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Resilience and Change in Private Standard-Setting The Case of LIBOR

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5.1 INTRODUCTION

The LIBOR scandal stands out as the most striking failure of private financial standard-setting in the post-crisis era. LIBOR, the London Interbank Offered Rate, is a well-known and widely used benchmark interest rate. For decades, it has been used to set rates for financial transactions around the world, ranging from home mortgages to syndicated loans, debt securities, and derivatives. In aggregate, these transactions amount to hundreds of trillions of dollars.[1] In June 2012, a settlement by Barclays Bank with the US Department of Justice (DOJ), Commodity Futures Trading Commission (CFTC), and UK Financial Conduct Authority (FCA) revealed that this key rate had been manipulated for years.[2] The culprits included brokers at smaller firms on the margins of the global financial system but also dozens of traders affiliated with the world's largest banks – the very same banks that sat on LIBOR's governing committee and provided the daily estimates on which it was based.

These revelations caused scandal and generated intense political pressure to reform LIBOR and other financial benchmarks. The LIBOR scandal and its consequences thus provide a crucial case study for the theory articulated in this project's framing chapter.[3] The chapter's central claim is that "crisis events or other

[1] See P.-H. Verdier, *Global Banks on Trial: U.S. Prosecutions and the Remaking of International Finance* (2020), at 45. This chapter draws on the research conducted on the LIBOR case for chapter 2 of *Global Banks on Trial* but omits much of the narrative detail and concentrates on analyzing the case in light of this volume's theoretical approach to the resilience of private authority. The information on the LIBOR transition process was current as of April 2021.

[2] Barclays Bank PLC Admits Misconduct Related to Submissions for the London Interbank Offered Rate and the Euro Interbank Offered Rate and Agrees to Pay $160 Million Penalty (June 27, 2012), www.justice.gov/opa/pr/barclays-bank-plc-admits-misconduct-related-submissions-london-interbank-offered-rate-and.

[3] See P. Delimatsis, "The Resilience of Private Authority in Times of Crisis" in this volume (Chapter 1).

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unfortunate regulatory disasters" tend to further empower, rather than weaken, private authority.[4] Private authority's resilience arises from several factors: its transnational nature,[5] regulatory capture,[6] the value of the system to its actors and their preferences,[7] and the focus of public actors on short-term crisis-fighting rather than reform.[8] Because of these factors, "the State and its public agents will rarely exercise coercion vis-à-vis private regulatory bodies and even less reclaim authority to protect the public interest."[9] The ultimate consequences are twofold: perpetuation of "free riding of private ordering"[10] and reinforcement of "the neoliberal orthodoxy premised on the concepts of market competition and an increasingly limited role for the State."[11]

As this chapter will show, the LIBOR scandal constitutes a hard case for the theory. Indeed, it appears to contradict nearly all its central predictions. Public authorities engaged in resolute enforcement against the actors involved in LIBOR manipulation, including corporate criminal cases against several of the world's largest banks that led to penalties of tens of billions of dollars. Prosecutors also brought individual charges against several brokers and bankers, some of which resulted in substantial prison sentences. As a direct consequence of the scandal, regulators replaced LIBOR's private administrator, the British Bankers Association (BBA), which was widely seen as having failed to respond effectively to indications of possible manipulation. Since then, the public sector has played a central role in creating and administering new, more robust benchmark interest rates and encouraging their adoption. As part of this vast effort, public actors are orchestrating multiple public and private organizations, deploying regulatory tools to steer private actors to adopt the new rates, and addressing many complex legal and logistical issues raised by the massive stock of legacy LIBOR contracts.

Overall, the LIBOR scandal and its aftermath amount to what the theory suggests we should not observe: a substantial reassertion of public authority over a crucial element of the global financial infrastructure in response to a crisis. Neither the transnational nature of the benchmark itself, its users, and the manipulation scheme, nor the fact that the scandal coincided in time with the global financial crisis and the European debt crisis prevented this outcome. Moreover, private governance in this area appears to have shown little resilience once the scandal broke. Although one should be careful in drawing conclusions from a single case

4 Ibid., at 22.
5 Ibid., at 27.
6 Ibid., at 27, 42–43.
7 Ibid., at 37.
8 Ibid., at 43.
9 Ibid., at 44.
10 Ibid., at 22, 39.
11 Ibid., at 21.

study, the LIBOR scandal casts doubt on the idea that the expansion of private authority in economic governance is a one-way trend that even major crises fail to reverse. Instead, this case suggests that the equilibrium between public and private authority can and does shift in response to crises, at least in certain circumstances.

