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THE LIBOR SCANDAL: THE FIX IS IN—THE BANK OF ENGLAND DID IT!

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In the last week of June, three investigative reports appeared—from the Financial Services Authority (FSA 2012) in the United Kingdom and the Commodity Futures Trading Commission (CFTC 2012) and Department of Justice (DoJ 2012a) in the United States—containing evidence that a substantial number of financial institutions had colluded to manipulate and misrepresent their submissions to the calculation of the benchmark London Interbank Offered Rate (LIBOR) issued by the British Bankers' Association (BBA).[1] Barclays Bank, a British bank, admitted culpability, and to avoid penal action paid a record fine to the DoJ and the FSA in exchange for providing full information and taking steps to eliminate the activity in future. As the results of the various official investigations generated by these reports spread, it becomes more and more apparent that a large majority of financial institutions engaged in fraudulent manipulation of LIBOR to their own advantage. It is also apparent that, as with the fraud involved in the subprime mortgage market, bank management and regulators were unable to effectively monitor the activity of institutions because they were too big to manage and too big to regulate.

However, instead of drawing the obvious conclusion—that structural changes are needed to reduce banks to a size that can be effectively regulated, as proposed on numerous occasions by the Levy Economics Institute (2011, 2012)—discussion in the media and political circles has instead

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turned to whether the problem was the result of the failure of central bank officials and government regulators to respond to repeated suggestions of manipulation, and to stop the fraudulent behavior.

Just as the "hedging" losses at JPMorgan Chase have been characterized as the result of misbehavior on the part of some misguided individual traders, leaving top bank management without culpability, politicians and the media are now questioning whether government officials condoned, or even encouraged, manipulation of the LIBOR rate, virtually ignoring the banks' blatant abuse of principles of good banking practice. Just as in the case of JPMorgan, the only response has been to remove the responsible individuals (with the only difference being that in this case the ax fell higher up the corporate ladder, with the chairman of the board and the CEO of Barclays being dismissed), rather than questioning the structure and size of the financial institutions that made managing and policing this activity so difficult. Again, the rotten apples have been removed without anyone noticing that it is the barrel that is the cause of the problem. But in the current scandal, the ad hominem culpability has been extended to central bank officials in the UK and the United States.

This line of discussion has been ignited by the testimonies of the former head of Barclays and a senior Bank of England official before a UK parliamentary committee that suggested that Bank officials had actively encouraged Barclays in the manipulation of its LIBOR submissions. Recent hearings of US congressional committees have also focused on the possible failure of New York Federal Reserve Bank officials to respond to reports of manipulation with prompt action to stop the practice. Yet, a close reading of the facts suggests that there is no other culprit than Barclays' management, which was either unaware of the fraudulent activity or overlooked it because it was good for the bank's bottom line.

The persuasiveness of the argument that regulators bear a major part of the blame in this scandal derives from a failure to distinguish between two different types of LIBOR rate manipulation that occurred during two different periods and were driven by very different motivations. Before the collapse of the subprime market bubble, manipulation was driven by the venal greed of individual traders designing their submissions to ensure higher profits, while the manipulation that occurred during the heart of the crisis, in the context of a breakdown of market signals, was driven by response to the collapse of the short-term money markets. It appears that management and regulators had indications of the latter activity but were ignorant of the former. The failure to make this distinction is at the root of a common but misleading interpretation of the significance of testimony delivered in early July before the House of Commons Treasury Committee (2012) by Robert Diamond, then head of Barclays Capital, and Paul Tucker, the current deputy governor of the Bank of England. It is the erroneous interpretation of this testimony that has created confusion in identifying responsibility for the LIBOR crisis.

The main subject of the hearings was a 2008 telephone call made by Tucker, who was then head of the Bank of England's markets division, to Diamond, and the representation of the contents of that conversation as preserved in the latter's file note of October 29, 2008. It is important to remember that the call took place two weeks after the Lehman bankruptcy, at the height of the collapse of liquidity in financial markets and in the context of a series of special crisis-response measures taken by the British government and the Bank of England, including a special liquidity scheme and the nationalization of several major and minor financial institutions.

In this context, Barclays was of special concern to the Bank of England because it had chosen not to accept official government support, instead introducing a series of measures of its own to respond to the widening crisis in money markets. The 2008 call to top management focused on Barclays' LIBOR submissions because the borrowing rates submitted by individual banks and reported by the BBA provide an indication of the market assessment of the risk of lending to that bank. In general, a higher-rate submission suggests an implicit assessment by the market of a higher risk and difficulty in funding its balance sheet positions.

