Libor scandal

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Scale of the scandal

This dwarfs by orders of magnitude any financial scam in the history of markets.[1][2]

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Andrew Lo, MIT Professor of Finance

The **Libor scandal** is a series of fraudulent actions connected to the Libor (London Interbank Offered Rate) and also the resulting investigation and reaction. The Libor is an average interest rate calculated through submissions of interest rates by major banks in London. The scandal arose when it was discovered that banks were falsely inflating or deflating their rates so as to profit from trades, or to give the impression that they were more creditworthy than they were.[3] Libor underpins approximately $350 trillion in derivatives. It is controlled by the British Bankers' Association (BBA).[4]

The banks are supposed to submit the actual interest rates they are paying, or would expect to pay, for borrowing from other banks. The Libor is supposed to be the total assessment of the health of the financial system because if the banks being polled feel confident about the state of things, they report a low number and if the member banks feel a low degree of confidence in the financial system, they report a higher interest rate number. In June 2012, multiple criminal settlements by Barclays Bank revealed significant fraud and collusion by member banks connected to the rate submissions, leading to the scandal.[5][6][7]

Because Libor is used in U.S. derivatives markets, an attempt to manipulate Libor is an attempt to manipulate U.S. derivatives markets, and thus a violation of American law. Since mortgages, student loans, financial derivatives, and other financial products often rely on Libor as a reference rate, the manipulation of submissions used to calculate those rates can have significant negative effects on consumers and financial markets worldwide.

On 27 July 2012, the *Financial Times* published an article by a former trader which stated that Libor manipulation had been common since at least 1991.[8] Further reports on this have since come from the BBC[9][10] and Reuters.[11] On 28 November 2012, the Finance Committee of the Bundestag held a hearing to learn more about the issue.[12]

The British Bankers’ Association said on 25 September 2012 that it would transfer oversight of Libor to UK regulators, as predicted by bank analysts,[13] proposed by Financial Services Authority Managing Director Martin Wheatley's independent review recommendations.[14] Wheatley's review recommended that banks submitting rates to Libor must base them on actual

inter-bank deposit market transactions and keep records of those transactions, that individual banks' LIBOR submissions be published after three months, and recommended criminal sanctions specifically for manipulation of benchmark interest rates.[15] Financial institution customers may experience higher and more volatile borrowing and hedging costs after implementation of the recommended reforms.[16] The UK government agreed to accept all of the Wheatley Review's recommendations and press for legislation implementing them.[17]

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[edit] Early reports of Libor manipulation

[edit] WSJ Libor study

Libor manipulation to lower rate

Hi Guys, We got a big position in 3m libor for the next 3 days. Can we please keep the lib or fixing at 5.39 for the next few days. It would really help. We do not want it to fix any higher than that. Tks a lot.

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Barclays Bank trader in New York to submitter,
13 September 2006[18]

On 16 April 2008, *The Wall Street Journal* (WSJ) released a controversial article, and later study, suggesting that some banks might have understated borrowing costs they reported for the Libor during the 2008 credit crunch that may have misled others about the financial position of these banks.[19][20] In response, the BBA claimed that the Libor continued to be reliable even in times of financial crisis. Other authorities contradicted *The Wall street Journal* article saying there was no evidence of manipulation. In its March 2008 Quarterly Review, the Bank for International Settlements stated that "available data do not support the hypothesis that contributor banks manipulated their quotes to profit from positions based on fixings."[21] Further, in October 2008, the International Monetary Fund published its regular *Global Financial Stability Review* which also found that "Although the integrity of the U.S. dollar Libor-fixing process has been questioned by some market participants and the financial press, it appears that U.S. dollar Libor remains an accurate measure of a typical creditworthy bank's marginal cost of unsecured U.S. dollar term funding."[22]

A study by economists, Snider and Youle, in April 2010, however, corroborated the results of the earlier *Wall Street Journal* study that the Libor submissions by some member banks were being understated.[23] Unlike the earlier study, Snider and Youle suggested that the reason for understatement by member banks was not that the banks were trying to appear strong, especially during the financial crisis period of 2007 to 2008, but rather that the banks sought to make substantial profits on their large Libor interest-linked portfolios.[24] For example, in the first quarter of 2009, Citigroup had interest rate swaps of notional value of $14.2 trillion, Bank of America had interest rate swaps of notional value of $49.7 trillion and JP Morgan Chase had interest rate swaps of notional value of $49.3 trillion.[25] Given the large notional values, a small unhedged exposure to the Libor could generate large incentives to alter the overall Libor. In the first quarter of 2009, Citigroup for example reported that it would make that quarter $936 million in net interest revenue if interest rates would fall by .25 percentage points a quarter, and $1,935 million if they were to fall by 1 percentage point instantaneously.[26]