Yet, in other respects, the LIBOR case illustrates the phenomena described in Chapter 1. In the period that preceded the first settlement by a major global bank of US criminal charges in June 2012, the relationship among the public and private bodies involved in LIBOR oversight was characterized by a collaborative approach and a clear preference on the part of public authorities for private design, management, and oversight of financial benchmarks. This remained true even after the first indications of possible manipulation became public in mid-2008. At the time, public bodies, their attention consumed by crisis-fighting, showed limited interest in the problem and underwrote the BBA's tepid and ultimately ineffective reforms. In stark contrast, the Barclays criminal settlement precipitated much broader public intervention in the form of a wide-ranging enforcement campaign and fundamental LIBOR reforms.

This chapter argues that the intervention of a different set of public actors – namely prosecutors and the enforcement arm of the CFTC, a derivatives market regulator – is the key factor that explains this stark difference in outcomes before and after 2012. These public actors' priorities and incentives differ substantially from those of those public actors – namely prudential banking regulators and central banks – traditionally involved in overseeing private standard-setting in the banking industry. Their generalist nature and lack of close cooperative relationship with the industry make them less vulnerable to capture.[12] Because their responsibilities do not include crisis-fighting, they can concentrate on investigating and prosecuting misconduct. And at least for US agencies, the transnational nature of the relevant market poses little obstacle to effective enforcement. Thus, many of the factors described in the framing chapter that perpetuate the resilience of private standard-setting cease to apply when these public actors take center stage.

These considerations suggest that the phenomena described in the framing chapter are characteristic of a particular version of private-public sector relationships, one that reflects preference for private ordering and finds its proponents in agencies whose mission centers on prudential oversight and financial stability. To the extent that this approach creates blind spots, the intervention of other public actors is key to restoring the balance between private standard-setting and effective public oversight. At the same time, one should not expect complete replacement of private standard-setting by public management, even in response to a major crisis, in areas like benchmarks where widespread adoption by private actors is essential to

[12] See M. A. Livermore and R. L Revesz, Can Executive Review Help Prevent Capture?, in *Preventing Regulatory Capture: Special Interest Influence and How to Limit it* (D. Carpenter and D. A. Moss eds., 2013), 434–437.

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achieve the benefits of the standard. Thus, the transition to the new benchmarks that will replace LIBOR involves collaboration among central banks, regulators, market participants, and industry bodies. It takes place, however, under a conspicuous shadow of public authority.

Section 5.2 briefly describes the evolution of LIBOR and its functioning prior to the global financial crisis. Section 5.3 examines how the relevant private and public actors, most centrally the BBA and UK authorities, reacted to the first public reports of potential LIBOR manipulation in mid-2008. Section 5.4 examines the June 2012 Barclays settlement and the broader enforcement campaign against LIBOR manipulation, focusing on the role of US prosecutors and market regulators. Section 5.5 describes the regulatory aftermath of the scandal, including immediate steps to reform the LIBOR-setting process and impose new regulation on benchmarks and longer-term reforms that will replace LIBOR with publicly managed, transaction-based benchmark rates. Section 5.6 concludes.

5.2 ORIGINS AND EVOLUTION OF LIBOR

LIBOR grew out of private initiative in the offshore US dollar market. As US dollar holdings overseas grew in the 1950s and 1960s, a vibrant interbank lending market emerged, centered in London. Foreign holders of US dollars deposited them in London banks, including branches of major banks from around the world, which lent dollars to each other through overnight and term deposits. Increasingly, they also lent dollars to end users, funding these loans through interbank deposits. The growth of this market generated demand for standardization of contract terms. One such crucial term was the interest rate, as banks sought a uniform way to link the floating rate paid by borrowers to their own funding costs. Initially, individual loan contracts created mechanisms to aggregate the interbank borrowing rates reported by major London banks. In the 1980s, the BBA consolidated the process and began publishing a single set of rates.

To generate LIBOR for each reported currency and maturity, the BBA received daily submissions from a panel of large banks active in the London interbank market. Each bank submitted an estimate of "the rate at which an individual contributor panel bank could borrow funds, were it to do so by asking for and then accepting interbank offers in reasonable market size just prior to 11:00 London time."[13] The BBA generated LIBOR by eliminating submissions in the top and bottom quartile and averaging the remaining submissions. The rules were designed and the process overseen by a BBA committee composed of representatives of the contributing banks. Thus, the initial creation and management of LIBOR required

[13] British Bankers' Association, Understanding the Construction and Operation of BBA LIBOR: Strengthening for the Future (2008), para. 12.2.

little official assistance or public imprimatur: an industry group simply aggregated and published market information for the benefit of its members.