Barclays' rate submissions had been consistently higher than those of other banks, and this had drawn the attention of the British Treasury and financial market participants to the possibility that there were funding difficulties at the bank. The object of the call was to assess Barclays' financial condition in order to determine whether it would indeed require government support.[2]

It was thus important for the Bank of England to determine if Diamond was aware that his money market desk's submissions were sending signals of weakness to the market by submitting rates well above the rest of the market, and, if he was aware of it, to determine whether this in fact meant that Barclays was facing market resistance in raising funds. If the latter option was correct, the solution would have been to force Barclays to take the same support as other British banks.

Diamond's indicated response was that he was aware of the submissions but that Barclays was not in trouble and did not need to raise additional funds—he could hardly have responded otherwise, since that would have involved admission of management failure. And whether or not he was aware of the precrisis manipulation of Barclays' traders' submissions to benefit their bottom line that would eventually be revealed in the official DoJ charges (in his testimony he confirmed that he only discovered the manipulation from reading the DoJ reports), he could hardly have responded that the submissions were made in order to improve the profitability of the bank's trading positions. Diamond thus gave the only possible explanation: the problem was not Barclays' submissions, which were correct, but rather the submissions of the other members of the LIBOR panel being too low and probably fictitious.[3]

And this is where the confusion about culpability and responsibility begins. With the benefit of hindsight provided by the official investigations confirming manipulation through managed submissions, Diamond's explanation of the disparity of Barclays' submissions appears to be a clear signal to a senior official of the Bank of England that the LIBOR rate was being manipulated by the other members of the panel. Diamond's statement in the phone conversation could be, and has been, widely interpreted as providing direct evidence of the continuation of practices that were uncovered in the FSA, CFTC, and DoJ investigations of other traders' manipulations of their LIBOR submissions for the period January 2005 – July 2008. That the Bank of England did not react to this presumed denunciation of market manipulation by launching an immediate investigation thus appears as prima facie evidence that it was willing to overlook or condone such practices from the time they first appeared in 2005.

Tucker's response, as presented in Diamond's note on the call, may appear to support this mistaken interpretation, for rather than expressing surprise, he is reported to have indicated that he was aware that many of the panel's bank members' submissions were probably not representative of market conditions. Indeed, it was widespread knowledge since the first signs of crisis in 2007 that there were difficulties with LIBOR submissions due to the breakdown of short-term interbank lending.[4] But it is clear that Tucker's response was not based on prior knowledge of the self-interested rate manipulation conducted by traders seeking to increase their profits, but rather on the recognition that, in the absence of market trades due to the difficulties of the interbank funding market during the crisis and its virtual collapse after mid-October, LIBOR submissions could not have truly reflected the rates at which banks were willing to lend. Tucker noted in his 2012 testimony to the House of Commons Treasury Committee that after the Lehman bankruptcy brokers were unwilling to deal with banks they believed to be in difficulty; any transactions that occurred were bilateral transactions between banks, and obviously not market determined. The submissions could not be accurate, since they could not have been based on actual market conditions.

Indeed, LIBOR had never been presented as a reflection of actual market transactions. For example, if a bank had not had to borrow funds, it would have to submit a best guess at the rate at which it believed that it could transact. In response to the lack of market activity in the crisis, the BBA had issued a note encouraging banks to submit on a best-effort basis. Diamond's warning was not necessary to alert any market participant or central bank official that LIBOR rates in this period were generally considered to be largely "hypothetical." And given the risk of full-scale market collapse, it was thought to be imperative to preserve stability and thus impossible to take action to remedy the defects inherent in the reporting of LIBOR in distressed market conditions. This was eventually to be the task of the BBA.

Tucker thus advised Diamond that, if Barclays' condition was sound, he should take measures to avoid giving the market the opposite impression; that Barclays' submission methods should be adjusted to reflect the methods employed by other banks on the panel in response to the absence of normal market conditions. On the other hand, if Barclays was not sound and was indeed paying the higher funding costs represented by their submission, then the solution would have been direct government support.

Tucker also indicated that, if Diamond's contention was indeed correct and the other banks were producing low submissions to give a better impression of their condition, this was even more disturbing—not because of the indication of the acknowledged misreporting of submissions, but rather because it would suggest that the Bank's emergency measures to restore liquidity to the system and reduce rates were not working as anticipated and further systemic actions needed to be taken. What is clear is that there was no "new news" in Diamond's indication in the 2008 call that LIBOR submissions were being underreported. And his testimony to the Treasury Committee that he had no knowledge of manipulation would suggest that he did not consider this to be rate manipulation.

