FINANCE FACTORS

**With the LIBOR scandal shocking world financial markets, Canada looks inward to see if something like it could happen at home**

# LENDING RATE REPEAT?

BY | JOEL KRANC

Many of us read the headlines in the early days of summer concerning the LIBOR scandal and how it led to the disgrace of Barclays Bank and its chief executive, Bob Diamond who resigned as a result of the bank's activities. The bank also offered a public apology and agreed to pay US$453 million to settle manipulation charges brought against it by many US and UK banks.

And in a post-Great Recession world, it's easy to start asking the obvious questions. How could this happen? Aren't there new safeguards against such practices? Why weren't the regulators watching more carefully? And when looking at it from a local perspective, could such an event occur in Canada or are we sufficiently regulated to ensure interest rates cannot be manipulated?

## Brief Explanation

Simply, LIBOR or the London Interbank Offered Rate is an average interest rate derived by surveying the leading banks in London, if those banks were to loan money to one another. Many of the world's financial products such as derivatives and mortgage rates are underpinned by LIBOR. Barclays had submitted lower rates so as to project a position of strength. Because it is relatively early days, investigations and suggestions of how better to monitor such situations are still being explored.

Many in the finance sector, still hung over from the financial scandals and crises of 2008-09, are questioning the steps taken to address these issues and are beginning to look deeper into the root problems. Issues that are top of mind include initiating the right sanctions against malfeasance. "It's important to have proper deterrents," says David Wright, secretary general of the International Organization of Securities Commissions (IOSCO). "If people don't feel the deterrents are particularly high, whether it's LIBOR or any other market manipulation, they will be more tempted to abuse markets than if they knew they were going to be subject to very strong penalties, including jail terms."

In Canada, however, financial markets are still considered stable and, in many cases, a model that has avoided much of the world's financial woes. The bank-lending system here has its own set of circumstances.

## Canadian Lending

For instance in Canada, CDOR, or the Canadian Dealer Offer Rate, is determined by a daily survey of rates by the "main market makers," which include the major banks. The results are released 15 minutes after the survey is conducted. Unlike LIBOR, which is internationally recognized and accounts for 10 different currencies and 15 different borrowing rates, the pricing

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of CDOR mainly affects a handful of Canadian securities and other products.

Also, in Canada, banks often go to public markets (where rates can be lower) when looking for funding rather than using each other's services—something that occurs more often by banks in Europe, the UK and the US using LIBOR as their benchmark.

And although it is perhaps premature, Bank of Canada governor Mark Carney has stated there may be alternatives, including CDOR, which could act as different rates for different currencies. At a press conference in Ottawa in July, Carney said: "Canada's CDOR actually has some attractions because it is a committed rate. It's actually a borrowing rate that is used by banks on a regular basis, almost daily basis… It's very early days, but we may end up with different types of rates used in different currencies."

Stricter regulations and stress limits compared to other countries have helped Canadian banks through the last few years of volatility. However, regulations did not stop Barclays when it came to the type of inter-bank lending scandal that occurred. How can Canada safeguard its bank-lending practices?

So far, there has been little public comment in the Canadian financial sector that would lead people to believe that a similar scandal could occur here. But that doesn't mean Canadian regulators are being complacent. In 2007, a working group comprised of all CDOR survey participants, the Investment Industry Regulatory Organization of Canada (IIROC) and the Bank of Canada, was created. The group acts as a forum to discuss matters related to the setting and dissemination of CDOR. For its part, IIROC says it will "continue to engage this working group and other stakeholders as appropriate as it conducts its review."

In relation to the current scandal, the organization released a statement saying: "Recent experiences with LIBOR point to a need for increased scrutiny of such survey-based reference rates and IIROC is conducting a review of current practices among CDOR survey participants."

## The Bigger Picture

Proper oversight is a given when it comes to ensuring large financial institutions are playing by the rules. But choosing the right methods is not always so simple. "You have to have a system that avoids any danger of conflict of interest. For example, the data must be collected by people who understand it and who are distant from the suppliers of the data," says IOSCO's Wright. "The more transactions, the better."

As for the lending institutions, Wright highlights the importance of proper risk controls and places special emphasis on the importance of good corporate governance. That includes ensuring "competent" people are being appointed to boards as a proper safeguard. "You can do whatever you want to reform financial markets but if you have people at the top that are not fit for the purpose, or boards that are weak or risk management that is poor or compliance that is not complying, you're in trouble," he adds.

He explains that organizations such as the Financial Services Authority in the UK are already taking steps such as vetting people who are appointed to boards, for example.

Although he would not comment specifically on the Canadian model, he says, "In Canada you've had a very good 'war.' People should be looking very hard at those jurisdictions that seem to have done better. You should never be complacent about these things but it is certainly clear that some countries have done considerably better than others."

Overall, the LIBOR scandal has shone a light on the failings of certain systems—mostly due to the gaps in human capital, risk management and a disregard for rules and regulations put in place to prevent such activity.

"Corporate governance, proper controls in financial firms, controls of risk and competent people being on boards of firms all have their role," notes Wright. "I think these issues are going to become more and more important." R

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