In doing so, these private actors provided a public good: LIBOR was published in leading financial newspapers and could be used by anyone. Because it was set independently, it circumvented disputes that might arise between parties to a contract as to whether the party responsible for setting the rate did so accurately. It also reduced search and transaction costs for market participants by facilitating rate comparisons and avoiding the need to design a rate-setting mechanism for each contract.[14] Network effects also meant that using the benchmark became more attractive as more market participants did so. Unsurprisingly, LIBOR came to dominate lending markets worldwide, including many transactions and products with no direct link to the London interbank US dollar market.[15]

For decades, the private sector managed LIBOR without much public intervention or oversight. There seemed to be little concern among regulators, the BBA, or market participants that glitches could emerge. However, potentially significant problems were lurking below the surface. Because the contributing banks traded numerous assets whose value was linked to LIBOR, they had significant financial stakes in the daily LIBOR fixings. This was even more so for individual traders or desks within the bank, whose positions would likely be more concentrated. The fact that representatives of these same banks made and oversaw the process generated potential conflicts of interest. The risk of inaccurate or biased submissions was exacerbated by the fact that they were not based on actual transactions but on estimates by traders of the bank's borrowing costs for the relevant currency and maturity. Because many currencies and maturities were illiquid, data from actual transactions provided limited discipline on submitters' discretion.

Bankers often asserted that LIBOR's design ensured that it could not be manipulated.[16] Because outliers were excluded, it was said, a single bank could not meaningfully affect the rate by skewing its submissions. Although this belief was demonstrably false,[17] it appeared to be widely shared among market participants and regulators. This attitude reflected faith in the self-correcting nature of markets: the BBA and reporting banks had incentives to preserve LIBOR's franchise value and therefore to provide effective oversight. UK officials also saw LIBOR as a success story, cementing the centrality of London in worldwide credit markets.

[14] D. Duffie and J. C. Stein, Reforming LIBOR and Other Financial Market Benchmarks (2015) 29 *Journal of Economic Perspectives* 191, at 193–196.

[15] Verdier, *supra* note 1, at 45; Duffie and Stein, *supra* note 14, at 198.

[16] See L. Vaughan and G. Finch, *The Fix: How Bankers Lied, Cheated and Colluded to Rig the World's Most Important Number* (2017), at 17.

[17] P. Gandhi et al., Financial Market Misconduct and Public Enforcement: The Case of Libor Manipulation (2019) 65 *Management Science* 5268.

5.3 THE FINANCIAL CRISIS AND THE BBA'S REFORMS

The first signs of trouble with LIBOR emerged during the financial crisis. In April 2008, after the collapse of US investment bank Bear Stearns, news reports emerged suggesting that major banks might be misreporting their borrowing costs to avoid appearing to be under stress. In fact, studies showed, LIBOR submissions were very close to each other, which experts saw as evidence that they were inaccurate.[18]

These news reports prompted a first round of LIBOR reform. Under pressure from regulators and market participants, the BBA announced that it would review its rules on LIBOR reporting and increase its efforts to detect and sanction inaccurate submissions. It soon became clear, however, that the BBA was unwilling to undertake any major reforms to the LIBOR-setting process or its governance structure. Senior BBA officials declared that any problems were minor and transitory, accused critics of misunderstanding the process, and reiterated that the LIBOR methodology ensured that the rate was accurate. After several weeks, the organization announced that there would be no immediate changes and made vague promises to strengthen LIBOR oversight, with details to be announced later.

The BBA's inaction did not go unnoticed by regulators. Upon learning of it, Mervyn King, the Bank of England's governor, responded to a Bank official: "This seems entirely inadequate. What should we do?"[19] Timothy Geithner, the head of the Federal Reserve Bank of New York, who had also become concerned about LIBOR's integrity, sent King a list of proposed reforms. The proposed changes, while modest, would have addressed some of the most salient vulnerabilities.[20] UK. authorities, however, proved unwilling to press the BBA to undertake such substantive reforms, let alone to increase public oversight. They agreed with the BBA's plan to conduct a months-long consultation. During that process, virtually all the FRBNY's proposals were quietly dropped. In November 2008, as the financial crisis raged, the BBA announced minimal reforms, effectively promising that its existing committee would oversee submissions more closely under the existing rules.[21] Although several commentators criticized the reforms as insufficient, UK and US regulators appeared to accept them.