However, when taken out of context, Tucker's response to Diamond's claim of underreporting does leave open the interpretation that a Bank of England official had encouraged Barclays to "lowball" its submission, and that he thereby also condoned the fixing of submissions by other banks to give a better impression of their funding needs and condition. And from there it is thus only a small jump to presume that if the Bank approved and recommended such underreporting of LIBOR in October 2008, it had also condoned the manipulation of rates that occurred from January 2005 to July 2008, well before the outbreak of the crisis, leading to the conclusion that the Bank of England was the major culprit in Barclays' and other banks' scandalous manipulation of the LIBOR rate uncovered by the CFTC, DoJ, and FSA for that period. In short, according to this (confused) interpretation, Barclays should not be responsible for behavior that the Bank of England encouraged and condoned. Recent congressional hearings in the United States have taken the same tack, investigating the role of the New York District Federal Reserve Bank's failure to take action in response to evidence of manipulation.

The confusion regarding responsibility is further heightened by the fact that the three reports (which all use the same information and are thus very similar) charge Barclays with manipulation in both the period before the subprime crisis and the period following the outbreak of the crisis in 2007, thus giving the impression that the two periods were similar in terms of the actions of market participants in manipulating LIBOR, when in fact they were radically different. Before the crisis, traders colluded to make submissions to the benefit of their trading activities, while during the crisis there was widespread misreporting.

For example, under the heading "Inappropriate submissions to avoid negative media comment," the FSA (2012) states that "Barclays acted inappropriately and breached Principle 5 on numerous occasions between September 2007 and May 2009 by making LIBOR submissions which took into account concerns over the negative media perception of Barclays' LIBOR submissions."

According to the CFTC (2012, p. 4):

> During the financial crisis period, Barclays believed that the market and media inaccurately perceived Barclays as having liquidity problems in part because the rates submitted for LIBOR by Barclays were significantly higher at times than the rates submitted by other banks. Barclays contended the other banks' submissions were inappropriately low given the realities of the market conditions and lack of transactions occurring in the interbank markets. To manage public perceptions that its higher LIBOR submissions meant Barclays was a weaker institution, Barclays' senior management directed the Barclays submitters to lower Barclays' submissions in order to be closer to the rates submitted by the other banks, and thus, be a less noticeable outlier from the rest of the banks. The Barclays submitters complied with the management directive by submitting artificially lower rates than they would have otherwise submitted and that were inconsistent with the definition and criteria for submitting LIBOR. As a result, Barclays did not submit rates reflecting or relating to borrowing of unsecured funds in the relevant interbank markets. . . . Accordingly, during the financial crisis period, Barclays, through its submissions, knowingly delivered, or caused to be delivered, false, misleading or knowingly inaccurate reports that affected or tended to affect LIBOR, a commodity in interstate commerce.

However, this type of underreporting, intended to influence the market perception of financial conditions, is far different from the collusion to rig rates that characterized the manipulation that is the major focus of the three reports. For example, in the earlier period the FSA gives this description of that activity:

> Barclays' Derivatives Traders made requests to its Submitters for submissions based on their trading positions. These included requests made on behalf of derivatives traders at other banks. The Derivatives Traders were motivated by profit and sought to benefit Barclays' trading positions. The aim of these requests was to influence the final benchmark LIBOR and EURIBOR rates published by the BBA and [European Banking Federation]. The misconduct involving internal requests to the Submitters at Barclays was widespread, cutting across

> several currencies and occurring over a number of years. The Derivatives Traders discussed the requests openly at their desks. At least one Derivatives Trader at Barclays would shout across the euro Swaps Desk to confirm that other traders had no conflicting preference prior to making a request to the Submitters. (FSA 2012, p. 10)

The motivation for this fraudulent manipulation is also far different from that which was the subject of the 2008 Bank of England call to Barclays. The grouping of the two types of manipulation as representing similar fraudulent behavior lends support to the idea that regulators treated the two in the same way. But there is no evidence that this was the case. Two points emerge from the testimony to support this conclusion.

First, while there was fraudulent misreporting by bank money market or treasury desks both before and during the financial crisis, the incentives for misreporting were rather different in the two cases. Before the crisis, the collusion was intended to increase individual and institution profits; during the crisis, it was meant to enhance the ability to survive the collapse of market transactions.

