

ISSUE BRIEF

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LIBOR Rigging Scandal: No New Laws Are Necessary

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As the evidence mounts about the scope of efforts to rig the London Interbank Offered Rate (LIBOR), a significant financial index, the predictable calls for new laws and even a radical restructuring of major segments of the financial services industry are coming from both the U.S. and Europe.

However, facts show that new laws are not needed. The system worked. It is true that some regulators on both sides of the Atlantic should have acted sooner and more aggressively, but new laws would not improve their performance.

How LIBOR Was Rigged and Why. LIBOR is a system of rates that acts as a benchmark for interest rates around the world, including some U.S. mortgages. It represents the estimated average interest rate that certain large international banks' London offices would pay to borrow

from another large bank for a list of 15 specific maturities (time periods) and 10 different currencies. Many other financial institutions base their own interest rates for a wide variety of financial products on the LIBOR rate, commonly adding a certain premium over LIBOR depending on the financial instrument in question and the credit quality of the borrower.

At present, 18 large international banks,¹ including three American banks, participate. At about 11 a.m. each U.K. business day, the British Bankers' Association polls the 18 banks for that day's estimated rates. The top and bottom four for each currency and maturity are dropped, and the mean of the middle 10 is used as that day's LIBOR rate and reported about 11:30 a.m. U.K. time by Thomson Reuters.²

There were actually two LIBOR manipulations dating as far back as 2005.³ The first was by traders at several banks, including Barclays, who routinely tried to move the index up or down in a way that would boost their individual profits. This practice was so well known that traders joked about it in e-mails.⁴ By submitting estimates that were too high or low, traders would seek to push one of the more accurate bids out of those used for the calculation, thus moving the

index up or down by a couple hundredths of a percent.

While this amount seems tiny, it is enough to make a huge derivatives transaction profitable or to edge out a competitor. One analyst estimated that moving the bond interest rate for a 50 billion euro bond by 1/100th of a percent could increase bank profits by 417,000 euros.⁵ Barclays, a major dealer in derivatives, could increase its profits by millions of dollars a day.

The second rigging took place during the 2008 financial crisis when Barclays and other banks found that concern about their financial condition—and particularly their exposure to toxic mortgage securities—required them to pay higher interest rates to borrow from other banks.

When the Bank of England expressed concern that Barclays's higher borrowing rates would cause other banks to stop lending to it and require a government bailout, Barclays began to submit falsely low numbers. This made it appear to have the same risk level as other big banks. Other banks appear to have manipulated LIBOR during late 2008 in much the same way and for the same reason.⁶

Both U.S. and U.K. regulators have levied huge fines against

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Barclays Bank for rigging the LIBOR rates. Because of these manipulations, millions of Americans' mortgage or credit card interest rates may be inaccurate, costing them potentially billions of dollars more than they should be paying. Barclays agreed to pay fines of \$200 million to the Commodity Futures Trading Commission (CFTC), another \$160 million to the Department of Justice (DOJ), and \$91 million to the U.K.'s Financial Services Authority (FSA). These are the largest fines in the history of both the CFTC and the FSA.

In addition, criminal indictments of individuals and possibly some banks are expected shortly,⁷ and the bank expects to be sued by entities that were damaged by the rigged index.⁸ Additional banks are under investigation, with Royal Bank of Scotland announcing that it expects substantial fines for its role.⁹

Regulator Delays Prolong the Problem. Regulators have known

about the LIBOR manipulations for some time, but they did not act until recently. The British Bankers' Association, which compiles LIBOR quotes, was receiving regular complaints about its accuracy as far back as 2008.¹⁰ It took no action and appears not to have contacted regulators. The New York Federal Reserve Bank, then headed by Treasury Secretary Timothy Geithner, started to receive reports in April 2008 about Barclays's actions and began to talk to other U.S. regulators the following month.¹¹ However, it did not contact the DOJ. In June 2008, Geithner sent a memo to Bank of England head Mervyn King¹² expressing concern about the accuracy of LIBOR and proposing changes. Nothing happened in either the U.S. or the U.K. for almost four years.

As LIBOR is a rate set in London, U.K. regulators should have taken the lead in both punishing Barclays and other banks and generally

reforming the process. Clearly, they failed to do this. However, as the huge fines from the CFTC and DOJ show, there was also a U.S. legal interest. If the NY Fed had been more aggressive, action could have occurred much faster.

Unnecessary New Laws. In both the U.S. and Europe, there have been calls for tough new laws and even for a major industry restructuring. The European Commission has announced plans to make the manipulation of benchmark interest rates like LIBOR a crime,¹³ at the same time criticizing the U.K. regulators as being too lax. Their action reflects as much a long-standing disagreement about how to regulate financial institutions as anything else. Meanwhile, the U.K. government has started an urgent study of the issue, with a report on causes and potential solutions expected in September.