[18] C. Whitehouse and M. Mollenkamp, Study Casts Doubt on Key Rate, *Wall Street Journal* (May 29, 2008) www.wsj.com/articles/SB121200703762027135.

[19] Further Information and Correspondence in Relation to the BBA LIBOR Review in 2008 (July 20, 2012) (transcript of Mervin King, Governor, Bank of England's written comments on an email entitled "Result of BBA review: just 'strengthen the oversight of BBA Libor'" [May 30, 2008]).

[20] They included measures such as auditing bank submissions, reducing the number of reported maturities, adding more banks to the panels, and randomly selecting a subset of banks to generate daily rates.

[21] The reforms contemplated that the committee would exercise more probing review of banks' submissions, issue warnings, and possibly sanction repeat offenders by excluding them from the panel.

To this point, the story of the LIBOR scandal seems in line with the theory proposed by the framing chapter. Shaken by a major crisis that undermined LIBOR's credibility, the BBA adapted to deflect the scandal. After delaying action, it adopted largely cosmetic reforms that preserved private authority over LIBOR. Public actors proved willing to accede to this outcome. As predicted, their intense focus on crisis-fighting facilitated the BBA's approach: UK and US regulators and central bankers were consumed by the growing financial crisis. Beyond this, internal discussions in the UK government reveal officials' strong reluctance to impose public regulation or oversight and a corresponding preference for a private sector solution, supporting the notion that "cognitive capture" may play a role in perpetuating private authority. The benchmark's transnational nature also inhibited public intervention: US and UK regulators, while appearing to cooperate, in fact clashed. The latter, including officials at the Bank of England and the Financial Services Authority (FSA), apparently believed that the FRBNY was trying to exploit the crisis to undermine the "London-centric" nature of LIBOR. They thus dismissed its suggestions and supported the BBA's modest reforms.

5.4 THE BARCLAYS SETTLEMENT AND ITS AFTERMATH

The Bank of England, FRBNY, and FSA were not the only public actors looking into LIBOR manipulation. The CFTC had launched an investigation, later joined by the DOJ, which culminated in April 2012 in a first criminal settlement with Barclays. Under a non-prosecution agreement, the bank agreed to pay $453 million in penalties.[22]

The settlement revealed extensive misconduct relating to LIBOR setting. As journalists and economists had suspected, Barclays and other banks had understated their borrowing costs during the financial crisis to avoid appearing financially distressed, thus skewing LIBOR downward. In addition, multiple traders and brokers had conspired to fix LIBOR to benefit their trading positions, often at their own customers' expense. At Barclays, derivatives traders routinely asked LIBOR submitters to skew the bank's submissions in their favor, taking advantage of the submitter's relatively junior position and lack of effective compliance oversight. This revelation further undermined LIBOR's credibility.

Barclays was far from the only bank involved in LIBOR manipulation. The bank's leadership apparently hoped that, by settling first, they would minimize the scandal's fallout. That strategy proved a failure: the settlement triggered an enormous scandal that soon spun out of control, forcing Barclays' CEO, COO, and chairman to resign in short order. The public bodies that had approved LIBOR reforms in 2008,

[22] Barclays Bank PLC Admits Misconduct Related to Submissions for the London Interbank Offered Rate and the Euro Interbank Offered Rate and Agrees to Pay $160 Million Penalty, *supra* note 3.

especially the Bank of England and the FSA, came under heavy criticism. The LIBOR scandal triggered parliamentary hearings in the United Kingdom, Congressional hearings in the United States, and an internal review by the FSA. Eventually, the FSA was broken up and its market oversight and enforcement functions were transferred to the newly created Financial Conduct Authority (FCA).

Barclays was the opening salvo of a broader enforcement campaign by the DOJ and CFTC. In subsequent years, US authorities brought criminal and regulatory charges against several other global banks, including UBS, RBS, Lloyds, Deutsche Bank, and Citigroup, imposing fines and penalties of more than $4.5 billion. This enforcement campaign was part of a larger trend of US criminal prosecutions targeting major international banks for a range of violations, including benchmark manipulation, tax evasion, and sanctions violations, that resulted in fines and penalties of more than $34 billion.[23] In subsequent years, prosecutors and regulatory agencies in other jurisdictions joined this enforcement campaign. In several cases, home state regulators participated in US-led enforcement actions; but non-US governments also grew more assertive in initiating their own actions. Investigations spread to related markets and benchmarks, most notably foreign exchange.