The important question is whether bank management and regulators were aware of these abuses before the crisis, since management was well aware after the crisis broke out. During the crisis, the recognition of manipulation could occur from direct observation of the (absence of a) market. If there was no trading due to collapse of normal trading conditions, then the submissions were clearly hypothetical, and little could be done about this problem. There could be differences in subjective assessments, as was the case with Barclays and other members of the panel, and there was no way to discern how far they differed from a "correct" representation. Barclays clearly believed that their assessments were more correct, but given that it had chosen not to receive direct government support, their higher borrowing costs may have been a reflection of this choice rather than due to errors on the part of other banks. But there is no way to know. The only other alternative open to regulators would have been to request suspension of the publication of LIBOR, which would have been much more disruptive of financial market conditions. And since LIBOR was a proprietary product of the BBA, the only avenue open to regulators would have been to suspend the use of LIBOR in financial contracts in a way similar to the Dodd-Frank suspension of the use of credit ratings in regulatory actions.

Before the crisis, conditions were rather different. There was no reason to suspect rigging of the market, although there was always the potential for this to occur and many market participants had drawn attention to this fact via official and unofficial channels. The evidence presented indicates that many of the traders' requests were for deviations of a single basis point, and often the submissions were not even part of the final average composition that determined LIBOR. Since a "correct" LIBOR submission is not necessarily a representation of an actual market transaction, it would have been extremely difficult for anyone not actively trading in the market or using LIBOR in a trade to notice such a small variation in submission rates. Further, the manipulation was not just in one direction, as it was after the outbreak of the crisis—different traders and different positions required different manipulations of rates, some higher, some lower, or some with different combinations across fixings of different maturities.

It is thus most probable that management was aware of this problem and that as long as it generated higher returns it was condoned. On the other hand, the market was subject to self-regulation by market participants, and it would not have been the responsibility of the Bank of England to monitor such behavior, which had become the responsibility of the FSA. There would have been no reason for regulators to suspect fraudulent activity unless it was reported by panel participants, who had little if any incentive to do so. At no time did anyone reporting irregularities suggest that there was outright manipulation for profit—if the practice was widespread, there would clearly be no incentive to do so.

The House of Commons testimony produced one instance in which this might have been the case. The minutes of the Bank of England Sterling Money Markets Liaison Group of November 15, 2007, with Paul Tucker in the chair, noted under section 2 ("Interbank market and Libor fixings"), subsection 2.1, that "[s]everal group members thought that Libor fixings had been lower than actual traded interbank rates through the period of stress. Libor indices needed to be of the highest quality given their important role as a benchmark for corporate lending and hedging, and as a reference rate for derivatives contracts." And subsection 2.2 reads: "John Ewan (BBA) outlined the quality control and safeguard measures used by the BBA to ensure the quality of Libor. Dispersion between panel banks' submissions had increased during August but had since fallen back, in part reflecting clarification from the BBA on Libor definitions."[5]

Again, this minute has been interpreted as a failure of the Bank of England to recognize and take action against manipulation of submissions. But as the minute clearly states, this is again a case in which diversion of rates was the result of market disruption, not of manipulation for private benefit. Tucker responded to questions during his testimony before the Committee in precisely this vein, and there is no evidence that there was any suggestion of manipulation similar to that which occurred before the crisis.

The Department of Justice statement of facts supports this conclusion. However, the Department of Justice, which also combines the two periods as manipulation, notes that the representations by Barclays' management were not interpreted as an indication of market manipulation:

> During approximately November 2007 through approximately October 2008, certain employees at Barclays sometimes raised concerns with individuals at the BBA, the Financial Services Authority, the Bank of England, and the Federal Reserve Bank of New York concerning the diminished liquidity available in the market and their views that the Dollar LIBOR fixes were too low and did not accurately reflect the market. In some of those communications, those employees advised that all of the Contributor Panel banks, including Barclays, were contributing rates that were too low. Those employees attempted to find a solution that would allow Barclays to submit honest rates without standing out from other members of the Contributor Panel, and they expressed the view that Barclays could achieve that goal if other banks submitted honest rates. *These communications, however, were not intended and were not understood as disclosures through which Barclays self-reported misconduct to authorities.* Indeed, after the communications, Barclays continued improperly to take concerns about negative publicity into account when making its submissions. (DoJ 2012b, p. 18; italics added)

