The LIBOR Scandal

LIBOR is used to set the interest rate on a huge volume of adjustable-rate mortgages, corporate loans, and swap transactions. In addition, the spread between LIBOR and the rate on Treasury bills (the TED spread) is an important indicator of stresses in the banking system. It is important, therefore, that investors can be confident that the measure accurately records the rates at which major banks are able to borrow from one another.

This confidence was dealt a blow in May 2008 at the height of the financial crisis, when *The Wall Street Journal* reported claims that 3-month LIBOR was understated by 20-30 basis points. The *Journal*'s allegations were reinforced by a comparison between the TED spread and the cost of insuring bank lending with a credit default swap.

The *Journal*'s assertion created considerable debate, though there was little consensus on why banks might wish to understate their borrowing rates. Some commentators suggested that individual banks with relatively high borrowing costs faced a potential loss of confidence amongst other creditors if their true costs became public. Others suggested that some banks had an incentive to reduce LIBOR in order to improve the profitability of their swap positions.

The U.S. Justice Department, CFTC, and SEC initiated an investigation into the issue and related probes were undertaken by Canadian, European, and Japanese regulators.[1] The first results were announced in June 2012 when Barclays was fined $450 million for attempting to manipulate LIBOR both upwards and downwards for at least four years up to 2009. For example, one exchange of emails between a trader and the data submitter went as follows:

Trader: "Pls set 3m libor as high as possible today."

Submitter: "Sure 5.37 okay?"

Trader: "5.36 is fine."

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[1] A number of papers sought to provide harder evidence on the issue. See, for example, R. Abrantes-Metz, M. Kraten, A.D. Metz, and G. Seow, "Libor Manipulation?" August 2008, available at SSRN: http://ssrn.com/abstract=1201389; D. Kuo, D. Skeie, and J. Vickery, "How well did Libor measure bank wholesale funding rates during the crisis?" mimeo, July 2010; and C.A. Snider and T. Youle, "Does the Libor Reflect Banks' Borrowing Costs?," April 2010, available at SSRN: http://ssrn.com/abstract=1569603.

The revelations resulted in a storm of outrage, and within days the CEO of Barclays announced his resignation. No one believed that Barclays was the only guilty party, and in the weeks that followed, news about similar practices at other major banks began to emerge.

Initially manipulation of LIBOR seems to have been motivated by an attempt to increase the profitability of a bank's swap positions. Since LIBOR is an average of the rates submitted by a panel of banks, the opportunities for any single bank to affect the final figure were probably limited to a basis point or two, though this provides a poor excuse for any attempts at manipulation.

When the financial crisis struck in 2007, two things changed. First, the market for interbank borrowing largely dried up, so that each bank's submission inevitably involved an element of judgment. Second, since individual LIBOR submissions are publicly available, no bank wanted to admit to needing to pay more for loans than its rivals. Barclays appears to have instructed its staff to submit numbers that were high enough to be in the top four and therefore discarded from the calculation, but a number of more fragile banks, such as the Royal Bank of Scotland (RBS), were submitting much lower figures.[2] There is some evidence that Barclays thought mistakenly that it had the tacit agreement of the Bank of England in these attempts to bolster confidence in the bank.

[2] In 2008 RBS received the world's biggest bail-out during the financial crisis, at a cost of £45bn to UK taxpayers.