Several features characterized this campaign and distinguished these actions from previous regulatory enforcement: the use of broad criminal statutes to reach misconduct not explicitly targeted by more specific regulatory regimes; the use of criminal investigation techniques, such as whistleblower rewards and plea bargain offers to witnesses; and much higher penalties. Another notable feature is the prosecutions' explicit orientation toward organizational reform and self-regulation. US criminal enforcement policies adopted in the late 1990s and expanded since explicitly aim at providing incentives for organizations to establish effective compliance, internal investigation, and reporting policies and procedures in order to mitigate punishment.[24] In addition, prosecutors often impose extensive compliance obligations on organizations that settle criminal cases, requiring adoption of new internal policies, hiring of new staff, and external oversight by corporate monitors or regulatory agencies.[25]

These corporate prosecutions can also be accompanied by individual criminal charges. Prosecutors in the United States and the United Kingdom brought such charges against numerous individuals embroiled in the LIBOR scandal. Tom Hayes, the ringleader of a group of traders and brokers who repeatedly manipulated LIBOR,

[23] Verdier, *supra* note 1, at 8.

[24] J. Arlen and R. Kraakman, Controlling Corporate Misconduct: An Analysis of Corporate Liability Regimes (1997) 72 *NYU Law Review* 687.

[25] B. L. Garrett, Structural Reform Prosecution (2007) 93 *Virginia Law Review* 853; B. L. Garrett, *Too Big to Jail* (2014); J. Arlen and M. Kahan, Corporate Governance Regulation through Nonprosecution (2017) 84 *University of Chicago Law Review* 323; P.-H. Verdier, The New Financial Extraterritoriality (2019) 87 *George Washington Law Review* 239.

was found guilty and sentenced to fourteen years in prison in 2015.[26] In total, at least fifty individuals were indicted, of which several pleaded guilty. Others were acquitted, including six brokers accused of conspiring with Hayes. Although prosecutors found it difficult to extradite individuals,obtain convictions, and sustain them on appeal, the LIBOR scandal represented a significant shift from the lack of post-crisis individual prosecutions.

In sum, beginning with the Barclays case in 2012, prosecutors and regulators engaged in robust enforcement campaign against LIBOR manipulation, which went well beyond the public sector's tepid reaction to indications of manipulation in 2008. This campaign constituted a significant assertion of public authority in an area that had erstwhile been left almost completely to private standard-setting and oversight.

The deterrent effect of the enforcement actions by itself amounted to a form of re-regulation. A recent study found no indication of manipulation by major banks after 2010, which the researchers attributed to that deterrent effect.[27] This is consistent with the idea that, in areas where regulation aims to discipline self-serving behavior and internalize costs, private rule-making is unlikely to be stable unless some actor is available to punish deviations and impose a "penalty default rule."[28] While the BBA's own enforcement mechanism clearly did not fulfill that function, public enforcement of the private standards – in this case through criminal prosecutions of firms and traders who manipulated the process in their own interest – may provide such a background penalty default even without further public regulation.

In any event, prosecutors and regulators did not limit themselves to imposing fines and other sanctions. They also used settlements as vehicles to require banks to implement reforms to improve the integrity of their LIBOR submission process, consistent with their compliance-oriented approach to the resolution of other corporate criminal cases. Finally, as will be seen in Section 5.5, the enforcement campaign and the publicity that surrounded it provided the impetus for broader reforms that substantially increased public oversight of benchmarks and aim to eventually eliminate LIBOR altogether.

What explains this shift in the public sector's approach? The answer lies in the identity of the public actors involved. The central actors in the enforcement campaign that began in 2012 were not central banks and specialized regulatory agencies but prosecutors and, to some extent, the enforcement arms of market regulators.

[26] An appeal court later reduced Hayes's sentence to eleven years.
[27] Gandhi et al., *supra* note 17.
[28] T. Büthe, Private Regulation in the Global Economy: A (P)Review (2010) 12 *Business and Politics* 1; T. Büthe, Global Private Politics: A Research Agenda (2010) 12 *Business and Politics* 1.

