# London's Rate-Setting Is Raising Doubts

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## FOREIGN EXCHANGE

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LONDON – About $5 trillion of derivative contracts and loans may currently be based on a questionable interest rate set by London bankers.

The situation is raising doubts about investors' ability to reliably use the contracts to hedge interest-rate and currency risk. At risk: hedge funds, big investment dealers and multinational banks and corporations.

Some bankers contend that if the problem isn't cleaned up soon, London's reputation as Europe's premier financial center could be damaged at a time when continental cities are launching a serious challenge.

The culprit is the yen London interbank offered rate, or Libor – the interest rate at which banks in London lend money to one another. It is also the benchmark off which everything from yen loans to yen-derivative contracts are priced. In short, Libor is to financial markets what batting averages are to baseball.

Each day, the British Bankers Association asks 16 banks for the interest rate at which they could borrow yen for periods of a week to a year. The association then tosses out the four highest and four lowest quotes and averages the rest to get a single Libor rate.

### The Big Distortion

Selected banks and their differing 3-month London Interbank Offered Rate (Libor)

| Japanese Banks | 3-MONTH | LONG-TERM |
|---|---|---|
| Bank of Tokyo-Mitsubishi | 0.66% | A - |
| Dai-ichi Kangyo Bank | 0.84 | BBB + |
| Fuji Bank | 0.84 | BBB + |
| Industrial Bank of Japan | 0.78 | A - |
| Sakura Bank | 0.84 | BBB |
| Sanwa Bank | 0.74 | A - |
| Sumitomo Bank | 0.75 | A - |
| Tokai Bank | 0.84 | BBB + |

| Other Banks | 3-MONTH | LONG-TERM |
|---|---|---|
| Bank of China | 0.05% | BBB |
| Barclays Bank | 0.00 | AA |
| Citibank | 0.02 | AA - |
| J.P. Morgan | 0.00 | AA |
| Lloyds Bank | 0.03 | Not rated |
| Midland Bank | 0.06 | A + |
| National Westminster Bank | 0.00 | AA |
| UBS | 0.05 | AA + |

*Source: British Bankers Association, Standard & Poor's*

While eight of the banks (seven Western and one Chinese) are quoting rates of zero to 0.06% for three-month loans, another eight – all Japanese – are quoting 0.66% to 0.84%. As a consequence, the resulting average Libor rate – 0.39% yesterday – is way above what some people think it should be, as much as 0.25 to 0.30 of a percentage point.

The average bears no relationship to the rates offered by either the Western banks or the Japanese banks, says William Campbell, an analyst at J.P. Morgan & Co. in Tokyo. "Normally the average is close to everybody [and] representative of something, whereas here it is a mathematical abstraction," he says.

The wide gap between the rates quoted by Japan's banks and the others has created "a dysfunctional market," says Ravi Bulchandani, an economist at Morgan Stanley Dean Witter & Co. "One assumption of functioning markets is that the transacting agents – in this case banks – are a relatively homogenous group; but right now that has been called into question."

Mr. Campbell says the distortion will affect any transaction that uses yen Libor

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as a reference rate. That includes $4.6 trillion of interest-rate swaps, as of the end of 1997, according to the International Swaps and Derivatives Association, and an additional $823.6 billion of loans and bonds, according to Capital Data Ltd. (Swaps involve an exchange of payment streams over time, based on preset terms. In a common interest-rate swap, one party agrees to pay a fixed interest rate in return for receiving a floating rate from another party.)

### Volatility Is Cited

Traders say the distortion is also creating unnecessary volatility in the so-called basis-swap market where payments based on yen Libor are exchanged for those based on Libor-denominated in other currencies, such as dollars and marks. That, in turn, is making it harder for investors and companies to hedge against adverse interest rate and currency movements.

Who gets the short end of the stick depends on which side of the equation they sit. "If you are a lender [of yen], you are getting a higher return than you ought to; if you are a borrower, you are paying more than you should," says the head of risk management at a big U.S. insurance company. "People are winning or losing based on an improper index" that includes Japanese banks that are quoting rates way out of line with other institutions.

