SouthViews

No.26, 27 July 2012

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New Blow to Banking System

The still-developing LIBOR scandal is the latest and biggest blow to the credibility of big banks and their regulators, and should catalyse broad-ranging reforms to the financial system.

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By Martin Khor

The reputation and credibility of banks, regulators and the banking system in Western developed countries, already battered by the twists and turns of the financial crises, have reached new lows with the LIBOR scandal, which is still evolving and more wrong-doing involving not merely banks, but regulators too, may and perhaps will yet come out.

US media reports indicate that the US Justice Department has undertaken criminal investigations. As Mr. Simon Johnson , Ms. Yves Smith and other specialist blogs are bringing out, the LIBOR affair shows widespread market rigging that could not have succeeded as it did without widespread collusion and conspiracy across banks and their trading (and compliance) desks. Other specialist blogs bring out criminal conspiracy involved in rigging the market, and the need to identify, prosecute and punish not merely the traders, but those at the top.

Besides Barclays Bank, which has paid US$456 million in penalties to the UK and US authorities, at least another 11 banks that were part of the rigging of LIBOR face up to US$22 billion in penalties and damages to investors and counterparties, according to an article in the Financial Times.

This is likely to be an under-estimate because in addition they may also face fines of billions of dollars or euros from anti-cartel actions. And more than the 12 banks that are publicly named are involved.

The LIBOR scandal could not have come at a worse time for the banking sector, already mired in many deep crises. It greatly adds to the loss of confidence in the behaviour of bankers and the credibility of the banking system, which have taken such hard knocks in recent years.

That the biggest banks in the world have been manipulating the LIBOR rates, which the public for so many years considered something that is set objectively and scientifically, is almost unimaginable.

The manipulations were reportedly of two types: to influence LIBOR rates so that the bank could make profits in its derivatives trades, and to dishonestly portray that its own borrowing costs were lower than what they were, so as to raise the bank's image.

The scandal hits at the heart of the global banking business, because LIBOR (the London Interbank Offered Rate) is the benchmark relied upon for many thousands of contracts in the financial world, which may be worth $360 trillion in derivatives, loans and mortgages.

This new hit to the banks' credibility comes at a time when there are new signs of a serious downturn in the global economy. In particular, the growth rates of many major developing countries have declined significantly in the last three months, signifying that the banking and debt crises in Europe are beginning to have serious impact on the developing world.

The LIBOR scandal may contribute to the deteriorating world economic situation. At the least, the banks involved in the scandal may have a worsened financial position, with less credit to provide to the real economy.

The estimated fines would cut 0.5 per cent off their book value, and each bank may also have to pay an average of $400 million because of lawsuits, according to a study by Morgan Stanley, as reported in the Financial Times.

This may only be the tip of the iceberg. Regulators in many countries other than the UK and US are investigating, including Canada, Japan, and Switzerland, while many corporations and lawyers are considering lawsuits against the banks for damages caused to them.

The credibility of the European and US regulators has also been affected. Either they did not know about the manipulations of the banks and were thus not doing their job, or they knew about it and allowed the deception to continue for years.

Manipulation in the LIBOR system was apparently known, at least in the trade, by 2005. In April 2008, an article in the Wall Street Journal raised questions about the way LIBOR was set.

Last week (on 13 July), documents released by the New York Federal Reserve showed that US officials had evidence from April 2008 that Barclays was knowingly posting false reports about the rate at which it could borrow, according to several news reports, including in the Wall Street Journal.

According to documents made public last week by the New York Fed, a Barclay’s employee told a New York Fed analyst on 11 April 2008: "So we know that we're not posting, um, an honest Libor." He said Barclays started under-reporting Libor because graphs showing the relatively high rates at which the bank had to borrow attracted "unwanted attention" and the "share price went down".

The Fed analyst's information and concerns were passed on to Tim Geithner, then head of the New York Fed. In June 2008, Geithner sent a memo to the Governor of the Bank of England, with six proposals to ensure the integrity of LIBOR, including a call to "eliminate incentive to misreport" by banks.

The Bank of England Governor appears to have passed on the communication to the British Bankers Association, but it is not clear what further actions he, or the British regulators took.

The documents show that the US authorities knew about irregularities in the LIBOR interest-rate market and had discussed the need for reforms with the UK authorities as far back as mid-2008. The question being asked is why the regulators did not act, until 2012.

"The scandal also corrodes further what little remains of public trust in banks and those who run them," proclaimed The Economist magazine.

The LIBOR scandal may be, or should be, the final straw that forces the developed countries' political leaders and financial authorities to undertake a thorough and systemic reform of their financial system and institutions.

The system has been plagued by one crisis and scandal after another, and of crisis responses. These include the collapse of Lehman Brothers, the bankruptcies or bailouts in 2008-2009 of some of the biggest banks and insurance companies in the US and Europe, the more recent rescues of banks in Spain and other European countries, and the pumping of liquidity, loans and equity into the banking system.

There needs to be reform of the regulatory framework and enforcement, of the hugely excessive leveraging allowed by financial institutions, the laws that permit a combination of commercial banking and proprietary trading in the same institution, the speculative and manipulative activities and instruments of financial institutions, fraudulent practices, and the incentive system, including unjustified high pay and bonuses, and high rewards to bankers for speculation-based earnings.

A reform of the LIBOR system or establishing an alternative to it is of course also required. In the LIBOR system, a panel of banks set the borrowing rates for ten currencies at 15 periods of maturity. For example, the 3-month LIBOR for dollar is the rate banks would borrow dollars from other banks for three months; the daily rate is fixed by taking the reports from 18 banks of what they estimate they have to pay to borrow dollars.

Two types of manipulation emerged in the Barclays case. The first involved derivatives traders at Barclays and several banks trying to influence the final LIBOR rate to increase profits (or reduce losses) on their derivative exposures. Even small differences in the LIBOR rates could result in daily profits or losses worth millions of dollars. In its settlements with the UK and US authorities, Barclays accepted that its traders had manipulated rates on hundreds of occasions.

The second manipulation involved submissions by Barclays and other banks of estimates of their bank borrowing costs that were lower than what was actually the case. Almost all the banks in the LIBOR panels were submitting rates that may have been 30-40 basis points too low on average, according to The Economist.

"In its settlement with regulators, Barclays owned up to massaging down its own LIBOR submissions so that they were more or less in line with those of their rivals," according to the article.

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