The factors that tend to inhibit robust public response to crises or governance failures arising from private standard-setting are much less applicable to these actors. Unlike central bankers and banking regulators, prosecutors and market conduct enforcers have little or no role in immediate crisis-fighting; on the contrary, because of their more direct lines of political accountability, crises generate incentives for them to be seen as acting resolutely. As part of generalist law enforcement agencies, prosecutors are much less vulnerable than specialized agencies to capture – cognitive or otherwise – by a particular regulated industry. They also have little or no stake in fostering private governance for its own sake.

Finally, the transnational nature of private authority matters less to these actors: unlike central bankers and specialized agencies, which must maintain continuing collaborative relationships with regulated entities, industry organizations, and their own foreign counterparts, prosecutors and enforcement agencies are accustomed to acting unilaterally where needed. In the case of US authorities, the broad extraterritorial reach of the relevant US laws and the country's leverage over private actors – through its control of access to US dollar payments and other critical infrastructure – often allows them to bring successful enforcement actions even without meaningful foreign cooperation.

These factors suggest that the resilience of private authority, at least in international finance, is driven in significant part by the nature of the incentives of the specialized agencies that traditionally oversee financial institutions. In LIBOR and other cases, the shift in initiative within the public sector from these agencies to prosecutors and market regulators undermined the resilience strategies of private actors like the BBA and the banks themselves. That shift may be part of a broader trend, apparent since the financial crisis, by which areas such as international finance that were traditionally seen as effectively beyond the purview of ordinary law enforcement are losing the benefit of this exceptionalism.

5.5 REFORMING BENCHMARKS, REPLACING LIBOR

The Barclays settlement and subsequent prosecutions, by exposing widespread LIBOR manipulation, made it clear that the BBA's 2008 reforms had been ineffective and that public oversight was lacking. Ultimately, it convinced policymakers that continued private management of this vital benchmark was untenable and that it must be replaced altogether. Thus, LIBOR reform proceeded in two stages, the second of which remains ongoing.

The first stage followed immediately upon the Barclays settlement. The UK government appointed Martin Wheatley, an experienced regulator, to conduct an independent review of LIBOR. The report, released later in 2012, recommended a series of reforms amounting to substantially stronger public oversight. They included introducing new legislation to regulate LIBOR-setting, including specific criminal penalties for benchmark manipulation; transferring LIBOR to a new administrator

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selected by public tender; and discontinuing LIBOR for insufficiently liquid currencies and maturities.[29]

Most of Wheatley's recommendations were incorporated in the Financial Services Act 2012.[30] LIBOR management was transferred from the BBA to a new operator, an affiliate of the Intercontinental Exchange (ICE), by public tender.[31] European authorities also reacted: the Market Abuse Directive was amended to cover benchmark manipulation and the European Commission introduced a proposal that led to the adoption in 2016 of a regulation imposing extensive oversight of financial benchmarks.[32] IOSCO, for its part, adopted global principles for benchmark administrators.[33] The LIBOR scandal thus led directly to a substantial assertion of public authority, not only over LIBOR itself but over financial benchmarks generally.

Reforms, however, could not stop at this increased oversight. The scandal had exposed deeper weaknesses in LIBOR: manipulation was not just the result of poor governance but of the fact that the underlying market for interbank dollar lending had shrunk. As that trend continued, even the historically more active currencies and maturities would increasingly be based on estimates rather than actual transactions, threatening the accuracy of the benchmark and making it more vulnerable to manipulation. A 2014 report by the Financial Stability Board recommended reforms to financial benchmarks to base them on actual transactions rather than discretionary estimates; it further recommended the creation of entirely new, transaction-based risk-free reference rates to replace flawed benchmarks like LIBOR.[34]

In response to these recommendations, a series of national and regional coordinating committees were created to develop accurate and useful risk-free benchmark rates that could be used in a variety of financial instruments, and to foster their adoption. The US Alternative Reference Rates Committee, convened in 2014, selected the Secured Overnight Financial Rate (SOFR) as the main US dollar risk-free rate. Unlike LIBOR, SOFR is managed by a public sector entity, the FRBNY, and based on actual transactions in overnight repos on US treasuries, the world's largest funding market. Among the risk-free rates adopted by committees in

[29] The Wheatley Review of LIBOR: Final Report (HM Treasury 2012).

[30] Financial Services Act 2012, c. 21 (UK).

[31] While the ICE is also a private operator, unlike the BBA it is not managed by the banks who provide the submissions and stand to benefit from manipulation.

