The LIBOR Reader

The Institute of Economic Affairs
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Introduction

At the end of June 2012, news of a further scandal in the banking industry broke – although, there was widespread knowledge about this problem within the industry. One UK bank, Barclays, had fines levied by the US and UK authorities for manipulating a key interest rate index called LIBOR. Other banks are still under investigation.

LIBOR is an important market interest rate indicator because it measures the rate of interest at which banks can lend to each other, although, as the article by Stephanie Flanders shows, it does not necessarily measure the rate of interest at which banks actually *do* lend to each other. Many other financial contracts are therefore priced using LIBOR. For example, it would be reasonable for a bank to offer a mortgage product with a floating rate of interest of "LIBOR plus 1.5%". The bank could then be reasonably sure that, whatever happened to central bank interest rates, it could obtain funds at LIBOR to fund the mortgage, with a fixed margin for credit risk and expenses. In addition, many important derivative products are priced using the LIBOR interest rates. These products are used for long-term risk management purposes as well as being traded.

Quite quickly, two separate aspects of this scandal emerged. The first was that banks seemed to have been manipulating the rates that are used to calculate LIBOR so that their derivative positions on LIBOR contracts would show higher trading profits. The second was that, at the height of the financial crisis, Barclays bank seems to have reduced its LIBOR submissions to the British Bankers' Association in order to give the impression to the market that others were willing to lend to Barclays at lower interest rates than was actually the case. The idea of this action was to give the impression to the market that those lending money to Barclays were less concerned about the credit risk of Barclays than they were in practice.

Neither of these actions are victimless "crimes"[2]. In the first case, Barclays could have made trading profits on derivative products tied to LIBOR whilst the other party to the trade made a loss (as profits and losses must sum to zero). In the second case, banks could have been tempted to lend to Barclays at rates of interest that did not reflect the true credit position of Barclays because lenders would have seen the relatively low rates of interest at which Barclays claimed everybody else was lending. There is a twist in the tail of the second incident, however. It has been suggested that Barclays declared low LIBOR rates with the tacit encouragement of one or more of the Bank of England, the FSA or the Treasury – or, at least, it is claimed that messages were communicated from one or more of these organisations that were ambiguous.

If it is true that the regulators and central banks were keen to massage down published LIBOR

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[2] The word "crimes" is used a figure of speech not necessarily to indicate something that is a criminal offence in practice.

rates, people could have lost huge amounts of money from lending to banks they thought were creditworthy (because the published rates were low) if those banks had defaulted on their obligations. The LIBOR scandal is, of course, dwarfed by the continuing eurozone crisis were actions by central banks and governments are unilaterally re-writing the credit-worthiness of private contracts (by subordinating them to government claims) whilst completely distorting the price signals contained within interest rates and socialising credit risk in highly complex ways.

This brings us to the issue of the role of regulation and the respective failings of market participants and government institutions. There is no question that there have been deep failings within private banks. To a substantial degree – especially in relation to the manipulation of LIBOR to gain from derivative trades – there have been serious ethical failings. As a result, there have been many calls for regulation and the BBC has often run the line that we are suffering from the "light touch" regulation that began in 1986 and that was encouraged by Gordon Brown.

The government has argued that the fact that LIBOR was unregulated was a gap in the previous government's regulatory framework. However, these are difficult arguments to sustain for the following reasons:

- The calculation of LIBOR was not regulated, but nobody has complained about the calculation of LIBOR. The provision of information – which has been the problem here – was regulated.
- The fact that the provision of information was regulated is demonstrated by the fact that the regulators undertook an investigation and fined Barclays (and will possibly fine other banks).
- Even if there had been no specific regulation here, basic principles of civil and criminal law would surely suggested that some offence had been committed which can be investigated and prosecuted as part of the primary legal code. If this is not the case, it should be the case.
- The "market failure needs correcting by government regulation" line is seriously undermined by the fact that there may have been regulatory failings and also that regulators were warned about the setting of LIBOR and took no action.

Regarding the provision of information that is used to calculate LIBOR, though this is a regulated activity, it has been suggested by a leading lawyer that: "The FSA never established a rule that the data [that] banks submit to LIBOR should be accurate and fair. This is a major regulatory failing. It's frankly ridiculous that there wasn't one in place."[3]

This is perhaps a typical lawyers' view – as well as the typical view today in the financial sector and amongst political commentators. It is assumed that it should be possible to write a rule book that defines exactly how every action within the financial sector should be undertaken. It is that sort of view that has led to rule books of millions of paragraphs and banks employing literally thousands of compliance officers to ensure that staff tick all the right boxes.

[3] http://online.wsj.com/article/SB10001424052702303684004577508880361170286.html?mod=googlenews_wsj (accessed 6th July, 2012).

Perhaps, though, the LIBOR scandal suggests that we have to return to other approaches to regulating markets. We should ask whether, in fact, regulators have the ability to write detailed rules that will anticipate every possible action and set instructions for those actions. We should ask whether this approach prevents the development of discerning behaviour and crowds out the development of regulation generated within the market itself. We should ask whether basic principles of civil and criminal law cannot be used to deal with the kind of scandal we have witnessed. If this were the case, a manager in the bank would not be asking himself: “have I obeyed the letter of all the rules in the rule book?” but “have I done something that has misled and defrauded others for which I could face civil and criminal prosecution?” Good behaviour has much less value in a market guided by detailed rules and which is underwritten at several levels by governments and central banks.

