Libor

What’s Libor?

Libor stands for “London InterBank Offered Rate,” and it’s exactly what it says on the tin. Banks lend each other money all the time. Sometimes overnight just to close their books with enough cash, sometimes for a week or two, and sometimes for a year. It’s not that banks don’t have money, it’s just that the money they have is tied in assets like stocks, bonds, and derivatives, and there’s a minimum amount of cash they are legally required to hold on their balance at close of business. So they exchange currencies.

Each morning, 18 banks tell the British Bankers’ Association (the U.K.’s bank lobby) how much they think other banks will charge them for borrowing their money today: that’s an interest rate. There is a rate for 15 borrowing periods (from one day to 12 months) and 10 different currencies. The BBA compiles it all, eliminates the four highest and four lowest rates, then publishes a median for each of the maturities and each of the currencies.

What matters is that it is an honor system: the BBA is not an independent organization, and they trust the banks to tell the truth. There isn’t an existing mechanism to review or regulate what they say. Also, it is an estimate, not a report of how much it actually cost a bank to borrow money on any given day.

Why should it concern you?

If banks lied about the rates at which they borrow, your home could be costing you a lot more than it would in a clean system. If your country or your city bought financial products in the past decade, your taxes could be misspent. Libor is a benchmark for short-term interest rates. It is used as a reference for a $360-trillion worldwide securities market that includes loans and mortgages. At these levels, even slight variations in the rates reported could have huge repercussions. In short, it would be fraud on a global scale.

Did banks lie?

It looks that way. U.K. bank Barclays was the first to get in trouble, mostly because it was the only one willing to fully cooperate with the British authorities. All of the “submitters” (or banks that submit their rates to the BBA) may have participated in rate-rigging. And what is worse, some have suggested that from the beginning of the financial crisis in 2007-2008, regulators may have been encouraging banks to report low rates. Low rates mean low risk: this would’ve been done to keep the markets in the dark about the financial health of the submitters and protect their reputation as safe borrowers. It’s not crazy to think that at the height of the crisis, regulators would’ve done anything to keep fear in the markets at a minimum. These things run on confidence.

The fact is, both the U.S. Federal Reserve and the Bank of England knew about the problem since 2007 and 2008. U.S. Treasury Secretary Tim Geithner, then head of the New York Fed and in charge of looking into it, faced the Senate on July 25, 2012, evading questions about his own role in the scandal and promising to pursue criminal charges.

The practice of rate-fixing seems to have started long before all that, however. Documents going as far as 2005 have come up in the British parliamentary inquiry. Before the crisis, artificially raising rates would’ve also increased trading gains. And suspicion is that this may have also happened with Euribor (the same thing, but compiled in Brussels) and Tibor (in Tokyo). Some think we’ll soon find out it was endemic.

Why would they do that?

Because they could. Remember how it’s an honor system? Manipulating rates is very easy to do, as there is no way to supervise submissions. Also, Libor didn’t attract much attention before the crisis. When things were going well, only people in the know paid it any mind. As the financial world neared collapse and interbank lending ground to a halt, Libor became a vital indicator, mostly to those who followed markets closely. The feeling of impunity was such submitters were quite open about it, carelessly documenting their rate-rigging activities in e-mails and documents.

Now what?

U.S. authorities are involved. Cities like Baltimore are suing, the Justice Department is also building a case and more recently, prosecutors in New York and Connecticut followed suit. The investigation extended to Euribor, the European Union's equivalent. All submitting banks are being examined closely and individuals are likely to be charged in Britain and in the U.S. The U.K.'s Financial Service Authority wants to reform the way the benchmark rate is set, making its manipulation a crime. In fact, the BBA may lose the oversight of the rate. Three people were arrested in London on Dec. 11, 2012, and in the U.S., a settlement with Swiss bank UBS includes charges against individuals.

evening-edition.com/libor
Dec. 2012