[32] Directive 2014/57/EU of the European Parliament and of the Council of 16 April 2014 on criminal sanctions for market abuse (market abuse directive) [2014] OJ L173/179; Regulation (EU) 2016/1011 of the European Parliament and of the Council of 8 June 2016 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds and amending Directives 2008/48/EC and 2014/17/EU and Regulation (EU) No 596/2014 [2016] OJ L171/1.

[33] Principles for Financial Benchmarks: Final Report (July 2013), www.iosco.org/library/pubdocs/pdf/IOSCOPD415.pdf.

[34] Reforming Major Interest Rate Benchmarks (July 22, 2014) www.fsb.org/wp-content/uploads/r_140722.pdf.

other jurisdictions, several will also be publicly managed, such as SONIA (Bank of England), STR (European Central Bank), and TONAR (Bank of Japan).[35]

The initial expectation was that these rates would coexist with the reformed LIBOR and similar IBORs for other currencies and locations. In July 2017, that expectation changed radically. In a widely reported speech, Andrew Bailey, the FCA's chief executive, explained that despite improvements to LIBOR, it was becoming increasingly unsustainable and would need to be phased out. Panel banks, he said, "feel understandable discomfort about providing submissions based on judgements with so little actual borrowing activity against which to validate those judgements."[36] While the FCA could use its regulatory powers to compel panel banks to continue to provide LIBOR submissions, "it is not only potentially unsustainable, but also undesirable, for market participants to rely indefinitely on reference rates that do not have active underlying markets to support them."[37] Accordingly, the FCA did not intend to compel submissions after the end of 2021, meaning that most or all LIBOR rates would end on that date. Bailey's remarks were widely perceived as sounding LIBOR's death knell. The predicted end of LIBOR in 2021 raised serious concerns as trillions of dollars of contracts worldwide still referenced the benchmark, few of which had workable fallback provisions.

These events triggered a second, much more ambitious stage of reform: the enormous task of shifting market practices – including trillions of dollars in legacy contracts – to new benchmarks and ensuring that these new rates would be robust and useful to market participants. The FCA's announcements proved insufficient by themselves to shift market practices. Many participants apparently assumed that LIBOR would in fact continue after 2021 or that substitute synthetic LIBOR rates would be published that could be used seamlessly for existing contracts. The estimated volume of financial contracts based on USD LIBOR actually increased between the announcement and early 2021, reaching $223 trillion.

Regulators responded by acting to compel market participants to accelerate the transition away from LIBOR. The FCA issued further statements making it increasingly clear that market participants should not expect LIBOR to continue, culminating in March 2021 when it announced that most LIBOR settings would cease at the end of 2021 and that even the most widely used US dollar rates would cease in June 2023.[38] That statement added that even if synthetic LIBOR rates were published after these dates, they would not be considered representative, thus prohibiting their use in new contracts. US financial regulators issued a joint supervisory

[35] A. Schrimpf and V. Sushko, Beyond LIBOR: A Primer on the New Benchmark Rates [2019] *BIS Quarterly Review* 29.

[36] A. Bailey, The Future of LIBOR (July 26, 2017), www.fca.org.uk/news/speeches/the-future-of-libor.

[37] Ibid.

[38] Announcements on the End of LIBOR (March 4, 2021) www.fca.org.uk/news/press-releases/announcements-end-libor.

letter in November 2020 warning that issuing new LIBOR-based contracts after the end of 2021 "would create safety and soundness risks" and could lead to regulatory action.[39] In addition to stopping the issuance of new LIBOR-based contracts, regulators also required that market participants develop plans to include fallback language in existing contracts that may be affected by LIBOR's cessation.[40]

Regulators, the ARRC, and the private sector cooperated in designing and implementing contractual fallback language for existing contracts. The International Swaps and Derivatives Association (ISDA), an industry association heavily involved in developing model contracts for swaps and other financial derivatives, issued an IBOR Fallbacks Protocol under which participating firms agree to amend their existing LIBOR-based derivatives to add fallback provisions.[41] The ARRC and its multiple working groups issued model fallback clauses for numerous categories of LIBOR-based contracts, including mortgages, business loans, debt securities, and securitizations.[42] For legacy contracts that parties are unable to amend, the ARRC lobbied the New York State legislature to adopt legislation to automatically switch to a prescribed fallback rate upon termination of the benchmark.