The excellent short articles in this reader on the LIBOR scandal deal with these issues. They look for a deeper understanding of the crisis rather than taking the view that: “something has gone wrong, therefore we obviously did not have the rules to stop it, therefore we need more rules.”

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Your questions answered

- **What is LIBOR?**

  LIBOR is the London Interbank Offered Rate. This rate determines the interest rates that banks pay to borrow money from one another. It is set by large banks submitting to the Thomson Reuters Corporation the interest rate that they would have to pay to borrow money in specific currencies at specific time periods. Thomson Reuters then averages these costs and creates LIBOR quotes. The rate affects the pricing of around £200 trillion of financial services around the globe and, as such, is one of the most important benchmarks for interest rates internationally. LIBOR is also used in many instances to determine the financial health of a bank.

- **How Did Barclays Affect the LIBOR?**

  Barclays Capital is believed to have been attempting to manipulate the LIBOR rate since as early as 2005. The bank frequently gave false information to LIBOR calculators to make it appear as though its credit quality was better than it actually was while allowing its traders to profit from rate speculation. Barclays is thought to have engaged in these rate-rigging practices mainly between 2006 and 2009.

- **What Has Happened to Barclays So Far?**

  In response to the scandal, the UK's Financial Services Authority has given Barclays a record £59.5m penalty. The bank has also been fined in the United States by the Commodity Futures Trading Commission (£128m) and the US Department of Justice (£102m), bringing the total to nearly £290m. As a result of this, the value of Barclays' stocks fell 15% on 28 June. CEO Bob Diamond, Group Chairman Marcus Aguis, and COO Jerry del Missier have also resigned from their positions in the wake of the scandal.

- **How Has the Average Person Been Affected?**

  When the LIBOR rate increases, mortgages become more expensive and vice versa. Hundreds of thousands of mortgages are linked to the LIBOR rate and, as such, Barclays' misconduct may have affected many homeowners personally – though not necessarily so and, if so, probably not to any great degree. As a variety of rates are set

relative to the LIBOR rate, from credit cards to student loans to other financial services, the effects of the rate manipulation are potentially widespread.

- **How Far Does This Scandal Go?**

  The answer to this question is unclear at the moment. While the evidence shows that Barclays was involved in some extensive misconduct, suspicion has now shifted towards other banks involved in setting the LIBOR rate. A Parliamentary investigation has been planned and events are still developing.

Timeline

2005 - 2006

Although the majority of Barclays' misconduct is believed to have occurred between 2006 and 2009, a report by the Financial Services Authority asserts that efforts to manipulate the LIBOR rate can be dated back to 2005. Specifically, section 60 of an FSA report in June 2012 (http://www.fsa.gov.uk/static/pubs/final/barclays-jun12.pdf) details an email exchange between Barclays employees and a derivate trader from 27 May 2005:

Submitter: "Hi *All, Just as an FYI, I will be in noon'ish on Monday* [...]".

Trader B: "Noonish? *Whos going to put my low fixings in?* hehehe"

Submitter: "*[...]* [X or Y] *will be here if you have any requests for the fixings*".

Email exchanges such as these contributed to the FSA's conclusion that Barclays' misconduct had been occurring for several years, leading to its decision to impose financial penalties on the bank. Requests similar to these occurred 257 times between 2005 and 2009 according to the FSA.

2007

In the early stages of the global financial crisis, Barclays manipulates the LIBOR rate in an effort to convince the public that the bank was in a better position than the then-collapsing Northern Rock.

Since Barclays was giving LIBOR submissions that were not consistent with other large banks at the time, financial analysts and the media in general began to publish reports that questioned whether these rates accurately reflected Barclays' financial situation. Several internal emails from late 2007 have shown that Barclays submitters were concerned about the possible effect of false submissions on the bank's reputation.

2008

In April, the Wall Street Journal (along with several other major media outlets) publishes reports doubting the reliability of LIBOR as an indicator of financial health. In mid-April, a senior Barclays employee contacts the British Bankers' Association (BBA) to inform them that Barclays had not been submitting accurate rates for the LIBOR. Over the next several months, the BBA publishes feedback and consultation papers proposing ways to modify LIBOR.

It is also during this year that former CEO Bob Diamond claims that senior officials at the Bank of England voiced some degree of support for Barclays' LIBOR rate-fixing. These allegations have now been investigated by the Treasury Select Committee and will be investigated further in the coming months.

2009

In November, the BBA releases new guidelines for the ways that member banks would set their LIBOR rates. Barclays is not believed to have made any major efforts towards meeting these guidelines.

2010

Barclays revises its standards for LIBOR submitters, enforcing stricter rules with regards to any communication with traders that could be interpreted as an attempt to manipulate the LIBOR rate.

2011

Four employees of the Royal Bank of Scotland are sacked due to their alleged connection to LIBOR manipulation in late 2011.

Following the breaking of the current Barclays LIBOR-fixing scandal, the Royal Bank of Scotland has become one of several banks under investigation for similar misconduct.

