LIBOR: A Question of Trust

Edwin M. Truman explains why the spreading LIBOR scandal has the potential of raising new doubts over the reputations for honesty of many large financial institutions.

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Steve Weisman: The scandal over Libor [London Inter-Bank Offered Rate] -- which is the benchmark interest rate set in London -- is spreading and produced a leadership shakeup at Barclay's Bank in London. It's threatening other major financial institutions in the United States and in London. This is Steve Weisman at the Peterson Institute for International Economics, with Edwin Truman, to explain the context and the significance of this scandal. Ted, first, what is Libor and what is the controversy?

Edwin Truman: Libor is actually one of 150 rates set every day in London by a consortium of banks who operate there and who are supposed to report the rate at which they are able to obtain funds at various maturities and in various currencies. They take those reports and discard the quarter of the ones that are higher and the lower ones, and they average them, and that becomes a benchmark rate for all kinds of financial contracts around the world.

Steve Weisman: This is a self-reporting exercise?

Edwin Truman: It is an exercise that was originally formalized in 1986. It is what's often found in financial markets. Participants in the market hit on this mechanism to set a bench-mark rate.

Steve Weisman: They may have been manipulating these rates, or not reporting them accurately or reporting them in a way that was covering up difficulties at these financial institutions. Some people are calling this fraudulent. Some are saying it's just notional anyway. How significant do you think this situation is?

Edwin Truman: Let's step back one minute. For many years, observers thought that there were probably some distortions in the rates that came out. In particular times of stress, the banks may not have been reporting as accurately as they should have been their rates.

So for example this was a case that affected the rates at Japanese banks and the yen-Libor rates that were used in the late 1990s when Japanese banks were under stress. So there's some suspicion about how accurate the quotations were all along.

I think what's new is that the move from a position of an individual bank or two or three who may be from time to time not being completely accurate, to a process in which an individual bank and banks collectively were manipulating rates, either to put them too high in some circumstances, or too low in some circumstance.

So you move into a world in which it becomes an issue of at least honesty, if not criminal fraud. Certainly it's very bad for markets. And as you said in your introduction, there are at least a couple of dozen banks around the world who are involved in this process. Why precisely Barclay's went first and settled I don't know.

It may be that its offenses were the most egregious. But it's pretty clear that many institutions participated in one form or another, at least in the form of collusion. Whether they also colluded on behalf of their own traders is a different issue, but I would not be surprised at anything at this stage.

And the general question of distorting the rates to cover up the seriousness of their problem is also a feature for many banks, especially in times of stress. I think that part is, in a way, less significant in the greater scheme of things than the market manipulation part of it. This investigation has been going on now for four or five years, which raises the question of what else has been going on. But it's going to involve major institutions and a lot of money both in terms of settlements with the authorities of various countries, and potentially lawsuits, which could be very expensive for the banks involved.

These lawsuits no doubt will drag on for years and really only make the lawyers rich. But they could well bring down the institutions. It is remarkable that this settlement with Barclay's so swiftly claimed the leadership of the institution. That is a very impressive action.

And if other institutions were similarly involved to that degree, and we don't know that, we could find major changes at other institutions as well. The other institutions may have been involved at a lower level and less systematically so that their leadership may escape having to walk the plank.

Steve Weisman: If this manipulation was widespread, how hurt were consumers, governments that relied on interest rate swaps, institutions, mortgage borrowers?

Edwin Truman: It depends on which way it was manipulated. If it was manipulated down, actually the borrower gains.

Steve Weisman: Right.

Edwin Truman: If it was manipulated down and it was a lender at Libor, which is some of the cases involved, in which the institutions entered into contracts that involved their receiving Libor, then they lost. So it depends on whether you were a creditor at Libor or a borrower at Libor. The creditors will be the ones getting lawyers and have gotten lawyers. And there are cases already. The investigation obviously has been going on for some time and there were actually rumors and stories about it. But it hadn't burst onto the front pages until a couple weeks ago.

Steve Weisman: Were regulators as alert to this as they should have been?

Edwin Truman: Certainly in retrospect, they weren't. I think there really are two questions. What were they doing four and five years ago, if not before that? And what were they doing in the meantime? Four or five years ago, when the first allegations took place, at that point the questions were whether the regulators should have been the supervisors of the markets—and not just regulators, but the institutions—that in one form or another supervise markets either directly or indirectly.

To the extent that they were informed that there were these problems, they should have acted at least then, if not before. Once there became a criminal investigation, there was in some sense nothing that could be done. Generally, the legal authorities don't want the regulatory authorities to get their fingers into things while they are doing the investigation.

Steve Weisman: Presumably, once the investigation starts, the regulators are going to be more alert going forward.

Edwin Truman: Yes. What's going to have to happen is they're going to change the rules of how it's set or the rules will be changed. And there will be closer supervision over the setting of these kinds of rates. It's fair to say that these kinds of rates are set in lots of markets around the world, right?

It's just that the London rates are the most prominent. There are equivalent rates in New York and for various purposes. But these are the ones that involve most of the national contracts. There will be new mechanisms used to set these rates. The effort will be to provide more transparency and to ensure, essentially, that the banks -- when they're quoting their rates, at a minimum – that their rates are associated with actual transactions.

That is not the easiest thing to do, but it's obvious what needs to be done. The system was trusting the banks to be honest about their cost of funds when they, for one reason or another, were not. And that becomes a problem.

Steve Weisman: This is about how much one should trust or has trusted the banks to be honest. To what extent was this, on one hand, an inevitable problem that arises with notional rates being established -- or on the other, banks committing fraud to protect themselves and shield themselves from scrutiny.

Edwin Truman: I think a lot of it is the former -- some marginal transgressions. But the real problem is that there was enough fraud, rate fixing and essentially a form of insider trading involved that it will have a serious impact on the reputation of the institutions and the markets.

And the trust in financial markets and the people who operate in financial markets, if it could go any lower, will go lower. I think that's very, very, very serious. We should probably come back to this question about the regulators. Part of the problem here is the world in which we live. This was a London bank offered rate. The London market is the major international money market in the world.

Not that there aren't other markets in the United States and Tokyo, and Hong Kong, and Singapore. The supervision such as it was, was in the first instance the obligation of the British authorities -- the Bank of England, the banking authority, the UK Treasury.

Again, that's not always clear because it was a self-policing mechanism organized by the British Bankers Association with the understanding of the authorities. To the extent that problems were raised about this, either from abroad, the problems were bucked to the British. And the British chose not to do anything in the period up until the time that the investigation started.

What we really don't know is to what extent there were serious allegations of problems with the way Libor was being set in the period up to 2007. I think there certainly were stories. The problem for the regulatory supervisory committee was whether those stories were not pursued with the level of aggression that they should have, certainly in retrospect.

I think the new feature was the stories that banks were not always being honest. That is a problem, but probably not the most serious problem. If there was conspiracy within banks and among banks to collectively not be honest, [that] is where I think the problem comes and where the potential for having imposed large losses on some people—notwithstanding the fact that some people gained—puts the banks at very high liability.

Most of these banks know this is coming, that the investigation has been going on. I understand the newspapers that say at least 15 or 16 people already have been arrested. So the news was when the Barclay settlement happened.

Steve Weisman: That brought it out into the open.

Edwin Truman: Brought it out into the open, put it on the front page, and will challenge the institutions and a year ahead of any one of these other institutions, whether it's Citi Bank or Bank of America or UBS, or Bank of Tokyo Mitsubishi, I think that those people presumably are losing a lot of sleep.

Steve Weisman: Thank you very much.

Edwin Truman: You're welcome.