LIBOR, Part I: Fraud Is the Issue

Simon Johnson explains why the LIBOR scandal is at heart a matter of financial fraud, with broad repercussions for consumers, financial institutions, and other players.

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Steve Weisman: As the Libor scandal unfolds in Europe and other financial centers, more questions are being raised about its impact. Simon Johnson of the Peterson Institute for International Economics and MIT is here with me, Steve Weisman, to explore some of those questions. First, let's walk through what this scandal consists of.

Simon Johnson: The scandal consists of fraud, or what appears to any informed reader as fraud -- deliberate misrepresentation of interest rates at which banks could borrow, and individual banks stating that interest rate gets put into Libor, the London Inter-Bank Offered rate. That calculation is based on what banks report as their interest rates.

Steve Weisman: That rate underpins transactions that are in the millions, billions, trillions of dollars.

Simon Johnson: Depending on exactly how you measure it, you get different numbers from various sources, but around $300 trillion in transactions is what the bank of England is using for derivatives and other contracts that use Libor as a reference. Libor has many interest rates. It's ten currencies and fifteen maturities between overnight and twelve months, so it's different measures of short-term interest rates.

Again, in this off shore market between banks' lending, I suppose to each other in London, the interest rate on a particular day was going to affect the pricing, or how much you're going to have to pay, and how much you're going to be owed on securities with a notional value in the hundreds of trillions of dollars.

Steve Weisman: It appears that Barclays was understating the rate, a reflection of its desire to understate its financial situation, or the dangers that it was facing.

Simon Johnson: There are actually two specific accusations, and actually Barclays has agreed that this is what happened. From at least 2005 until 2007, Barclays traders were manipulating Libor sometimes up and sometimes down, in order to benefit their specific trading positions. From the onset of the financial crisis in 2008, perhaps in 2007 also, there was a systematic attempt by management at the bank to lower their reported interest rates to the British Bankers Association that calculate Libor.

They wanted to lower the rate they reported in order to make it look like Barclays faced less pressure. In the first period, management is culpable because of a failure of internal controls. In the second period, they are culpable because they themselves were directing this cheating. That's what's been established.

Steve Weisman: What do we know about the extent to which other major financial institutions, including American ones, were involved?

Simon Johnson: I think that's the really interesting question. There are three American banks on the so-called Libor panels that report interest rates that are used in the calculation of various Libors. They are the big three at this point; JP Morgan Chase, Bank of America, and Citigroup. We know from what has been set out by the Commodity Futures Trading Commission that Barclays and Barclays' traders did not act alone.

In fact, it's impossible to act alone because these are panels of between eighteen and seven banks that are involved in setting and in-putting the data for Libor at any given moment. So there are other banks involved. Were they U.S. Banks? We don't know. Were they involved in the sense that management knew what was going on? Again, we don't know. Was it a failure of internal controls? Well, there are a lot of questions already about internal controls during this period at Citi, at Bank of America. And of course now we have issues around internal controls at JP Morgan Chase. So we'll see where this scandal goes and how big the losses will be, for example, from litigation arising from this.

Steve Weisman: Who's investigating it?

Simon Johnson: All of the usual suspects presumably are involved in investigating. The CFTC, the Commodity Futures Trading Commission, has taken the lead on this and has really pushed it forward, apparently over foot dragging from other official institutions.

Steve Weisman: Such as?

Simon Johnson: The Financial Supervisory Authority in the UK doesn't get great credit. There is no evidence that the Federal Reserve has been pushing this issue in the United States. I imagine a number of other regulatory bodies have not been helpful. At this point, the CFTC seems to be in the driving seat. Given the way this is played out politically in the United Kingdom, I think it becomes quite hard for other regulators and supervisors not to get involved. I would think the New York Fed would play a critical role in any investigation of this kind—

Steve Weisman: Wouldn't it have to investigate itself as well?

Simon Johnson: I think that this is where it starts to get awkward, yes. Who was asleep at the switch? Who was not paying attention? Who had what kind of informational or tip offs and how did they act on that? That is absolutely got to be an important part of any meaningful investigation.

Steve Weisman: Is there an extent to which we can say that American consumers or Governments, have been hurt by this manipulation?

Simon Johnson: Many people have been hurt, including in the United States. I don't think we have a handle on the extent yet. It depends on how much the rate was manipulated on particular dates; what kind of transactions this impacted. And I think there's going to be a great deal of litigation to establish the damages there.

Steve Weisman: Let's stop there and pick up on this in Part 2 and talk about what should be done. Thank you.