2012

- **27 June**
  UK and US regulatory agencies fine Barclays £290m for LIBOR-manipulating

practices. CEO Bob Diamond apologises and suggests returning his bonus for the year.

- **28 June**
  Barclays shares fall 15%. The FSA announces investigations into HSBC, the Royal Bank of Scotland, and several other banks.

- **29 June**
  Prime Minister David Cameron announces his support for regulators to continue action against Barclays. The Bank of England Governor, Sir Mervyn King, describes the scandal as a problem with banking culture as a whole. Both reject Labour's demands for an extensive inquiry.

- **30 June**
  Labour leader Ed Miliband calls for an independent inquiry into UK banks.

- **1 July**
  Barclays' shareholders call for CEO Bob Diamond and Group Chairman Marcus Agius to resign. Increasing calls for a criminal investigation into banks involved in LIBOR-fixing is echoed by Business Secretary Vince Cable.

- **2 July**
  Marcus Agius announces he will be stepping down from his position.

- **3 July**
  Bob Diamond announces he will be stepping down from his position as CEO. Barclays' COO Jerry del Missier also announces his resignation.

- **4 July**
  Bob Diamond stands before MPs for nearly three hours. During his questioning Diamond states that he only knew about the LIBOR-fixing for three months.

- **5 July**
  Barclays' credit rating is lowered from stable to negative by Moody's.

- **9 July**
  Paul Tucker, Deputy Governor of the Bank of England, denies ever giving Barclays permission to give false LIBOR submissions.

- **14 July**
  According to the New York Times, the US Department of Justice begins preparing for criminal investigations into banks that have been accused of manipulating LIBOR.

- **16 July**

  Former Barclays COO Jerry del Missier tells a parliamentary inquiry that former CEO Bob Diamond instructed him to manipulate the interest rate.

LIBOR manipulation scandal is a disastrous own goal for City[4]
Allister Heath, City AM (Editor's Letter), Thursday 28 June,2012, 2:17 am
http://www.cityam.com/latest-news/allister-heath/LIBOR-manipulation-scandal-disastrous-own-goal-city

What preposterous emails. What were these traders thinking? That they would get away with it? Barclays and the entire banking industry have been badly damaged by the LIBOR manipulation scandal – and this time it is entirely a crisis of their own making. This is not like some previous rounds of banker-bashing, where lenders were wrongly blamed for developments that were actually caused by central banks' cheap money or regulators' promotion of sub-prime. No – this latest fiasco is all too real and unprovoked. Barclays' inability to ensure that some of its staff behaved appropriately was a major failing of its corporate controls. People knowingly broke the rules. Shame on them.

The LIBOR row will have many other consequences, none of them positive. Many will ask why there were no criminal prosecutions in this case, in addition to the regulatory settlement. Once again, many will believe there is one law for rich rule-breakers – and another law for poor criminals. This will help fuel the feeling that "we are not all in this together" and will trigger demands for retribution, such as higher taxes, which would be irrelevant to the problem at hand and damage the economy.

The view that all of the world's economic problems came out of London – AIG's trades, JP Morgan's recent problems, now LIBOR – will continue to gain ground, propagated by buck-passing Americans. Needless to say, the real problems that actually caused the crisis – sub-prime lending, the Fed's madness, huge East-West imbalances, intellectual errors, implicit government guarantees – were largely invented in America, and AIG and Lehman were US firms. In no way should the LIBOR scandal be downplayed but it wasn't a contributor to the recession. But it is true the UK authorities have discredited themselves over LIBOR. It beggars belief that this sort of behaviour was tolerated – the setting of the interbank rates appeared to have been conducted under the sort of amateurish club-like rules that were the norm in the early 1980s. It is truly astonishing.

The fine will also be damaging to Bob Diamond. He wasn't the firm's boss when the scandal happened, though he was a top executive. He's actually a superb CEO who has built up a strong investment banking business almost from scratch. But this scandal could yet engulf him, especially when he is hauled in front of the House of Commons Treasury select committee. It also remains to be seen what happens if the separate interest rate swap misselling allegations explode in the industry's face.

The scandal will make it more difficult to have a sensible debate on levels of regulatory capital. This will mean the economy being further squeezed. It will also make it almost impossible for anybody to oppose the latest batch of ridiculous anti-bonus rules from Brussels, which aim to cap variable compensation at 100 per cent of base pay. Such a "reform" would be disastrous – banks would become far riskier and less able to survive recessions.

I have previously defended banks or bankers when they were unfairly attacked. I will do so again when warranted – but not today. This is a clear-cut case of an industry shooting itself in the foot. It is good

[4] Published with the kind permission of City AM

that Barclays has apologised and that top execs won’t be taking bonuses. But some other banks have undoubtedly also misbehaved. When they too settle in return for massive fines, the industry will be hit by further reputational damage.