[edit] Central banks aware of Libor flaws

The Governor of the Bank of England, Mervyn King, by the end of 2008, described the Libor to the UK Parliament saying "It is in many ways the rate at which banks do not lend to each other, .. it is not a rate at which anyone is actually borrowing."[27][28]

The New York Federal Reserve in July 2012, released documents dating back to 2007 which showed that they were aware that banks were lying about their borrowing costs when setting Libor and chose to take no action against them at that time.[29][30] Released minutes from the Bank of England indicated similarly that the bank and its deputy governor Paul Tucker were also aware as early as November 2007 of industry concerns that the Libor rate was being underreported.[31][32] In one 2008 document a Barclays employee told a New York Fed analyst, "We know that we're not posting an honest Libor, and yet we are doing it, because if we didn't do it, it draws unwanted attention on ourselves."[30]

The documents show that in early 2008 a memo written by then New York Fed President Tim Geithner to Bank of England chief Mervyn King looked into ways to "fix" Libor.[33][34] While the released memos suggest that the New York Fed helped to identify problems related to Libor and

press the relevant authorities in the UK to reform, there is no documentation that shows any evidence that Geithner's recommendations were acted upon or that the Fed tried to make sure that they were. In October 2008, several months after Geithner's memo to King, a Barclays employee told a New York Fed representative that Libor rates were still "absolute rubbish."[30]

[edit] Regulatory investigations

The *Wall Street Journal* reported in March 2011 that regulators were focusing on Bank of America Corp., Citigroup Inc. and UBS AG in their probe of Libor rate manipulation.[35] A year later, it was reported in February 2012 that the U.S. Department of Justice was conducting a criminal investigation into Libor abuse.[36] Among the abuses being investigated were the possibility that traders were in direct communication with bankers before the rates were set, thus allowing them an unprecedented amount of insider knowledge into global instruments.[37] In court documents, a trader from the Royal Bank of Scotland claimed that it was common practice among senior employees at his bank to make requests to the bank's rate setters as to the appropriate Libor rate, and that the bank also made on occasions rate requests for some hedge funds.[38] One trader's messages from Barclays Bank indicated that for each basis point (0.01%) that Libor was moved, those involved could net “about a couple of million dollars”.[37]

The Canadian Competition Bureau was reported on 15 July 2012 to also be carrying out an investigation into price fixing by five banks of the yen denominated Libor rates. Court documents filed indicated that the Competition Bureau had been pursuing the matter since at least January 2011. The documents offered a detailed view of how and when the international banks allegedly colluded to fix the Libor rates. The information was based on a whistleblower who traded immunity from prosecution in exchange for turning on his fellow conspirators. In the court documents, a federal prosecutor for the bureau stated that the “IRD (interest-rate derivatives) traders at the participant banks communicated with each other their desire to see a higher or lower yen LIBOR to aid their trading positions". The alleged participants are the Canadian branches of the Royal Bank of Scotland, HSBC, Deutsche Bank, JP Morgan Bank, and Citibank, as well as ICAP (Intercapital), an interdealer broker.[39]

[edit] Fines for manipulation

Libor manipulation to raise rate

Pls go for 5.36 libor again, very important that the setting comes as high as possible ... thanks.

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Barclays Bank trader in New York to submitter,
29 July 2007[18]

On 27 June 2012, Barclays Bank was fined $200 million by the Commodity Futures Trading Commission,[5] $160 million by the United States Department of Justice[6] and £59.5 million by the Financial Services Authority[7] for attempted manipulation of the Libor and Euribor rates.[40]

The United States Department of Justice and Barclays officially agreed that "the manipulation of the submissions affected the fixed rates on some occasions".[41][42][43]

Barclays manipulated rates for at least two reasons. Routinely, from at least as early as 2005, traders sought particular rate submissions to benefit their financial positions. Later, during the 2007–2012 global financial crisis, they artificially lowered rate submissions to make their bank seem healthy.[6]

Following the interest rate rigging scandal, Marcus Agius, chairman of Barclays, resigned from his position.[44] One day later, Bob Diamond, the chief executive officer of Barclays, also resigned from his position.[45][46] Bob Diamond was subsequently questioned by the Parliament of the United Kingdom regarding the manipulation of Libor rates. He said he was unaware of the manipulation until that month, but mentioned discussions he had with Paul Tucker, deputy governor of the Bank of England.[47] Tucker then voluntarily appeared before parliament, to clarify the discussions he had with Bob Diamond. He said he had never encouraged manipulation of the Libor, and that other self-regulated mechanisms like the Libor should be reformed.[48]

