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## Market Facts

### Distorted LIBOR Continues To Show Stress In Markets

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*The recent turmoil is prompting suggestions that LIBOR is no longer offering such an accurate benchmark of borrowing costs as before. As a result, some bankers are beginning to suggest that the status of these indices may need to be reconsidered in the future. "The LIBOR rates are a bit of a fiction. The number on the screen doesn't always match what we see now," complains the treasurer of one of the largest City banks. [LIBOR's value is called into question](#), The Financial Times Sep. 25, 2007*

As the quote above suggests, the recent credit crisis has affected LIBOR negatively. Much of this distortion derives from the mechanics of LIBOR's calculation.

In the case of USD LIBOR, the British Bankers Association (BBA) surveys 16 banks daily for their interbank lending rates. The four highest and lowest rates are dropped, and the average of the eight remaining rates is disseminated as LIBOR.

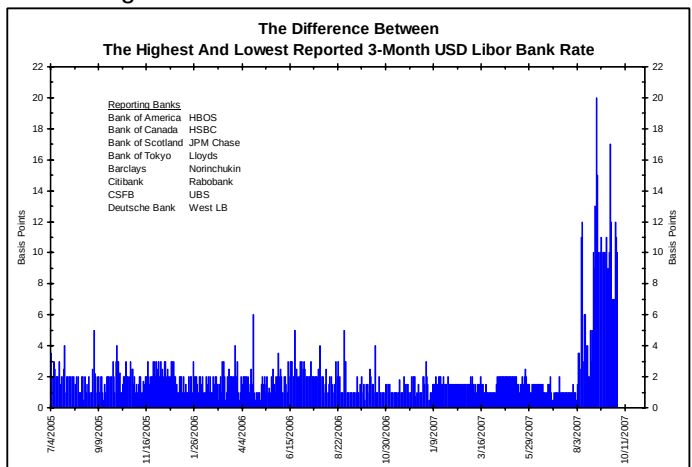
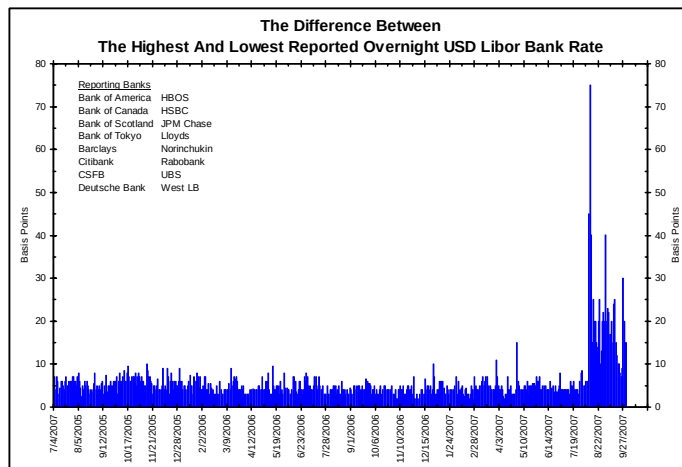
The process is repeated for a range of maturities ranging from overnight to 12-month loans and across a set of ten major currencies. Different respondent banks are surveyed for different currencies.

This method of calculation has largely been an irrelevant topic in the past, as the rates of the 16 banks used to calculate USD LIBOR rarely deviated

from one another. As the charts below show, however, the recent credit crunch has distorted the somewhat stable interbank loan market.