Too many people turned a blind eye to the wrongdoings of too many others. The City's reputation as a trustworthy marketplace will take years to recover. Barclays' reputation is severely damaged but it will not be alone[5]
Ken Okamura, City AM (City AM Forum), Friday 29 June 2012, 1:54 am
http://www.cityam.com/forum/barclays-reputation-severely-damaged-it-will-not-be-alone

There can be little that is more precious to a bank than a reputation for integrity. The revelation that Barclays has paid a £290m fine for "misconduct" with regard to the setting of benchmark interest rates affecting trillions of pounds of financial contracts is a big blow for the bank's reputation. Cue politicians calling for heads to roll and demands for criminal prosecutions.

Yet the details of the LIBOR scandal suggest that this goes beyond any one bank. Every bank has multiple reputations with different stakeholders. It is likely that the revelations about LIBOR will impact Barclays' reputation most with regulators and clients. But, if Barclays is guilty, so are many others. UBS last year settled with regulators and gained conditional immunity in this affair. The list of those supposedly still being investigated includes many of the big international investment banks. By being first to settle, Barclays and its chief executive Bob Diamond have exposed themselves to extra flak, but this may have limited the size of the fines.

A key question is whether Barclays' reputation with customers has been affected. The large decline in the share price of Barclays can be seen as an attempt by the market to assess potential future liabilities. Academic research shows that in addition to the cost of fines and settlements, incidents of rule breaches only have significant negative effects on the market capitalisation of firms if customers or shareholders are negatively affected – breaches of, for example, environmental laws have no further effect on market capitalisation. The logic being that firms suffer from a decline in business or a higher cost of capital if the offence is committed against customers or shareholders, but not if it is against third parties. At first glance this might suggest that Barclays will suffer further losses, as some customers may well have been negatively affected by the compromising of LIBOR. But, given the way that LIBOR is set, Barclays by itself could not have significantly impacted the level of LIBOR. This diffusion of blame for the LIBOR rate fixing means that Barclays' reputation with its corporate and institutional customers is unlikely to suffer relative to its competitors. This is part of a trend over the past decade in the US and globally where major banks have settled with (primarily US) authorities over issues such as independence of research and mortgage foreclosures, and seen little harm to their reputations with corporate clients. It is perhaps a little disappointing that we are left with the feeling after these repeated settlements and fines that most banks are "no worse than any of the others".

Indeed, while the LIBOR scandal has helped to chase the RBS computer problems from the front page, it is possible that the latter will be the one that has a greater impact on the individual bank. The computer problems at RBS hit the reputation of the bank for competence with its customers. Unlike the slightly involved explanations of LIBOR, the computer glitch has impacted many more customers directly. And blame cannot be spread around the sector as a whole.

This leads us to reputation with regulators. The LIBOR fixing may have more serious implications for regulation. The setting of LIBOR was one of the few areas of self-regulation remaining in an increasingly

[5] Published with the kind permission of City AM

rule-bound financial world. The assumption that reputational concerns and self interest would bind banks to report honestly their cost of funding has been shown to be misplaced. The demands for more onerous regulation are increasing, although it is not clear that the extra rules being mooted will solve cultural problems or excessive risk taking. Once again, it is not just Barclays that is in the frame here, but the entire banking sector. Banks share a common, and increasingly poor, reputation with regulators.

Finally, it is important that UK regulators and politicians do not go too far in their outrage. What is required is judicious regulation to prevent a repetition of the problem and suitable penalties for wrongdoers. There is some pressure from US politicians to add to the "London problem" meme, suggesting that boom time scandals are concentrated in the UK. Yet the present benchmark interest rate fixing scandal also involves Euribor and Tibor, the benchmarks of the Eurozone and Japan, neither market known for "light touch regulation". The UK needs to maintain its reputation as both a clean and competitive financial hub.

Ken Okamura is a researcher at the Oxford University Centre for Corporate Reputation.

From boom to bezzle: this banking scandal will run and run[6]
Allister Heath, City AM (Editor's Letter), Friday 29 June 2012, 2:51 am
http://www.cityam.com/latest-news/allister-heath/boom-bezzle-banking-scandal-will-run-and-run

Can it get any worse for Britain's banks? Well, yes. Much, much worse. Not only is Barclays merely the first firm to settle when it comes to the despicable LIBOR scandal – others are also being investigated – but the FSA is about to announce that it will penalise a number of banks for a separate scandal which involved mis-selling swaps to small businesses. In at least some cases, retail bankers talked absolute nonsense to their customers, telling them they couldn't lose out when they obviously could and did.

This is a perfect storm for the banking industry, and one from which it will take years to recover. Just when it seemed the industry was on the mend, this latest blow could set it back years. And this time those institutions being targeted actually deserve the opprobrium they are getting. The behaviour of a small minority of staff was disgusting, and should have been checked by senior management. Those of us who believe that we need a strong, healthy and honest City, for the sake of hundreds of thousands of jobs and of the UK economy, have the right to be very angry at the idiocy of many individuals and institutions. Ordinary City workers in banks, fund managers, law firms and other related industries are especially entitled to be furious.

It is vital that all banks deal with their problems, and that heads roll. It beggars belief that Bob Diamond thought all those months ago that the time for contrition was over for his industry. He must have known he was sitting on the LIBOR scandal.

