has been rocked again – this time by what may prove to be the fraudulent quotation of the London Interbank Offered Rate (Libor). Libor has been used as a funding benchmark since it was used for pricing floating rate loan and bond products in 1970, and has become the principle rate used for many products in London and elsewhere, in many currencies and for many maturities. The British Banking Association (BBA) have owned and been responsible for Libor since 1986 and regard the misuse of Libor very seriously.

As press and media attention is being given to the Libor 'scandal' and Parliamentary sponsored enquiries and the Serious Fraud Office investigation gird themselves to identify wrongdoing and search for those responsible, work is in progress to rehabilitate Libor and make it fit for purpose for modern markets. These initiatives are crucial for industry and political reasons and will no doubt take quite a while to come to full fruition. But behind the scenes the much less exciting or newsworthy task of examining what lessons there are for risk managers has been well underway. The success of any changes that will be made will be the key factor in determining how banks can avoid the massive damage to their reputations such episodes can bring.

Much will be learned in the upcoming investigations about the mistakes made and how internal processes and controls failed to identify such a serious problem. Risk managers don't need to wait before reviewing their own internal procedures and simulate how to react to the overt or accidental misquoting of rates.

Before a judgement can be made on whether or not fraud took place (in any of the banks involved) it is necessary to pull together the mechanism of how Libor was agreed internally, who had the obligation of sign off, which internal departments were involved or informed, and how far up the management tree any 'outlier' rates were reported. Board level oversight of Libor will not escape scrutiny.

Libor quotations can only originate from the trading desks or wherever treasury and rates businesses are located. What matters is the verification of the quoted rates by a function independent of any P/L responsibilities for trading operations. For decades dealing rooms and eventually the BBA would contact each other to agree rates for multiple maturities and currencies. This worked smoothly, with some disruption during times of significant market stress, and no sense of collusion or internal abuse dented the confidence in Libor. Its success led to Libor being used as a benchmark for many products, some of which it was not suited for – such as US sub-prime and some liability products. Whilst it is not the most pressing concern at the moment the risk of using the wrong benchmark is one that will have to be managed properly in future and is bound to have an effect of interest rate pricing policy. This is another example of how far the suitability test needs to permeate RM.

Irrespective of whatever misdeeds occurred there has been plenty of room for mistakes to have been made in quoting Libor as pure rates

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markets evolved and became cross fertilised with derivative and collateralised products. Libor began as a funding rate in the London market for Sterling and Euro products alike and became the central rate for pricing IRS among other products. Rates desks became split between trading in repos, IRS, FRAs, futures, treasuries and other products, and the traditional treasury function became subsumed obscuring the rates that applied to pure funding. For a long while the various interest rate curves associated with these products were not far apart and they tended to move in tandem. It was only when the dislocation of unsecured interbank wholesale markets became obvious (in H2 2007, and especially 2008) that the cost of funds moved significantly higher than derivative and collateralised curves.

With the benefit of hindsight the risks of mis-quoting crept up on banks without risk mangers being aware of them or realising the damage that might be caused by a curve being fixed some way away from the true cost of funds. We now know that traders quoting Libor were gaming internal P/L revaluations, but it is highly likely that Libor quotes were simply based on the wrong curve as well. The RM task is to prevent or discover misquotation whether caused by mistake or mischief. Many of the lessons learned in early 2000s from the Allfirst, (a North American Bank) and National Australia Bank cases of FX rate manipulation are transferable to how to address the risk mitigation applicable to quoting Libor rates. In both of these cases, FX losses were hidden by false revaluations which were not picked by any function outside the dealing room.

The RM lessons to be learned from this crisis can probably be divided in to five categories:

- Ensuring that those responsible for quoting the rate (whether internally or to the BBA as calculating agent) use a rate that reflects the rate at which funding is available in the London market, or an agreed proxy for that rate. This should be confirmed by or originate from the treasury desk of the bank and be the rate used by financial control, probably along with other rates relevant to off balance sheet and derivative positions.
- The Middle Office should ensure the alignment of the right rates for different interest rate products and act fully independently of the front office. The MO should do so for control and reporting purposes and have oversight of how those rates are used in lending or other, fixed income, or other product pricing divisions.
- Audit, finance compliance and risk departments must be adequately resourced with staff that understand interest rate structures, or be able to source independent skills internally or externally to interrogate benchmark rate fixings. They must also be adequately empowered to provide independent oversight and escalation.
- The reporting of Libor and other rate fixing through the RM division up to board level. There are at least three key risks to be monitored: the reputation risk to the bank; the legal risk of exposure to fraud; and the misuse of rates for product pricing purposes.
- The board and senior management in turn are responsible for establishing the right risk culture "From the top". This is where there is a shared understanding of what is acceptable (and tangible consequence when behaviour deviates from this), they lead by example, there is clarity of accountability, transparency in decision making, remuneration and reward structures that drive the right behaviours and balanced outcomes and where there is respect for others particularly those in control functions such as Risk Management.

Waiting for the outcome of current investigations is not an option for the RM response to this latest crisis. It is not necessary to know the motives of those responsible to be able to upgrade RM and the whole risk culture of the organisation to give assurance that the legal, reputational and financial welfare of the bank is prioritised. If that work is not already underway, it should start immediately "From the top".

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