ABSTRACT

What factors and developments have fuelled the „cartelisation“ of capital markets? - to the extent of the rigging of EURIBOR and LIBOR rates? In what ways can EURIBOR and LIBOR rate rigging practices be addressed?

How and why have offshore markets expanded to the degree and extent to which they exist today – this partly being explained through the multiplier effect, as well as the fact that onshore (national) regulations have boosted and facilitated the growth of offshore financial centers? This paper is not only aimed at addressing these issues and developments, but also highlights why (even though) the need for de regulation of national capital markets is justified, the converse appears to apply to the liberalisation of external capital markets. Furthermore, the liberalisation of global and external capital markets has provided the impetus and justification for the need to de regulate national capital markets.

The need and concern for increased regulation of bond, equity markets, as well as other complex financial instruments which can be traded in OTC (Over- the-Counter) derivatives markets is evidenced by Basel III's focus. „Cartelisation“ and organised activities relating to rate rigging in global capital markets have been evidenced recently by sophisticated EURIBOR and LIBOR rate rigging practices and occurences.

Key Words: EURIBOR (Euro Inter-Bank Offered Rate), LIBOR (London Inter-Bank Offered Rate), de regulation, monetary policies, rate rigging, equity, bond markets, derivatives, capital markets, liberalisation

LIBOR, EURIBOR and the Regulation of Capital Markets: The Impact of Eurocurrency Markets on Monetary Setting Policies

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A. Introduction

Pressures for the de regulation of national capital markets and calls for less restrictions in respect of capital controls in national capital markets, have increased over the years in response to the liberalization of global financial capital markets. The liberalization of global capital markets, as well as differences in the levels and extents of regulatory and capital controls which operate within banks' national borders, have also impacted the competitive positions of banks in external markets.

Whilst the growth of markets, such as the Eurodollar market, can be explained through the multiplier concept, some of the basic characteristics of the Eurodollar market which include:

1) Freedom from regulations that constitute a problem of most national markets
2) Its international scope and dimension

have also contributed to its popularity and attractiveness for investors since such offshore markets provide cheaper and more profitable services to these investors at lower cost. Furthermore, a huge level of resources may indeed have migrated from onshore to offshore destinations but for the fact that:

- offshore depositors have to bear additional risks in taxes in addition to inconveniences with deposits outside their home country
- Size, credit quality which may restrict some firms from accessing offshore markets.

According to D'Arista[1], two developments which have dominated how financial markets were liberalized, are as follows:

- The rise of the Eurocurrency markets in the 1960s
- The shift from banks to port folio investment in the 1980s.

„The waves of capital flows into the United States, and subsequently into Germany, Switzerland, and other European countries in the late 1960s and early 1970s, demonstrate how effectively the Eurocurrency markets are able to circumvent capital controls by making it possible for participants to change the currency denomination of loans and investments outside national markets in response to changes in interest rates, and subsequently (to) changes in exchange rates."[2]

1 J D'Arista, „Financial Regulation in a Liberalized Global Environment" in *International Capital Markets : Systems in Transition* (eds J Eatwell and L Taylor) 2002 at page 76
2 Ibid at page 77

Hence Eurocurrency markets have not only facilitated the undermining of regulatory strategies – given their ability to circumvent national capital controls and regulations, but have also affected central banks' abilities to effectively implement monetary policies. Whilst these constitute consequences of negative impacts of liberalization, a more lethal consequence has also emerged over the years : the rigging of LIBOR and EURIBOR.

In demonstrating the extent of the „cartelisation“ and manipulation of such rates, the ensuing section will commence by providing definitions of LIBOR and EURIBOR.

B. Definitions Attributed to LIBOR and EURIBOR and Self Regulation

Libor, the London Inter-Bank Offered Rate, is defined as „the benchmark interest rate that underpins trillions of loans, credit cards, mortgages and derivatives around the world“[3], whilst Euribor is the Euro Inter-Bank Offered Rate - which is also of vital significance given its role in setting borrowing rates for trillions worth in mortgages, loans and credit cards.