But it is important to understand what is really going on. I'm no fan of John Kenneth Galbraith, the US economist. But he was right about one thing: at the height of a bubble, a punch drunk world becomes so wealthy that it turns a blind eye to financial crime (embezzlement, or the "bezzle). But when the music stops, and the crash comes, everybody suddenly uncovers past scandals. It is worth quoting him at length: the bezzle, he said, "varies in size with the business cycle. In good times people are relaxed, trusting, and money is plentiful. But even though money is plentiful, there are always many people who need more. Under these circumstances the rate of embezzlement grows, the rate of discovery falls off, and the bezzle increases rapidly. In depression all this is reversed. Money is watched with a narrow, suspicious eye. The man who handles it is assumed to be dishonest until he proves himself otherwise. Audits are penetrating and meticulous. Commercial morality is enormously improved. The bezzle shrinks." We are now at this stage of the cycle.

Yet while the discovery of lies is shocking, it will inevitably confuse our understanding of the boom and bust. The wrongdoings were overwhelmingly the product, not the cause, of the bubble. Of course, they contributed to the subsequent pain – but only marginally. There would still have been a sub-prime crisis and a recession had everybody behaved legally: it was US government policy to subsidise mortgages for those who couldn't afford them. It would have ended in tears regardless of whether everybody had been honest or not. Greece would still be bust even it hadn't lied about its deficit in the run-up to euro membership. Others made honest but terrible mistakes. And so on. It is vitally important to crack down and punish

[6] Published with the kind permission of City AM

wrongdoing – but doing so won't prevent another economic crisis. The two problems need to be tackled in parallel.

The biggest issue is this: this latest outburst of self-harm from the City is bound to hinder the recovery. It will make all of us poorer. It will prolong the crisis. It is very, very bad news.

To the man with a hammer…every problem is a nail
Phillip Booth, IEA Blog, Friday 29 June 2012
http://www.iea.org.uk/blog/to-the-man-with-a-hammerevery-problem-is-a-nail

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This week a major scandal came to light with regard to the setting of LIBOR, which is the interest rate at which banks lend to each other. It would appear that this rate, which is a useful index of short-term interest rates by which interest rates on other contracts (including mortgages) are set, was manipulated by traders in a particular financial institution. Presumably this was done for their own gain – at the expense of others who were counterparties to the contracts.

There have been the predictable calls for regulation. The French have said that this is a problem of rampant Anglo-Saxon capitalism which needs regulating – ignoring the fact that Euribor uses a more or less identical system. Mark Hoban – the relevant government minister – has said both that this is a moral problem and that LIBOR should be regulated. Others have said that the problem is that we have nationalised central banks setting interest rates. Still elsewhere, it has been suggested that the problem is that we have a banking cartel and we need more competition.

The latter two positions have been taken by respected free-market commentators, but I don't think they are correct. Certainly, central banks distort LIBOR. They do this both because they determine very-short-term interest rates which feed into LIBOR indirectly and also because they try to smooth liquidity in the market. However, even if central banks did not do this, there would probably be a need for something like LIBOR as a base interest rate that is used to set interest rates on other financial transactions. In fact, LIBOR is a very useful market instrument because it means that banks can lend to and take deposits from customers at a rate which is always related to an objective and transparent market interest rate. Customers can be sure that they will not get taken for a ride. At the same time, the bank will know that it can always get funding for or make deposits at roughly that rate. Without LIBOR long-term, floating-rate mortgages would be that much more risky.

The bank cartel argument is also something of a red herring. Yes, it is true that the smaller the number of banks, the easier it is to manipulate the rate, but there are 16 banks on the sterling LIBOR panel, so the cartel argument is stretching things somewhat.
However, the main threat comes from those who only have the regulatory hammer and think that regulation is the only solution to any problem.

Older readers of the blog may remember the Maxwell scandal. This was a case of theft from a pension fund. Not surprisingly, theft of hundreds of millions of pounds is illegal. But, the government thought that, rather than making some simple changes to primary legislation to make theft less likely (for example, by having more independent trustees within pension funds), they would regulate defined-benefit pension schemes. Older readers of this blog might also remember private-sector, defined-benefit pension schemes. Younger readers cannot join them anymore because the regulation hammer (and some other factors) led to the vast majority closing down.

We must be careful with regard to the LIBOR scandal. The British Bankers Association (BBA) is, in a sense, a private regulator for LIBOR and the government seems to be using this as an excuse for castigating the private sector and bringing in government regulation. However, private regulation has an excellent history, and government regulation certainly has not proven itself superior in the financial sector. We should resist arguments for more government regulation of LIBOR: neither government nor private regulation can bring about perfection. But we also need to point out any disingenuous statements from the proponents of government regulators given that the BBA states: ‘As all contributor banks are regulated, they are responsible to their [government] regulators, rather than BBA LIBOR Ltd. or the FX&MM Committee, for maintaining appropriate procedures for contributing, including the maintenance of internal chinese walls.’

But, surely, the main problem is not regulation in any case. Given Britain’s strict libel laws, I need to tread carefully. However, if what has happened is not fraud (and it is not being prosecuted as such at the moment) it ought to be. We do not need a specific government financial regulator to prosecute fraud and theft.

Secondly, as the minister has said, there is a moral and cultural issue here. Regulation is the wrong tool to deal with moral and cultural issues.