On 19 December 2012, UBS agreed to pay regulators $1.5bn ($1.2bn to the US Department of Justice and the Commodity Futures Trading Commission, £160m to the UK Financial Services Authority and 60m CHF to the Swiss Financial Market Supervisory Authority) for its role in the scandal.[49] The investigations revealed that UBS traders had colluded with other panel banks and had made over 2,000 written requests for movements in rates from at least January 2005 to at least June 2010 to benefit their trading positions.[50] According to transcripts released by the U.K.'s Financial Services Authority, UBS traders also offered financial inducements to interdealer brokers to help manipulate rates by spreading false information. In one exchange between a UBS banker identified as Trader A and an interdealer broker, the banker wrote "if you keep 6s [i.e. the six month JPY LIBOR rate] unchanged today … I will f—ing do one humongous deal with you … Like a 50,000 buck deal, whatever … I need you to keep it as low as possible … if you do that …. I'll pay you, you know, 50,000 dollars, 100,000 dollars… whatever you want … I'm a man of my word." Subsequent trades between UBS and this broker generated more than $250,000 in fees to the broker.[51][52]

US Assistant Attorney General Lanny Breuer described the conduct of UBS's as "simply astonishing" and declared the US would seek, as a criminal matter, the extradition of traders Tom Hayes and Roger Darin.[49] The bank has stated that these and other fines would probably result in a significant fourth-quarter loss in 2012.[49] The fine levied by the FSA, reduced due to the bank's cooperation, was the largest in the agency's history.[49]

[edit] Breadth of scandal becomes apparent

By 4 July 2012 the breadth of the scandal was evident and became the topic of analysis on news and financial programs that attempted to explain the importance of the scandal.[53] Two days later, it was announced that the U.K. Serious Fraud Office had also opened a criminal investigation into manipulation of interest rates. The investigation was not limited to Barclays.[54][55] It has been reported since then that regulators in at least ten countries on three

different continents are investigating the rigging of the Libor and other interest rates.[56][57] Around 20 major banks have been named in investigations and court cases.[58]

Early estimates are that the rate manipulation scandal cost U.S. states, counties, and local governments at least $6 billion in fraudulent interest payments, above $4 billion that state and local governments have already had to spend to unwind their positions exposed to rate manipulation.[59] An increasingly smaller set of banks are participating in setting the Libor, calling into question its future as a benchmark standard, but without any viable alternative to replace it.[60]

[edit] United States investigations

The United States Congress began investigating on 10 July. Senate Banking Committee Chairman Tim Johnson (D., S.D.) said he would question Treasury Secretary Timothy Geithner and Federal Reserve Chairman Ben Bernanke about the scandal during scheduled hearings. Rep. Randy Neugebauer (R., Texas) of the House Financial Services Committee, wrote New York Federal Reserve (New York Fed) President William Dudley. He was seeking records of communications between the New York Fed and Barclays between August 2007 and November 2009 related to Libor-like rates.[61]

On 4 October 2012, republican U.S. Senators Chuck Grassley and Mark Kirk announced that they were investigating Treasury Secretary Tim Geithner for complicity with the rate manipulation scandal. They accused Geithner of knowledge of the rate-fixing, and inaction which contributed to litigation that "threatens to clog our courts with multi-billion dollar class action lawsuits" alleging that the manipulated rates harmed state, municipal and local governments. The senators said that an American-based interest rate index is a better alternative which they would take steps towards creating.[62]

Federal Housing Finance Agency Inspector General and auditor Steve A. Linick said in a 3 November memo that Fannie Mae and Freddie Mac may have lost more than $3 billion because of the manipulation.[63]

[edit] Parliamentary investigation

Appearing before Parliament on 16 July, Jerry del Missier, a former senior Barclays executive, said that he had received instructions from Robert Diamond to lower rates after Diamond's discussions with bank regulators. He said that he had received information of a conversation between Diamond and Paul Tucker, deputy governor of the Bank of England, in which they had discussed the bank's financial position at the height of the 2008 financial crisis. It was his understanding that senior British government officials had instructed the bank to alter the rates. Del Missier's testimony followed statements from Diamond in which he denied that he had told his deputies to report false Libor rates. Speaking before Parliament the previous week, Tucker stated that he had shared concerns regarding Barclays Libor rates because the markets might view Barclays to be at risk if its Libor submissions continued to be higher than those of other international banks. In the midst of the Lehman Brothers collapse, there was concern the bank might need to be bailed out if the financial markets perceived it was a credit risk. Tucker told the

committee, “I wanted to make sure that Barclays’ day-to-day funding issues didn’t push it over the cliff."[64]

[edit] Libor banks are sued in civil court

[edit] Libor fixing operates as a cartel

Libor fixing a banking cartel

It’s just amazing how Libor fixing can make you that much money or lose if opposite. It’s a cartel now in London.

