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Time is nigh to rethink the role of benchmarks

New indices should reflect lessons learnt from recent scandals

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Worldwide investigations into financial benchmarks have been under way for years now and the list of suspect benchmarks continues to grow.

It now includes headliners such as Libor, Euribor, Tibor, ISDAfix, Platts and foreign exchange, with potentially more to come. Hundreds of trillions of dollars in contracts and trades are anchored to these benchmarks, impacting financial markets across the globe.

These recent scandals have shaken the market's confidence in benchmarks. Market participants are beginning to understand that too many benchmark systems are structured to provide the means, motive and opportunity to collude and manipulate these important numbers.

Re-establishing confidence will require a major restructuring of the ways in which these benchmarks are set. To this end, Iosco's guidelines for financial benchmarks provide a good starting point, but such changes still need to be put in place and adequately monitored.

Restoring confidence will also require market participants to better understand which indices are more appropriate to their needs. Not every benchmark reflects the same type of risk or the same type of lending, and understanding these differences will be important. Expect to see innovative benchmarks, some of which may replace existing benchmarks while others serve the needs of particular market niches.

But how can an investor sort out which to use for their specific investment? Let's go back to Libor. It is a benchmark for the costs of unsecured borrowing in the London interbank market for a small group of banks with minimal credit risk. These costs reflect compensation for the time value of money, a credit premium and a liquidity premium that a highly-rated bank should expect to be offered by one with a similar credit risk profile.

Though all interest rates reflect the time value of money, they can significantly vary with respect to how much credit and liquidity risks they incorporate, or whether the loan is secured or not. Secured, or collateralised, lending is cheaper since if the borrower defaults, the lender will have immediate recourse to collateral to cover some or all of the loan value.

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If a credit premium is not an important feature of the investor's contract, then she may opt for a Treasury bill benchmark of the appropriate tenor, such as the Federal Funds Rate, the rate at which depository institutions lend to each other, may also be an option, or the Overnight Index Swap. All of these are well known and established benchmarks.

When counterparty risk is a key component of an investment, indices primarily based on unsecured lending such as Libor, commercial paper or certificate of deposits will be more suitable.

How do these benchmarks differ from each other? During normal economic times, the credit risk of Libor contributing banks is quite low but is highly correlated with other low risk/high liquidity rates. During stressful economic times these measures can significantly diverge, since at the same time that credit risk may increase leading to higher Libor and credit default spreads, softer monetary policy will lower interest rates.

But "stressful times" are precisely when an investor wants to be referencing the appropriate benchmark. It is also the reason why indices such as Libor, which reflect credit risk, will always have a role to play.

That said, in the last few years collateralised lending has been increasing in importance to the detriment of unsecured lending. This is not surprising given the depth of the financial crisis and the market's stronger preference for collateral.

Benchmarks of the future need to be based on actual trades whenever possible

This, coupled with the flawed structures of many existing benchmarks opened the doors for newer indices to be developed. An example of such a benchmark is DTCC GCF Repo Index, based on actual repo transactions. This index contains a small portion of credit risk and, when coupled with futures contracts traded on this benchmark, it provides the maturity structure necessary for broader adoption.

Benchmarks of the future need to be based on actual trades whenever possible, and be administered by independent bodies without direct financial interests in the values taken by the benchmarks.

These administrators need to be appropriately equipped to actively and regularly screen any attempts at abuse, perhaps with the assistance of independent third parties, as even market prices can be manipulated. This may require clearing houses observing the whole universe of risk with infrastructures such as those of the Depository Trust and Clearing Corporation, CME Group, and Intercontinental Exchange.

If the market is to decide that it prefers to transfer some of its contracts benchmarked against Libor to newer indices, structures as those described above would be better equipped to provide such a transition.

Market innovation will provide new, robust indices, reflecting the lessons learned from recent scandals. Such developments should be encouraged and welcomed.

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