We have a confused regulatory system here. Instead of blaming private regulation we should perhaps go the whole hog and remove government regulation from the picture. LIBOR is a private arrangement and the banks that set it have the strongest incentives to keep it honest. The government should stick to prosecuting fraud. The private sector institutions that have an interest in LIBOR should club together and make sure that they impose the strongest possible penalties on those that disobey the letter or the spirit of the LIBOR regulations set by the BBA. Something like ‘my word is my bond’ would be a good start and, if someone’s word proves not to be their bond then the sanctions – administered by the club itself – should be severe. Indeed, the market sanctions have been severe already. Barclays’ share price is down 15 per cent. We cannot expect perfection and to avoid all incidents within financial markets, but this seems like a good feedback mechanism to me.

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Questions for Barclays and the FSA[7]
Tim Ambler, Adam Smith Institute Blog, Monday 02 July 2012
http://www.adamsmith.org/blog/questions-for-barclays-and-the-fsa

Just when we think we have heard the last of massive bungling by the banks, it gets worse. The FSA's Final Notice to Barclays of 27th June is 45 pages and an interesting read. Apparently the manipulation of LIBOR and Euribor interest rates continued from 2005 to 2011 but the implication is that it has been standard practice since derivatives were invented.

The FSA fine of £59.5M was discounted at 30% (it would have been £85M) to recognise Barclays' "early" stage settlement. The US fines were £128.5M (Commodity Futures Trading Commission) and £103M (US Justice Department's Criminal Division) "in a related manner". The FSA has no methodology for calculating the fine, and the figures were plucked out of the air (BBC) - it is hard to see how the US fines can be "related". Or was the lead in this taken by the Americans with the FSA playing catch up and calculating the fine from US data?

One also wonders what "early" means. Barclays seem to have thrown in the towel before the other banks, but the malpractices have been continuing for at least seven years. The Final Notice does not say when they ceased, if they have, nor when their investigations began, nor what prompted them. The report does say that the three groups of people who should have brought the malpractices to an end, top management aside, namely the FSA, the Bank of England and Barclays' own compliance team, were each warned by traders concerned about legality some years ago, but the communications were too vague and muddled to have any effect.

The news breaking on Barclays before the other banks may not be down to Barclays' speed to settlement so much as being the main culprit. The other fines will presumably establish the culpability ranking.

So we need to hear from Barclays and the FSA exactly who blew the whistle when. The Times (30th June) reports possible whistleblowers as far afield as Singapore and Canada which indicates that the corruption, or knowledge of it, was global.

The vacuity of the calculation of the fine is not acceptable. Precedent is to calculate how much of the firm's profits is due to malpractice and then negotiate a reasonable division of that. The shareholders need to know these figures not least to calculate the management bonuses based on false profits. Future management may well seek to recover those bonuses either voluntarily or by law suit. Why should shareholders pay twice over (government fines and bonuses to executives) for the executives' misconduct?

In equity, however, Barclays are entitled to a discount due to the FSA being asleep at the wheel. It is good that the FSA has finally woken up after 10 years of inaction, but the specialist City press has carried concerns about the LIBOR setting process for years. All through the financial crisis of 2007/8 the press carried rumours about misleading interest rate reporting. How did the FSA miss all that and fail to investigate in a timely fashion?

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According to Ian King (The Times 30th June). Mervyn King was, in 2008, sufficiently concerned by the LIBOR methodology to press for changes, but gave up because he did not have regulatory responsibility. Why did he not phone the FSA?

Barclays' top management did express concerns about the poor PR they were getting for having to pay higher rates: the rumours about rate fixing implied Barclays financial position was not as strong as they were trying to make out. The Final Notice does not say that the malpractices followed specific instructions from the top. It does, however, claim that less senior managers interpreted the concerns expressed by top management as rate fixing instructions which they passed on to their market traders and submitters (to LIBOR and Euribor).

Bob Diamond tries to sweep this away by saying the inappropriate conduct was confined to "a small number of people" (The Times, p.1 29th June) but the FSA says that at least 14 traders were involved (para 57, p.11). If you add submitters and managers, the number may well be over 20. If you add the global dimension mentioned above, the numbers privy to these schemes must be in three figures.

It is hard to believe that hands-on top management of Barclays Capital did not know what was going on. The report notes that the British Bankers Association conducted an investigation in the summer of 2008 but, incredibly, the Barclays' Compliance Team was not involved. The result was a whitewash: the BBA restated the rules and the traders and submitters carried on regardless.

The FSA has as many questions to answer as Barclays. Press reports over the last week or so have portrayed them as the Sherriff riding in to clean up the City, but only part of the story has emerged. It is at least possible that the same inattention and inactivity which allowed the 2007/8 financial crisis to develop, have characterised this new disaster. When a householder leaves his keys in the front door, one cannot wholly blame the burglar.

What an inquiry into the banking crisis probably wouldn't tell us – six reasons why it happened[8]
Andrew Lilico, Conservative Home (Blog Section), Monday 02 July 2012
http://conservativehome.blogs.com/thecolumnists/2012/07/andrew-lilico-what-an-inquiry-into-the-banking-crisis-probably-wouldnt-tell-us-six-reasons-why-it-happened.html

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Following the recent debacle of the RBS IT "glitch" and the Barclays LIBOR-fixing scandal, there have been a number of calls for a wide-ranging public inquiry into the banking crisis and its causes. I think that would be a bad idea. The reason is that, by its nature, such an inquiry would focus on personalities, processes, and particular institutions. It would thus end up, at best, describing *what* happened. There have been many many inquiries that have covered this territory, including major inquiries by the Financial Services Authority and the Treasury Select Committee. There would be nothing valuable added by another one of this form.