In the U.S., responses have been even more aggressive. Some have

1. The banks include JP Morgan Chase, Bank of America, and Citibank in addition to 15 other large international banks with offices in London.
2. Editorial, "The Rotten Heart of Finance," *The Economist*, July 7, 2012, <http://www.economist.com/node/21558281> (accessed August 6, 2012).
3. Carrick Mollenkamp and Emily Flitter, "At Least Three Banks Seen Central to Libor Rigging," *Reuters*, July 28, 2012, <http://www.reuters.com/article/2012/07/28/us-banking-libor-traders-idUSBRE86R03220120728> (accessed August 6, 2012).
4. Lisa Pollack, "LIBOR Manipulation? Done for You, Big Boy," *Financial Times*, June 27, 2012, <http://ftalphaville.ft.com/blog/2012/06/27/1062301/libor-manipulation-done-for-you-big-boy> (accessed August 6, 2012).
5. Matt Levine, "Libor Was Whatever Barclays Wanted It to Be," *Dealbreaker*, June 27, 2012, <http://dealbreaker.com/2012/06/libor-was-whatever-barclays-wanted-it-to-be> (accessed August 6, 2012).
6. "The Rotten Heart of Finance," *The Economist*.
7. Ben Protess and Mark Scott, "U.S. Is Building Criminal Cases in Rate-Fixing," *The New York Times*, July 14, 2012, http://dealbook.nytimes.com/2012/07/14/u-s-is-building-criminal-cases-in-rate-fixing/?nl=business&emc=edit_dlbkam_20120716 (accessed August 6, 2012).
8. Joe Schneider, "Berkshire Bank Sues Barclays, Citigroup Over Libor," *Bloomberg Businessweek*, July 30, 2012, <http://www.businessweek.com/news/2012-07-29/berkshire-bank-sues-barclays-citigroup-over-alleged-libor-fraud> (accessed August 6, 2012).
9. Andrew Trotman, "Libor Scandal: RBS Facing Huge Fine, Warns Chief Stephen Hester," *The Telegraph*, July 29, 2012, <http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/9436474/Libor-scandal-RBS-facing-huge-fine-warns-chief-Stephen-Hester.html> (accessed August 6, 2012).
10. Ian Pollock, "Libor: BBA 'Warned Weekly' Says Former Rate-Compiler," *BBC News*, July 25, 2012, <http://www.bbc.co.uk/news/business-18930191> (accessed August 6, 2012).
11. Ben Protess, "Facing Congress, Geithner Grilled on Rate-Rigging," *The New York Times*, July 25, 2012, <http://dealbook.nytimes.com/2012/07/25/facing-congress-geithner-grilled-on-rate-rigging> (accessed August 6, 2012).
12. Timothy Geithner, "E-mail: LIBOR Recommendations," June 1, 2008, <http://graphics8.nytimes.com/packages/pdf/business/Geithner-Memo-080601.pdf> (accessed August 6, 2012).
13. Mark Scott, "Europe Aims to Make Rate Manipulation a Criminal Offense," *The New York Times*, July 25, 2012, http://dealbook.nytimes.com/2012/07/25/europe-aims-to-make-rate-manipulation-a-criminal-offense/?nl=business&emc=edit_dlbkam_20120726 (accessed August 6, 2012).

called for tougher regulation,¹⁴ while others blame the size and complexity of modern mega-banks.¹⁵ This has led to calls by several former bank leaders, most recently former Citibank chairman Sanford Weill,¹⁶ for resurrection of the depression era Glass–Steagall Act, which separated deposit-taking bank activities from securities-related functions. However, the Glass–Steagall Act had nothing to do with LIBOR, and reinstating it would do nothing to ensure that LIBOR is accurate.

The System Worked. The fact is that no new laws or regulations are necessary. While regulatory delay in both the U.S. and the U.K. prolonged a resolution to the manipulation, the massive fines paid by Barclays and the anticipated fines that other

banks face show that the manipulation is already considered an illegal act. When individual officials and bankers are indicted, it will be clear that such actions are also criminal offenses.

Individuals and financial institutions can be prosecuted for criminal acts, and rigging LIBOR could be considered fraud under several existing laws.¹⁷ The Justice Department’s agreement with Barclays¹⁸ shields the bank from criminal charges but explicitly leaves individuals who participated in rigging LIBOR open to prosecution. U.K. prosecutors in the Serious Fraud Office are also exploring indictments.¹⁹

As for LIBOR, it is likely to be replaced by another index that is more transparent and easier for

markets, their customers, and regulators to ensure is accurate and not tampered with. Several potential replacements are already being discussed. They range from new indices based on other financial data²⁰ to a completely new index, such as one that uses an auction process.²¹

The LIBOR manipulation is a serious crime that should have been detected and punished sooner. What is necessary is for regulators to enforce existing law. They already have all of the tools that they need; they just need to use them.

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