Perhaps the most challenging aspect of the LIBOR transition has been to make available a full set of term rates that can substitute for LIBOR. SOFR, for example, is an overnight rate: it measures the interest rate charged on overnight lending transactions secured by US Treasury securities. Because it is based on a large volume of actual transactions, it is very robust. But it does not directly substitute for the principal use of LIBOR, which is to prospectively set the interest rate for a given period, for example, three months, under a contract. To generate term rates based on SOFR that are also robust and transaction-based, the administrator must have access to a pool of relevant transactions. The market for such transactions – in this case, SOFR-based swaps – is still in its infancy. The ARRC and regulators have also tried to foster its development, and as of the fall of 2020 the latest signs were encouraging, but it remains much smaller than the market for LIBOR-based swaps.

For that reason, the contractual fallback clauses mentioned above typically do not prescribe a specific alternative term rate to be used upon LIBOR termination. Instead, they incorporate into the relevant contracts language such as "the forward-looking term rate … that has been selected or recommended by the

[39] SR 20-27, Interagency Statement on LIBOR transition (November 30, 2020), see also SR 21-7, Assessing Supervised Institutions' Plans to Transition Away from the Use of LIBOR (March 9, 2021); see also FCA, Letter to CEOs re: Firms' Preparations for Transition from LIBOR to Risk-Free Rates (September 19, 2018).

[40] SR 21-7, Assessing Supervised Institutions' Plans to Transition Away from the Use of LIBOR (March 9, 2021)

[41] ISDA 2020 IBOR Fallbacks Protocol (October 23, 2020), www.isda.org/protocol/isda-2020-ibor-fallbacks-protocol.

[42] Fallback Contract Language, www.newyorkfed.org/arrc/fallbacks-contract-language.

Relevant Governmental Body."[43] While this language reflects continuing uncertainty about the availability and exact nature of SOFR-based term rates, it also represents a remarkable conferral of authority to the public sector to effectively rewrite the terms of hundreds of trillions of dollars of financial contracts at the stroke of a pen.

5.6 CONCLUSION

The LIBOR scandal and its aftermath appear to be a clear case in which a major failure of private regulation led directly to a substantial reassertion of public authority over a vital aspect of the international financial infrastructure. As such, it calls for qualification of the conjecture in the framing chapter that the shift from public to private authority constitutes a one-way ratchet that even severe crises cannot reverse and even tend to accelerate.

At the same time, the LIBOR case also demonstrates several tendencies described by the framing chapter: the difficulty of coordinating public regulation of transnational markets, governmental focus on immediate crisis-fighting measures rather than long-term reform, and ideological preference for market-based regulation. These tendencies, however, dominate only as long as the main public actors involved are those – principally bank regulatory agencies and central banks – traditionally charged with prudential oversight of the banking industry. The intervention of public actors with different objectives and incentives – namely prosecutors and market regulation agencies – marks a major shift in the nature and scope of public regulation and oversight.

These observations suggest that the balance between public and private authority in regulating markets can indeed adjust in response to crises and failures. A key factor may be the existence and active involvement of public actors outside the traditional regulatory paradigm and less bound by the tendencies outlined above. In other words, the case argues for private authority to be overseen not by one but by multiple pairs of eyes in the public sector.

To be sure, one must be wary of drawing general conclusions from a single case. The future of LIBOR remains uncertain, and new opportunities for manipulation or other unintended consequences of the reforms may arise. Even if the transition proves entirely successful, specific features of the LIBOR case may not recur in other areas. For instance, the long-term decline of the underlying lending market on which LIBOR submissions were based and the limited benefits and increased risks

[43] ARRC Recommendations Regarding More Robust Fallback Language for New Issuances of LIBOR Floating Rate Notes (April 25, 2019), www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/FRN_Fallback_Language.pdf. The term "Relevant Governmental Body" is defined as "the Federal Reserve Board and/or the Federal Reserve Bank of New York, or a committee officially endorsed or convened by the Federal Reserve Board and/or the Federal Reserve Bank of New York or any successor thereto."

of participation for the contributing banks created demand for public involvement in coordinating the transition. Market participants may not have been as eager to participate in public-led reforms of a vibrant benchmark.

In addition, while prosecutors and enforcement-focused agencies can provide a strong impetus for reform, they can only respond to a limited class of crises, namely those that involve misconduct that can credibly be characterized as criminal. Where private authority generates other kinds of problems or externalities, these actors may lack the ability to intervene. Finally, other public actors may lack the resources or influence of US prosecutors and regulators, raising the risk that negative impacts of private authority on the public outside powerful countries may go unchecked. The circumstances in which crises may favor expansion or retrenchment of private authority thus constitute a rich area for further research.