What most public inquiries have made only limited progress in understanding is *why*. Saying *what* some individuals and institutions did is of only limited interest if one does not understand properly *why* they did it. In the case of the FSA's main report - the Turner Review - the mystery of why was sidestepped, because the Turner Review (in section 1.4) rejects almost the entire structure of finance theory as it has been developed since the late 1950s (rejecting it, shamefully, without even name-checking the great men that produced it or pausing for a moment to contemplate how they might explain these events using their theories). Since Turner threw away all the theories that might make the behaviour of the 2000s any kind of mystery, there was no question of *why* remaining. Simply describing the events was sufficient.

There have, on the other hand, been many detailed reports by bodies such as the Bank of England and the European Parliament that did cover the question of why. Those of you familiar with my own writings will recall this was a favourite topic of mine in late 2008 and early 2009. Given that it has not gone away and there are once again questions being raised about why the banking crisis occurred, let us remind ourselves of the key cause of the financial crisis.

We shall not here attempt to cover every single contributory factor – this article will be long enough as it is. But what we shall offer will hopefully be enough to see how one might grapple with the mystery of why. In particular, according to modern finance theory such crises fundamentally arise because of an initial over-estimation of returns and/or underestimation of risks, followed by a subsequent downgrading in view. The question then is why that happened, and to what extent there was nothing regulation (and other government policy) should have been trying to prevent it, to what extent regulation failed to prevent it when it should, and to what extent regulation (or other policy) actively made things worse.

1) Natural mistakes associated with innovation

When new innovations arise, the expected returns from them and the risks associated with them can be difficult to assess. Often this leads to their being under-valued initially (the personal computer may well be an instance of this).

Subsequent up-grading of expectations results in increased growth and asset valuations. Occasionally new innovations are significantly over-valued initially. Classic examples of this may include the railways,

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electricity, radio, and dot-com companies.

When expectations are down-graded, there are asset price crashes and collapses of a number of the companies that over-participated on the basis of over-optimism. The 2000s saw very considerable growth in the participation in various financial market innovations, particularly those associated with securitisation and natural partners thereof such as growth in wholesale money markets. It is natural that in periods of transition with growing use of new innovations, there will be increased leverage. If expected returns and risks have been assessed accurately, some increase in leverage is an appropriate and efficient symptom of transition.

However, it seems very likely, now, that, as with certain other new innovations, there was over-participation in these financial market innovations. With a downgrading in expectations and an upgrading in risk assessments, asset prices fell and some of those companies that had over-participated came close to collapse.

2) Increased dependence of regulatory badging, combined with the international coordination of regulation, and with mistakes in that regulation

Over the past 25 years, a core concept in regulation has been the idea that ordinary retail capital-providers (purchasers of retail financial products such as mortgages; ordinary depositors; ordinary small shareholders) are not competent to conduct their own monitoring of the robustness of financial institutions; or, if they are so competent, that they lack incentives to provide adequate monitoring, preferring instead to rely on the monitoring done by others. Instead of diversified individual assessments, financial robustness checking came to be seen as the responsibility of financial regulators. At the same time, financial regulation came to be enormously coordinated, internationally, through devices such as the Basel Accords and the European Union Single Market Programme.

Regulators conducted their own supervisory analysis and risk assessment, but also made use of a small number of ratings agencies.

The net result was that the number and methods of financial robustness analysis were very small and very similar, and the corresponding requirements imposed on financial companies (such as capital requirements) were again done in broadly the same way.

A consequence was that when an event occurred which defeated the risk analysis of this narrow set of actors and methods — a set of new innovations that models based on past data could not properly risk-model, engaged in by the market on a scale that defeated analysis of spillover effects — when this narrow set of actors got it wrong, they got it wrong for everybody. Risk was systemically coordinated nationally by financial regulators and coordinated internationally by international regulation and ratings agencies, as well as the internationalised financial linkages which these international regulations and agencies had facilitated.

3) The belief that governments would intervene in various ways to limit downside risk

The most obvious is the view that governments would not allow house prices to fall in an environment in which political popularity was intimately connected to the rise and fall of house prices — governments

taking the credit when prices rose and the blame when they fell. An implication of this is that lenders would be willing to provide excessive credit for mortgages, and products constructed from mortgages, such as collateralised mortgage obligations, and would be perceived as having reduced downside risk.

Related to this is the idea that governments were expected to bail out financial institutions, in particular by sparing depositors and bondholders, which I explored in considerable detail in a report for Policy Exchange. Such guarantees for creditors distort banking behaviour in a number of ways, including:

- The optimal proportion of bonds in the total capital structure will rise;
- The optimal proportion of high-quality capital buffers (cross-reference in particular, equity buffers) will fall.