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RBS trader in Singapore to Deutsche Bank trader,
19 August 2007[65]

In court documents filed in Singapore, Royal Bank of Scotland (RBS) trader Tan Chi Min told colleagues that his bank could move global interest rates and that the Libor fixing process in London had become a cartel. Tan in his court affidavit stated that the Royal Bank of Scotland knew of the Libor rates manipulation and that it supported such actions. In instant messages, traders at RBS extensively discussed manipulating Libor rates. In a released transcript of a 21 August 2007 chat, Jezri Mohideen, who was the head of yen products in Singapore, asked to have the Libor fixed in a conversation with other traders:[65]

> *Mohideen*: “What’s the call on the Libor?”
> *Trader 2*: “Where would you like it, Libor that is?”
> *Trader 3*: “Mixed feelings, but mostly I’d like it all lower so the world starts to make a little sense.”
> *Trader 4*: “The whole HF [hedge fund] world will be kissing you instead of calling me if Libor move lower.”
> *Trader 2*: “OK, I will move the curve down 1 basis point, maybe more if I can.”

In another conversation on 27 March 2008, Tan asked that RBS raise its Libor submission and noted that an earlier lower figure that the bank had submitted had cost his team 200,000 pounds. In other released instant chats, Tan made it clear that the Libor fixing process had become a highly lucrative money making cartel. Tan in a conversation with traders at other banks, including Deutsche Bank’s Mark Wong said on 19 August 2007:[65]

> *Tan*: “It’s just amazing how Libor fixing can make you that much money or lose if opposite. It’s a cartel now in London.”
> *Wong*: “Must be damn difficult to trade man, especially [if] you [are] not in the loop.”

[edit] Mortgage rates manipulated on reset date

Homeowners in the US filed a class action lawsuit in October 2012 against twelve of the largest banks which alleged that Libor manipulation made mortgage repayments more expensive than they should have been.

Statistical analysis indicated that the Libor rose consistently on the first day of each month between 2000 and 2009 on the day that most adjustable-rate mortgages had as a change date on which new repayment rates would "reset". An email referenced in the lawsuit from the Barclay's settlement, showed a trader asking for a higher Libor rate because “We’re getting killed on our three-month resets.”[66] During the analysed period, the Libor rate rose on average more than two basis points above the average on the first day of the month, and between 2007 and 2009, the Libor rate rose on average more than seven and one-half basis points above the average on the first day of the month.[67]

The five lead plaintiffs included a pensioner whose home was repossessed after her subprime mortgage was securitized into Libor-based collateralized debt obligations, sold by banks to investors, and foreclosed. The plaintiffs could number 100,000, each of whom has lost thousands of dollars.[68] The complaint estimates that the banks earned hundreds of millions, if not billions of dollars, in wrongful profits as a result of artificially inflating Libor rates on the first day of each month during the complaint period.[67]

[edit] Municipalities lost billions due to rigging

The city of Baltimore and others in the US filed a class action lawsuit in April 2012 against Libor setting banks which alleged that the manipulation of Libor caused payments on their interest rate swaps to be smaller than they should have been.[69] Before the financial crisis, states and localities bought $500 billion in interest rate swaps to hedge their municipal bond sales. It is estimated that the manipulation of Libor cost municipalities at least $6 billion. These losses were in addition to $4 billion that localities had already paid to unwind backfiring interest rate swaps.[70]

Municipalities began using interest rate swaps to hedge their municipal bond sales in the late 1990s. At this time, investment bankers began offering local governments a way to save money on the sale of municipal bonds. The banks suggested instead of selling fixed interest rate bonds that local governments sell variable interest rate bonds which typically have interest rates as much as one percentage point lower than fixed interest rate bonds. For a municipal government this could mean saving as much as $1 million a year on the sale of a $100 million bond.[71]