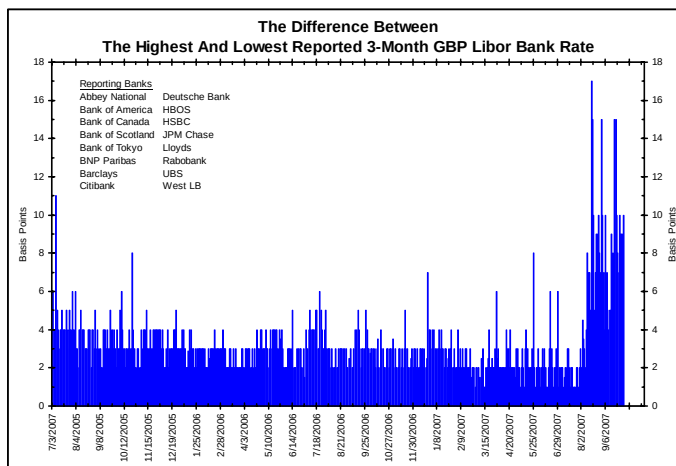
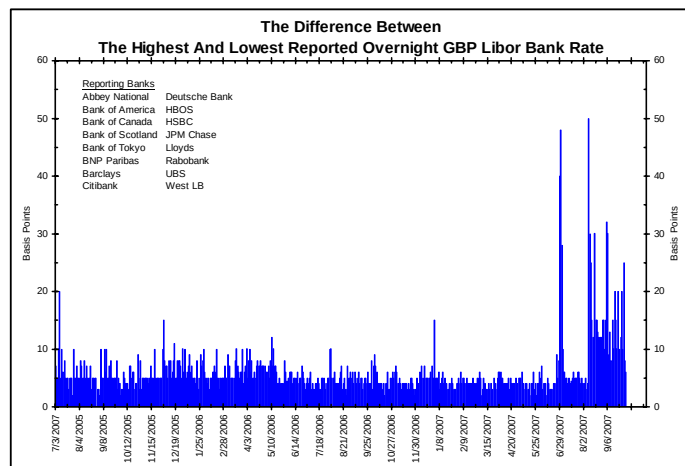
The chart on the left shows the high-low range for *overnight* USD LIBOR bank rates. Prior to the mid-August credit crunch, this range averaged about 5 basis points – nothing to write home about. However, once the credit market came under some pressure, this range expanded to more than 75 basis points. Those banks who were the most cash-hungry were offering much higher rates for USD deposits than their cash-flush counterparts.

The chart on the right shows the difference between the highest and lowest reported *3-month* USD LIBOR bank rates. It tells a very similar story to that of the overnight chart.



The same charts are shown below, but this time for the respective *overnight* and 3-month GBP LIBOR rates. Once again, these banks appeared to report very similar rates until the credit crunch began to

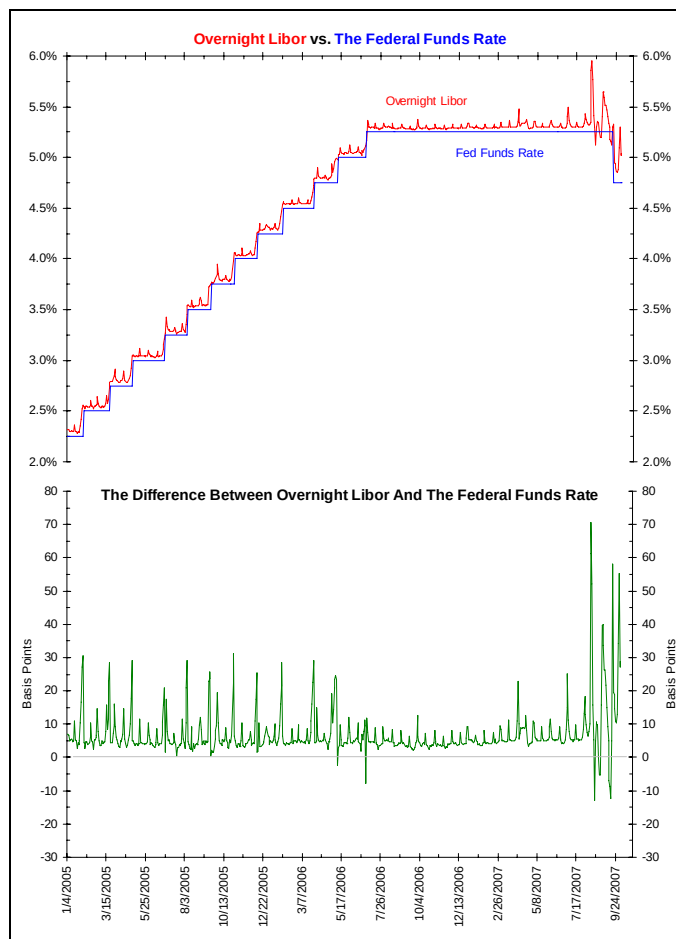
distort this relationship. The riskier, more illiquid banks were being forced to pay much higher rates for cash than they were prior to the problems in the credit market.



The distortions in the LIBOR market are also causing a divergence between overnight USD LIBOR and the target federal funds rate. These two measures used to closely follow each other, but as the chart to the right shows, the difference between *overnight* LIBOR and the target federal funds rate spiked as high as 70 basis points in mid-August.

### Conclusion

It is estimated \$150 trillion in securities, derivatives and loans are tied to these LIBOR rates. For this reason alone, the charts above bear watching. Alternatively, these charts can be viewed as yet another way to gauge the health of the credit markets worldwide. Until all 16 reporting banks can once again offer similar rates on interbank loans and overnight LIBOR comes back into line with the targeted federal funds rate, it is too early to sound the "all clear" signal on the current credit crisis.



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