- LIBOR and EURIBOR have different definitions, which makes the possibility of rate rigging different. However, they have one feature in common: they are calculated from contributions with in-built conflicts of interest and this characteristic is not compatible with the ambition of rebuilding integrity and trust in our financial system.[4]

Whilst LIBOR is considered to „reflect the cost of borrowing of the contributing bank“, EURIBOR on the other hand, is considered to „reflect the contributing bank's conviction about the cost at which a prime bank (i.e. not necessarily the contributing bank itself) would offer term deposits to another prime bank.“[5] Furthermore, the The London Inter-Bank Offer Rate is considered to be „the average rate at which a leading bank can obtain unsecured funding in the London interbank market for a given period, in a given currency.“[6]

Two ways whereby (it is argued that) corporations are said to be exposed to LIBOR and EURIBOR rates include:[7]

- Through LIBOR (or EURIBOR) related borrowings.
- The use of LIBOR and EURIBOR as reference rates in many derivative products, including swaps.

At present, LIBOR has 18 contributing banks and EURO EURIBOR has 44.

3 See Merco Press, „Euro zone to Tighten Financial Regulation following the Libor Rigging Scandal“ <http://en.mercopress.com/2012/07/09/euro-zone-to-tighten-financial-regulation-following-the-libor-rigging-scandal>

4 See Remarks by Thierry Philipponnat , Secretary General of Finance Watch, COMMITTEE ON ECONOMIC AND MONETARY AFFAIRS of the EUROPEAN PARLIAMENT Public Hearing on Tackling the culture of market manipulation, Sept 2012. Furthermore, he adds that the different definitions of EURIBOR and LIBOR rates reflects the fact that they were established by different private bodies pursuing different, and often competing, interests.

5 ibid

6 Treasury Today, „LIBOR Troubles: What Should You be Doing?“ <http://treasurytoday.com/2012/07/libor-fixing>„It is also to be noted it is a lending (offer) rate not a deposit (bid) rate and is calculated by averaging the middle two quartiles of the rates submitted on a daily basis by a panel of 16 banks to the BBA (British Banking Association). The top and bottom quartiles are discarded.“

7 See ibid

Self Regulation : LIBOR and EURIBOR

The self regulatory nature of LIBOR is illustrated by the fact that „it is not only presided over by the British Bankers' Association (BBA), a private banking trade and lobby group", but also the fact that eighteen of the world's largest banks „which submit loan data to the Libor board every morning, to help set the global rate to which their own trading bets are tied", also control the BBA.

As a result of the self regulatory nature of LIBOR, regulatory capture does not only constitute the inevitable consequence, but also the frequent occurence of practices attributed to a system void of adequate levels of accountability and transparency, as well as one embroiled in associated corrupt practices and conflicts of interests. Lack of accountability not only facilitates an environment whereby high degrees of conflicts of interests are encouraged, but also one whereby the „passing of the buck" results in the inability to bring to book (as well as pin point) the principal offenders. It is contended by several sources that the LIBOR and EURIBOR rate rigging scandals commenced as far back as 2005, whilst it is also said to have had its roots as far back as 2007 – particularly during the period culminating in the Financial Crisis. Even though concerns and suspicions of rate rigging practices had been raised as far back as 2007, these calls and concerns were evidently ignored – such that the rate rigging crisis has escalated to the levels which presently persist.

As stated by Philipponnat:

> *"Benchmarks with a large public impact should not be left purely to private interests.*
>
> *"The idea of 'effective self-regulation' has proven over and over again to be an oxymoron in financial services and is not the way to restore the public's profoundly shaken trust in the fairness of financial activities."*[8]

Recent discoveries not only point to revelations that a group of international banks have been manipulating interest rates for years[9] What is even more serious is the fact that some banks involved in the cartelisation process, are those responsible for setting and calculating the LIBOR rates. Whilst two traders have recently been made scapegoats for the regulatory failures and gaps in the rate rigging process,[10] it is becoming more likely that other participants in the rate rigging process (bankers inclusive), will be placed under pressure to disclose their involvements in the cartelisation process.