A careful review of the evidence provides no indication that the Bank of England or any other regulatory authority had received any information of market fixing during the crisis of a nature similar to the collusion practiced by traders that occurred before the crisis. The same conclusion results from the further information provided by the Federal Reserve's contact with the Bank of England, which deals with misreporting, but not with collusive manipulation. Nor is there any indication that government officials condoned or encouraged such behavior either before or during the crisis. Indeed, Tucker was probably correct in his representation that the Bank of England had no idea that fraudulent manipulation of the rate for private benefit had occurred in the period covered by the three investigations of the LIBOR fixing. Any attempt to lay the blame on regulators simply serves to divert attention from the failure of bank management to do anything to stop the practice; the difficulty involved in monitoring the integrity of markets, which are dominated by very large financial institutions; and the failure of self-regulation in ensuring that markets function efficiently for the benefit of all members of the public. Further, while there are problems with the private market provision and use of LIBOR that are similar to the role of credit ratings in the subprime crisis, they should not divert attention from systemic issues of financial institution reform that should emerge as the primary focus from the revelation of widespread fraudulent behavior in LIBOR fixing.

Notes

1. LIBOR is a proprietary index that is managed and sold by the BBA, just as the Dow Jones stock market indices or credit ratings are calculated and sold by their owners, who are solely responsible for their content and use. LIBOR is meant to represent a rough market average at which major banks operating in London are able to borrow or are willing to lend short term funds. It is calculated on the basis of unverified submissions of the rate at which a selected panel of banks have borrowed or hypothetically could borrow funds by asking for and then accepting interbank offers in reasonable market size just prior to 11:00 GMT. The highest and lowest 25 percent of the submissions are discarded in calculating the index rate. It is not a market interest rate, nor is it subject to any official regulatory body, although it is the benchmark rate that is used extensively in calculating reset interest rates and interest rates on swaps and structured derivatives transactions. The manipulation also involved the European interbank equivalent, Euribor. See BBA 2012.
2. There had been questions about Barclays' health linked to its LIBOR submissions from the beginning of the subprime

crisis. For example, the 2012 FSA report notes that already in September of 2007 Bloomberg had published an article, titled "Barclays Takes a Money Market Beating," noting that Barclays' LIBOR submissions in three-month sterling, euro, and US dollars were the highest of all banks contributing LIBOR submissions, and posing the question, "What the hell is happening at Barclays and its Barclays Capital securities unit that is prompting its peers to charge it premium interest rates in the money market?" (pp. 24–25).

3. According to the FSA (2012, p. 29), this had been Barclays' agreed response to press queries since 2007, and

> consisted of a statement that Barclays had always quoted accurate and fair LIBORs and had acted "*in defiance of the market*" rather than submitting incorrect rates. An internal email from an individual in Barclays' corporate communications department on 29 May 2008 also stated that the press had been told that:
> - "*We quoted higher LIBORs at the time as we saw the stress in the market early*
> - *Other banks followed us subsequently . . .*
> - *We do not want the market to think we misled it, so we have been robust to ensure this quote is not misunderstood*
> - *We have said on the record that we always quote accurate and fair LIBORs*."

4. The explanatory note provided by the Federal Reserve Bank of New York (2012) in its presentation of material on the issue notes,

> Among the information gathered through markets monitoring in the fall of 2007 and early 2008, were indications of problems with the accuracy of LIBOR reporting. . . . As the interbank lending markets dried up these estimates became increasingly hypothetical. Suggestions that some banks could be underreporting their LIBOR in order to avoid appearing weak were present in anecdotal reports and mass-distribution emails, including from Barclays, as well as in a December 2007 phone call with Barclays noting that reported "Libors" appeared unrealistically low. . . . As part of this broad effort, on April 11, an analyst from the Markets Group queried a Barclays employee in detail as to the extent of problems with LIBOR reporting. The Barclays employee explained that Barclays was underreporting its rate to avoid the stigma associated with being an outlier with respect to its LIBOR submissions, relative to other participating banks. The Barclays employee also stated that in his opinion other participating banks were also underreporting their LIBOR submissions. The Barclays employee did not state that his bank had been involved in manipulating the rate for its own trading advantage. Immediately following this call, the analyst notified senior management in the Markets Group that a contact at Barclays had stated that underreporting of LIBOR was prevalent in the market, and had occurred at Barclays. . . .
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> Five days later, the first media report on problems with the LIBOR emerged. From this point onwards the notion that banks were underreporting LIBOR in order to avoid signaling weakness was widely discussed in the press and in market commentary.

5. Note that this is at about the same time that the New York Fed formally acknowledges difficulties in the market.

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