Because they have borrowed hundreds of billions of yen at Libor and invested the proceeds in other markets, "hedge funds have gotten completely beaten up by this," says the head trader for a big fund in Bermuda. Bankers add that big Western banks, investment banks and insurance companies also put on similar trades.

Companies that have taken out loans or sold bonds that are priced off yen Libor include **Morgan Stanley Dean Witter & Co.**, **Merrill Lynch & Co.** and **BankAmerica** Corp., as well as foreign banks and national and local governments or state-owned companies from India, Australia, Canada, and South Korea.

On the other hand, an investor who purchased bonds issued by these governments or companies is getting paid more money than if the Japanese banks weren't part of the Libor calculation.

Why the mess? Max Whatmore, head of fixed-income derivative trading at Merrill Lynch in London, says the high rates quoted by Japan's banks reflect their own high funding costs, which in turn "reflect the poor state of Japanese banks and the Japanese economy generally." Others say it also indicates Western banks' reluctance to deal with Japanese banks near year end.

### Japan's Real Funding Costs

Still others accuse the Japanese banks of pushing up London lending rates to make extra money from customers who have borrowed at Libor. These skeptics argue that Japanese banks' real funding costs are lower than the rates quoted in international markets, because the Bank of Japan is lending them money at effectively no cost. An executive at Sanwa Bank in Tokyo says the eight Japanese banks' Libor quotes mostly reflect the "premium" they must pay for funds in global markets, but concedes that "everybody doesn't quote their real funding rate."

Many traders and bankers argue that low-rated Japanese banks — four are rated triple-B — have no right being in the British Bankers Association's Libor sample. They also contend that the association created a nightmare by changing the definition of Libor on Oct. 1.

Each of the 16 contributor banks is asked to quote a rate at which it could borrow funds "in reasonable market size." Before October, they were asked to judge what a "prime bank" could borrow at, which many U.S. and European bankers define as one rated no lower than single-A.

Libor "isn't as representative as it used to be, especially in yen," says Rudolf Enderli of UBS AG in Zurich.

The solution, say Western bankers, is to stop asking Japanese banks for quotes until they regain the confidence of the international finance community, and some are betting several Japanese banks will be removed from the contributor panel following a study now under way by the British Bankers Association, which, for its part, is saying nothing. "People are always talking to us about the composition of the yen Libor panel," says Simon Hills, a director of the British association.

Money managers and bankers warn that if the association doesn't move fast, it and London risk losing the ability to control what on Jan. 1 will become Europe's key interest-rate benchmark, that based on the euro, Europe's new common currency. Already, the European Banking Federation is advocating its own Euribor, based on quotes from mostly Continental banks.

### Yesterday's Market Activity

The dollar extended Monday's gains against the yen, although it ran into resistance in New York trading.

The U.S. currency also succumbed to some profit-taking against the mark. But in general, it remained well supported by a market that continues to take its cues from technical, rather than fundamental, factors.

Late in New York yesterday, the dollar was at 122.36 yen, up from 121.70 yen late Monday in New York. The U.S. currency also was trading at 1.6833 marks, down from 1.6883 Monday in New York. Sterling fell to $1.6593 from $1.6633.

"Overall, market sentiment is to sell dollar/mark on rallies and buy dollar/yen on dips," said Jeffrey Yu, chief dealer with Sanwa Bank in New York.

Such a strategy was reflected in the mark's rally against the yen to an intraday high of 73.08 yen around the same time that the dollar hit a one-month high of 123.36 yen in London trading. Traders noted, however, that the German currency was unable to hold above 73 yen.

Volumes continued thin, while a relatively steady performance on Wall Street helped to contain volatility, traders said.

*—Michael Casey in New York contributed to this article.*

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**SL Green Realty** Corp., a real estate investment trust, is expected to announce today that it will purchase the controlling interest in a New York City office property for $37.5 million in cash and the assumption of $29.25 million in debt. SL Green plans to purchase 65% of the 20-story, 950,000-square foot BMW Building at 555 West 57th St. from Blackacre Capital Group, a closely held investment firm based in New York. The building is 95% leased. The remaining ownership interest in the property is controlled by several limited partnerships. SL Green, a small office-property REIT, currently owns 18 buildings in New York.