C. Recent Measures and Proposals Aimed at Addressing the Rate Rigging Scandal

It is rightly stated[11] that the LIBOR's definition imposes more demanding requirements than the EURIBOR whilst the number of contributing banks to the EURIBOR rates determination, makes it

8 Finance Watch, „Finance Watch Response to Parliament on LIBOR and EURIBOR" <http://www.finance-watch.org/2012/09/finance-watch-response-to-parliament-on-libor-and-euribor/>

9 See Spielgel, „The Cartel Behind the Scenes in the Libor Interest Rate Scandal" <http://www.spiegel.de/international/business/the-libor-scandal-could-cost-leading-global-banks-billions-a-847453.html>

10 "Derivatives traders are also believed to have agreed upon the difference between the buy and sell prices (spreads) of derivatives, thereby selling these financial instruments to customers under conditions that were not customary in the market," says the Swiss Competition Commission, which is also investigating possible cartels." ibid

11 See Remarks by Thierry Philipponnat , Secretary General of Finance Watch, COMMITTEE ON ECONOMIC AND MONETARY AFFAIRS of the EUROPEAN PARLIAMENT Public Hearing on Tackling the culture of market manipulation, Sept 2012 at page 3 of 5

less likely for rate manipulating practices to occur. Greater accountability, it could therefore be argued, would be fostered, if the number of major contributing banks to the LIBOR rates were increased.

Greater consistency in the definitions applicable to LIBOR and EURIBOR, basing LIBOR and EURIBOR on effective rates,[12] making banks, managers, operators responsible for their actions, have also been proposed.[13]

Further, external regulatory oversight of benchmark setting, as well as greater use of transaction data, have also been put forward.[14]

The impact of LIBOR and EURIBOR rates on millions of lives can be illustrated thus:

- The daily Libor rate, which is supposed to measure the average cost of short-term loans between major banks, determines the interest rates for loans and investments that affect hundreds of millions of people around the world.Libor and Euribor , are used to set the borrowing rates for $10 trillion in mortgages, student loans and credit cards. Some 90 percent of US commercial and mortgage loans are said to be linked to the index.Libor influences an estimated $360 trillion of loans and credit default swaps. It impacts futures contracts traded on the Chicago Mercantile Exchange with a notational value of more than $564 trillion.[15]

It would therefore not only be in the public's interest, but also the interest of global and economic stabililty (and a means of restoring the credibility of the LIBOR and EURIBOR rates - on which many investors and markets rely), if measures and reforms aimed at addressing the rate rigging practices, could be effectively implemented.

D. Addressing Policy Concerns About the Impacts of Eurocurrency Markets: Monetary Setting Policies

The impacts of Eurocurrency markets on monetary setting policies and banks' competitive positions have also been highlighted. How can regulation be effectively implemented to ensure that they are not too rigid (such as to place banks at competitively disadvantaged positions in external markets) whilst not being too lax (such that effective monitoring, compliance and enforcement mechanisms are impeded)?

In addressing the issue of monetary policy setting, the challenges faced by the U.S Fed Reserve embraces the admission by several sources that current fiscal and monetary policies in the U.S are not feasible,[16] as well as the argument that the Federal Reserve's range of powers are too wide. The

12 As well as making contributions reflect financial reality, basing LIBOR and EURIBOR on effective rates is also said to provide less avenues whereby rate manipulation could occur ; see ibid

13 See ibid at pages 3 - 5

14 Finance Watch, „Finance Watch Response to Parliament on LIBOR and EURIBOR“ <http://www.finance-watch.org/2012/09/finance-watch-response-to-parliament-on-libor-and-euribor/>

15 Global Research, „Libor Scandal Exposes Banks’ Rigging of Global Rates“ <http://www.globalresearch.ca/libor-scandal-exposes-banks-rigging-of-global-rates/31783> „The Libor and Euribor (Euro Interbank Offered Rate) are used worldwide as the benchmark rates for financial transactions worth hundreds of trillions of euros. When a savings bank issues a loan to a business at a variable interest rate, the loan agreement is based on the Euribor. "In many cases, the Euribor is even the key guideline for the structuring of call money," says Falko Fecht, a professor at the Frankfurt School of Finance, referring to overnight and other such short-term loans. In Spain, in particular, tens of thousands of construction loans are based on the Euribor, while millions of mortgage loans in the United States are pegged to the Libor rate.“

16 Compare to the intended European Monetary Union Framework: „On the central bank side, the maintenance of

Federal Reserve is considered to have a role which encrouches and interferes with that of legislature and the executive – particularly in job creation issues which could impede the pace of achievement of fiscal policy objectives.