In order to hedge costs on the sale of variable interest rate bonds, which can rise and fall with the market, local governments, such as Baltimore, purchased interest rate swaps which exchange a variable interest rate for a fixed interest rate.[72] In a swap deal, when the interest rate rises, the swap seller pays the local government the increased cost on the bond, while when the interest rate falls, the swap seller saves and pays the local government the decreased cost on the bond. The interest rate swap mechanism generally works well, however, between 2007 and 2010 the payments to local governments on their swaps artificially decreased but the cost on their bonds remained at actual market rates. This was because most interest rate swaps are linked to the Libor interest rate, while municipal bond rates are linked to the SIFMA Municipal Bond Index

interest rate. During the financial crisis the two benchmark rates decoupled. Municipalities continued to pay on their bonds at the actual market Sifma rate but were paid on their interest rate swaps at the artificially lower Libor rate.[71]

[edit] Reactions and impact on banking regulation

The cost to colluding and suspect banks from litigation, penalties, and loss of confidence may drive down finance industry profits for years. The cost of litigation from the scandal may exceed that of asbestos lawsuits.[73]

[edit] United States

US experts such as Former Assistant Secretary of the Treasury Paul Craig Roberts have argued that the Libor Scandal completes the picture of public and private financial institutions manipulating interest rates in order to prop up the prices of bonds and other fixed income instruments, and that "the motives of the Fed, Bank of England, US and UK banks are aligned, their policies mutually reinforcing and beneficial. The Libor fixing is another indication of this collusion."[74] In that perspective they advocate stricter bank regulation, and a profound reform of the Federal Reserve System.

Former Citigroup Chairman and CEO Sandy Weill, considered one of the driving forces behind the considerable financial deregulation and "mega-mergers" of the 1990s, surprised financial analysts in Europe and North America by calling for splitting up the commercial banks from the investment banks. In effect, he says: "Bring back the Glass-Steagall Act of 1933 which led to half a century, free of financial crises." [75]

[edit] Europe

Mainland European scholars discussed the necessity of far-reaching banking reforms in light of the current crisis of confidence, recommending the adoption of binding regulations that would go further than the Dodd–Frank Act: notably in France where SFAF and World Pensions Council (WPC) banking experts have argued that, beyond national legislations, such rules should be adopted and implemented within the broader context of separation of powers in European Union law, to put an end to anti-competitive practices akin to exclusive dealing and limit conflicts of interest.[76][77] This perspective gained ground after the unraveling of the Libor scandal, with mainstream opinion leaders such as the *Financial Times'* editorialists calling for the adoption of an EU-wide "Glass–Steagall II".[78]

Naomi Wolf of *The Guardian* suggested in an editorial that the "notion that the entire global financial system is riddled with systemic fraud – and that key players in the gatekeeper roles, both in finance and in government, including regulatory bodies, know it and choose to quietly sustain this reality – is one that would have only recently seemed like the frenzied hypothesis of tinhat-wearers".[79] Looking at the fact that Tim Geithner went on to be promoted to Treasury Secretary, Wolf commented, "It is very hard, looking at the elaborate edifices of fraud that are emerging across the financial system, to ignore the possibility that this kind of silence – 'the willingness to not rock the boat' — is simply rewarded by promotion to ever higher positions,

ever greater authority. If you learn that rate-rigging and regulatory failures are systemic, but stay quiet, well, perhaps you have shown that you are genuinely reliable and deserve membership of the club."[79]

[edit] Recommendations

The British Bankers’ Association said on 25 September that it would transfer oversight of Libor to UK regulators, as proposed by Financial Services Authority Managing Director Martin Wheatley and CEO-designate of the new Financial Conduct Authority.[14] On 28 September, Wheatley's independent review was published, recommending that an independent organization with government and regulator representation, called the Tender Committee, manage the process of setting Libor under a new external oversight process for transparency and accountability. Banks that make submissions to Libor would be required to base them on actual inter-bank deposit market transactions and keep records of their transactions supporting those submissions. The review also recommended that individual banks' Libor submissions be published, but only after three months, to reduce the risk that they would be used as a measure of the submitting banks' creditworthiness. The review left open the possibility that regulators might compel additional banks to participate in submissions if an insufficient number do voluntarily. The review recommended criminal sanctions specifically for manipulation of benchmark interest rates such as the Libor, saying that existing criminal regulations for manipulation of financial instruments were inadequate.[15] Libor rates could be higher and more volatile after implementation of the reforms, so financial institution customers may experience higher and more volatile borrowing and hedging costs.[16] The UK government agreed to accept all of the Wheatley Review's recommendations and press for legislation implementing them.[17]

Bloomberg LP CEO Dan Doctoroff told the European Parliament that Bloomberg LP could develop an alternative index called the Bloomberg Interbank Offered Rate that would use data from transactions such as market-based quotes for credit default swap transactions and corporate bonds.[80][81]

[edit] References