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Barclays has been fined, the British have issued their report, and now the market is anxious for everything to go on as usual with the London Interbank Offer Rate (“LIBOR”). I think that would be a serious mistake.

The U.S. and British investigations into rate-fixing by Barclays revealed a widespread culture of pervasive, deceitful conduct in the setting of the most important private sector benchmark for over \$300 trillion in derivative contracts and \$10 trillion in adjustable-rate loans. It is highly unlikely that Barclays was the only major bank engaging in this conduct, and public investigations and private lawsuits against a range of participants in LIBOR rate-setting are likely to reveal further misconduct in the months ahead.

The basic structure for the setting of LIBOR is fundamentally flawed. It permits banks with obvious conflicts of interest to skew the LIBOR rate in order to benefit their own firm. Barclays, for example, was alleged to have attempted to manipulate LIBOR to benefit its traders and to hide its growing costs of borrowing in the financial crisis. The LIBOR structure also facilitates collusion among the rate-setting banks, in violation of the antitrust laws. Barclays, for example, was alleged to have attempted to manipulate LIBOR in collusion with other firms to benefit particular trades over a number of years. Both public antitrust investigations and a range of private lawsuits are likely to be pursued with vigor in the coming months.

The collusion and manipulation were alleged to have occurred during both quiescent markets and turbulent ones. That is, the attempted manipulation of LIBOR was apparently not confined to one extraordinary “once-in-a-lifetime” financial crisis, when extreme market pressures might have lured firms to engage in this unlawful conduct, but rather was ingrained in the regular setting of rates.

As it currently stands, LIBOR is not a market interest rate. It provides the illusion of market rates that are relied upon by everyone from sophisticated derivative traders to ordinary mortgage borrowers, but the rate itself is pure fiction. Banks submit a rate at which they supposedly could borrow, but there’s no requirement that the rates submitted be based on actual transactions. As Mervyn King, Governor of the Bank of England put it, LIBOR represents “the rate at which banks do not lend to each other.”

In normal times, the rate is not needed, as U.S. dollar LIBOR tracks (with a regular additional cost reflecting credit and liquidity risks of private borrowing) the risk-free rate of Federal funds and Treasury bills. In abnormal times—such as the financial crisis peak in the fall of 2008—no one can count on the fact that it tracks anyone’s true cost of funds. And if it did

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track someone's true cost of funds, it could hardly be said to track the costs of funds of any particular institution facing (or not facing) liquidity or solvency strains, even among the "elite" group setting the rate.

But what about reform? Didn't the British authorities just fix the problem?

No.

The "Wheatley Report" issued last month is definitely better than the status quo. It echoes a series of reform proposals first put out by the New York Federal Reserve Bank in 2008—making LIBOR less subject to manipulation, and requiring the auditing of submissions. This is all for the good. If we have to keep LIBOR, making it subject to greater scrutiny is definitely preferable to the status quo.

But at this point, it is not enough. The proposed reforms are too reliant on the existing structure of LIBOR, and come too late to save it. Continued reliance on LIBOR rightly undermines trust in the financial system.

What should we do going forward?

There are four potential paths:

First, reform LIBOR, along the lines of the Wheatley Report. Better than the status quo, but if you ask me, I wouldn't trust it. The incentives for manipulation are too strong, and regulators are never going to be able to keep up with the foul play. The regulatory apparatus required to enforce the reforms are likely to make LIBOR less risk-sensitive and more litigation-averse, which undermines the point of the reform.

Second, reform LIBOR, along the lines recently suggested by Commodity Futures Trading Commission Chair Gary Gensler. Much better: banks would rely on actual transactions (lagged by a day) instead of made-up claims about borrowing costs. But the market for actual, unsecured interbank lending is currently thin, and likely to get thinner, as both the Dodd-Frank Act's interbank credit limit and the Basel III's liquidity requirements will penalize such transactions. Thin trading means unreliable pricing, and the incentives for manipulation and collusion would remain strong unless actual borrowing volumes are high compared to the volumes of other LIBOR-related transactions that might benefit from cooked submissions.

Third, reform LIBOR by requiring banks to "commit" to a LIBOR rate, as suggested in a thoughtful article by Professors Abrantes-Metz and Evans, even if the transactions do not take place, on the grounds that reducing the incentive to lie involves committing firms to borrow or lend at the quoted rates, and one should be concerned about making sure there's a LIBOR rate in place even during periods of market stress when few actual transactions are likely to occur. But committing to borrow or lend at a certain rate is not likely to have much bite when you need it—during a financial panic—because other sources of borrowing, including from the central bank or from private sources on a secured basis, will often trump the option of unsecured borrowing at the quoted rate. And the benefits from misstating LIBOR to gain on trading positions may swamp the costs of borrowing (or lending) some amount at the committed rate even if the firm is forced to do so.

Fourth, reform LIBOR by replacing it with an actual, traded, transparent rate in a liquid market. For example, U.S. dollar LIBOR could be based on the Overnight Index Swap (“OIS”) rate (based on Federal funds) or Treasury-bill rate, plus a fixed spread.

At the end of the day, and acknowledging the costs, I’m with option four.

While the change will not be easy, it is time to abandon the fiction of “market” rate-setting by quotes from the largest banks. Using OIS or Treasury bills as the index rate would permit parties to hedge interest-rate risk, as LIBOR was intended. Parties that want to hedge bank credit and liquidity risk can do so with other instruments, although these instruments too have their own difficulties.

To be sure, there are costs to this approach: transition costs to moving away from a widely used market convention to a new system; the risks of market fragmentation and lower liquidity if market participants do not readily settle on a new contract rate; and the ongoing cost of having a rate that may diverge from actual bank credit and liquidity conditions, especially in a severe financial crisis.

But LIBOR apparently never actually reflected these market conditions. The supposed gains of having a rate that reflects interbank credit risk is belied by actual market practice and is unlikely to be fixed by other reforms. Transitional issues should not block fundamental reform. The markets have had to move to new contract rates in other contexts—for example, in the transition from European currencies to the Euro—and have managed these transitions quite well.

The financial sector is suffering from a deficit of trust. That lack of trust has been earned. To build a more resilient financial system, we need to start with the basics: trust in the financial system will be restored when it acts honestly.

And one key measure of that will be when the financial system bases contracts on actual, observable, transparent market transactions.