MV Capital Management Thought Leadership

Inside the Libor Scandal
What It Means and Why It Matters

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What is Libor? It's a word that has been much in the news over the past several weeks. It's reasonable to imagine that there are more people in the world who know that there is a scandal involving Libor than there are people who know what Libor actually is, and what it does. In this post we will start by explaining what Libor is and what role it plays in global financial markets, and then provide some context about the current scandal and why it matters.

Libor is an acronym for the London Interbank Offered Rate. It is an interest rate – a short term lending rate between financial institutions. In this it is unremarkable – Bank A wants to borrow funds from Bank B and the two agree on a rate that one will pay the other for the borrowed funds. What is noteworthy about Libor is that it has come to serve as essentially the default benchmark for credit agreements on a global scale. Floating rate mortgages in the US are pegged to Libor, as are the large borrowing facilities that hedge funds set up to lever their investments in global assets. In other words Libor is a credit rate that affects Main Street homeowners and Wall Street titans alike. There are hundreds of trillions – yes, trillions – of dollars worth of Libor-indexed financial instruments in the markets every day. And it is this scale that makes the current events surrounding Libor's rate-setting mechanisms so potentially far-reaching.

It may seem odd that "rate setting mechanism" and "scandal" would appear in the same sentence, but that is precisely what is at the heart of the controversy. What happens is that at the end of every day sixteen large London-based financial institutions submit indications to the British Banking Association (BBA) of what they would expect to pay for interbank credit at different maturities (e.g. overnight, 1-month, 3-months etc.). The BBA excludes the top four and bottom four indications, takes an average of the remaining eight, and – voila, that becomes the published Libor rate for the next day.

Now, the important thing to note about this is that – unusually for such a widely-used market benchmark – Libor is not a reflection of any actual market activity. Rather it is a collection of "best guesses" from bankers about what they would *expect* to pay. Think about it this way: the S&P 500, as a market benchmark for equities, goes up and down as shares are exchanged between buyers and sellers of the stocks included in the index. It's not somebody's guess as to what they *might* have to pay for a share of GE, but the price they actually *do* pay, that moves the value of the index. With Libor it's different. A banker at Barclays says "I think I would have to pay 0.5% for an overnight credit facility", writes "0.5%" on a piece of paper and sends that piece of paper off to the BBA, in so many words.

And that would not necessarily be a problem if banking were still the clubby world of yore where everybody knew everybody else and trust in your personal reputation was the only thing that mattered. The philosophy underlying the Libor mechanism is *self-regulation*, i.e. the idea that things work only if everybody plays by the rules and nobody seeks to game the system. Unfortunately we don't live in an age where trusting the bankers is a viable recipe for success. What happened – and this behavior was systemic, not the occasional work of a few bad apples – was that the banks began submitting indications to the BBA based more on their own internal profit considerations than on an objective appraisal of what a fair market rate would be.

Say, for instance, that a Barclays trader is operating a book of credit default swaps (Barclays is being singled out here largely because it was the first one to get caught in the regulators' crosshairs and has been providing copious evidence about these practices). That trader would stand to book a few more million dollars in profits if Libor were to be 25 basis points (0.25%) lower. The trader cajoles the Barclays executive responsible for sending the daily indication to the BBA, asking him to send an artificially low indication. The executive agrees and the grateful trader promises dinner at a swanky London restaurant with the Champagne flowing in return (yes, this is literally what happened according to the Barclays emails disclosed to the regulators). One bank realizes that another bank is doing that and pretty soon everybody is doing it. Whatever Libor is on any given day is thus less a fair-market reflection of demand and supply in credit markets, and more a complex assortment of insider tactics by banks with their own narrowly-defined agendas.

To re-emphasize why this matters: we are talking about hundreds of trillions of dollars of financial instruments, the value of which is directly or indirectly impacted by Libor. It's the mother of all insider trading scandals, and the consequences could be very far-reaching. You're not going to see juicy Libor stories in the press every day – even accomplished financial journalists would have a hard time attracting flocks of readers or click-throughs to stories about credit rate-setting mechanisms. But what we are likely to see is a steady trickle of new details as more banks are caught up in the investigations. Lawsuits are likely to follow as surely as night follows day, and that creates additional, and very unwelcome, uncertainty about the banking system itself. It is too early to tell what the actual consequences are going to be, but it is something that we have to be keeping a very close eye on as we follow the developments that can potentially impact market performance through the remainder of the year and beyond.

With warm regards,

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