In highlighting several reforms which should be implemented at the Federal Reserve, some reforms (which include the following) are highlighted:[17]

- That firstly, the Fed's dual mandate for monetary policy should be eliminated. „While it is clearly important for national economic policy to be designed to achieve "full employment" - which varies over time based on domestic and global conditions and to keep unemployment and underemployment as low as possible, that this should not be the Fed' Reserve's job.
- That the Fed's monetary policy charge should be to promote relatively stable prices and reasonable long-term interest rates. By doing so, it is further argued, it can help create an economic environment that will facilitate economic growth and job creation.
- Instead of the Fed, Congress and the president should be working together to address the many structural and sustainability challenges that directly impact economic growth and job creation."

Even though it is further added that whilst „the Fed needs to provide reasonable transparency regarding its decisions on monetary policy, after those decisions have been made, it is also mentioned that it should be able to conduct its research and deliberations on monetary policy without being subject to audit, in order to facilitate sound and nonpolitical decision-making". Given the recent LIBOR and EURIBOR scandals, should the Fed really be exempt from audits? Indeed, should any federal regulator or supervisor be exempt from audits?

E. Conclusion

In the wake of the EURIBOR and LIBOR rate rigging scandals, the British Bankers Association in September 2012 indicated its willingness to give up its role in setting LIBOR rates. Whether such a role is assigned to another body does not constitute the crucial issue since the new authority (should the BBA eventually give up its role) could still be controlled or influenced by the 18 contributing banks which „which submit loan data to the Libor board every morning, as well as help set the global rate to which their own trading bets are tied." In other words, the system of self regulation which currently governs the BBA's operations, as well as EURIBOR procedures, urgently needs to be reviewed.

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price stability over the medium-term is the most important contribution that monetary policy can make to sustainable growth, employment, and social cohesion. On the fiscal side, the institutional framework reflects our long-standing experience that sound and sustainable fiscal policies are in turn fundamental to fostering longer-term sustainable economic growth.

Following these principles, monetary and fiscal policies are mutually re-enforcing. Solid fiscal policy is conducive to a macroeconomic environment that facilitates the task of a stability-oriented central bank. At the same time, credible monetary policy contributes to a smooth conduct of fiscal policies by guaranteeing stable inflation expectations and low inflation risk premia, which is in turn beneficial for the level and volatility of long-term government bond yields and therewith sovereign financing costs. „ See ECB, „Monetary Policy at Crisis Times", Lecture by Peter Praet, Member of the Executive Board of the ECB, at the International Center for Monetary and Banking Studies, Geneva, 20 February 2012 <http://www.ecb.int/press/key/date/2012/html/sp120220.en.html>

17 Financial Executive „The Role of the Fed Reserve „ <http://www.financialexecutives.org/KenticoCMS/Financial-Executive-Magazine/2012_03/The-Role-of-the-Federal-Reserve.aspx the Fed Reserve>

Further, bank regulators and banks (managers and executives) need to be engaged on a greater level (than at present) in the calculations of LIBOR and EURIBOR rates, rather than the process of merely designating the bench mark rate determination to money market traders. Such traders are considered to exhibit higher tendencies of conflicts of interests.[18]

Whilst penalties and fines have been imposed on those banks involved in the recent „cartelisation“ and rate rigging scandals, the cost of rate rigging (inclusive of those costs to tax payers), is considered to be proportionately high relatively to those fines. Further, the passiveness and indifference of many national regulators and supervisors to rate rigging suspicions and practices constitutes a cause for concern. Hence, greater accountability and responsibility for rate rigging practices would need to embrace, more importantly, the involvement of national regulators and supervisors. Whilst the free market is considered by some to be capable of regulating itself and evolving with technological and global developments, some form of policing (in the form of adequately balanced regulation) is required to ensure that market participants do not exploit those opportunities which arise owing to insufficient (or lack of) regulatory controls.

The predecessors to Basel III were often criticised for the failure to address system wide risks – hence it is to be commended that Basel III places some degree of focus on such risks.

18 „An invitation to manipulate, according to the Bafin chief.“ See Spielgel, „The Cartel Behind the Scenes in the Libor Interest Rate Scandal“ <http://www.spiegel.de/international/business/the-libor-scandal-could-cost-leading-global-banks-billions-a-847453.html>

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