This will involve some combination of a fall in the amount of equity, relative to debt, and a rise in the riskiness of the balance sheet;

- Optimal liquidity ratios will fall — banks will want to become less liquid;
- Optimal remuneration schemes will involve more risk-taking;
- Optimal balance sheet size for the banking sector will rise. Indeed, ultimately banking sectors will continue to expand in size until they become so big that the risk of the government that backs them failing rises (cf the situations in Ireland and Spain).

4) Weak internal risk management and poorly-constructed remuneration incentives

Once the key final providers of capital — the purchasers of retail financial products, depositors, shareholders, etc. — did not take responsibility for assessment of the risk-taking of institutions (regulatory authorities) it became necessary for regulatory agencies to take a closer interest in these.

Otherwise, there was moral hazard — workers gained on the upside from bonuses if their risks turned out well, but had only limited downside losses if their risks turned out badly.

The key discipliners of downside risk in a market setting would be the providers of fixed charge loans — depositors and bondholders. But these were not monitored under the system as it evolved.

This issue appears not to have been understood by regulators.

Recent issues at RBS and Barclays simply fall under this category.

5) Regulatory get-arounds

Regulation needs to specify activities that are forbidden or controlled. But there is the incentive for firms to devise ways to restructure their activities — either by adapting what is done or adapting who does it — so as to get around restrictive regulations. This appears to have happened in the 2000s, when financial innovations allowed extensive use of off-balance sheet activities and the use of relatively high-risk AAA-rated investment instruments in liquidity silos.

Regulatory hubris is a constant danger. A classic error is to attempt to regulate away an activity, and instead merely chase it outside the regulatory net to somewhere it does even more harm than if it had been left

alone in the first place.

6) Weaknesses in monetary policy regimes leading to excessively-low interest rates

Interest rates were too low during the 2000s. For many analysts, that is true with the benefit of hindsight. Others of us argued it at the time. We can see a number of reasons for this.

First, inflation targeting naturally tends to create asset price cycles by keeping interest rates too low for too long following a shock of the nature of the dot-com and 911 shocks of the early 2000s. Second, the advent of the euro meant that policy interest rates were too low for several parts of the Eurozone. Third, policymakers used low interest rates to try to curtail the house price crash of the mid-2000s, retarding that in damaging ways and distorting other economic activity in the process. Fourth, inflation targeting will generate a flawed response to an event such as the growth of China, which by its nature tended to depress price pressures from the mid-1990s to mid-2000s (via impacts on manufactured goods import prices) and then contributed to them from the mid-2000 to today (via impacts on commodities prices).

We have only scratched the surface of most of these topics here. But the message should be that the key question for policy is not *what* happened in the financial crisis – the sort of issue that would inevitably be the focus of a public inquiry. It is *why* it happened. Why it happened is something that (pace the Turner Review) can be explained using the tools of modern economic theory. We are now in the process of introducing very widescale regulatory reform in response – some of which is damaging, but some of which addresses these

We don’t need more inquiries. We need regulatory reform – and that is well underway.[9]
LIBOR needs swift moderisation to recapture trust
Tom Kirchmaier, City AM (City AM Forum), Tuesday 03 July 2012, 12:33 am
http://www.cityam.com/forum/LIBOR-needs-swift-modernisation-recapture-trust

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problems directly.

We should be under no illusion about how catastrophic the failure of the LIBOR rate setting mechanisms has been. There has been widespread manipulation of the most important price of risk. And we don’t need reminding how important the price mechanism is for the allocation of everything from goods to services, and of course capital. Any manipulation of prices naturally leads to a misallocation of capital, redistribution of wealth, and arbitrage opportunities. With LIBOR forming the base for over £500 trillion in securities and loans, Barclays is lucky to get away with a fine of £290m.

However, just beating up Barclays as a proxy for our frustration will do nobody any good. We must identify the source of failure and take the right steps so it doesn’t happen again. The main culprit for this misery is the British Bankers’ Association, which has allowed a price setting mechanism to persist that was wholly inadequate for the task. It was designed in a period when trading was done over the telephone, and prices communicated via newspapers. It was never updated, despite enormous technological change in the trading room, and no safeguards developed, despite its tremendous success as a reference value.

The process invited manipulation, and some traders responded to the economic incentives manipulation offered. This is obviously a failure of the traders, but also of the institution that designed the process.

To regain trust in the system, the public debate needs to focus on how to restructure LIBOR. It must be robust to manipulation, using technology in a clever way to minimise the ability of ex-post manipulation – by delivering prices in real time. While internal and external oversight is desirable, we have to be realistic about how much can be achieved with it. Unfortunately, if a process that offers enormous rewards can be manipulated, eventually somebody will try to do it.

There are obvious things that need fixing. LIBOR needs to be based on real trades, and not assumed trades. It will need to be volume-weighted, and not treat every trade equally. The information needs to be sourced directly and automatically from in-house trading systems, and this interface has to be secure against human interference.

The delivery of real-time prices will allow users to average over a longer time period, making manipulation less rewarding and less harmful. We will also need to do spot checks that trades have eventually been settled.

Any manipulation should lead to automatic disqualification by the FSA (soon to be FCA). But we should not put all the responsibility onto the supervisor. In the end, the banks must look after themselves and their clients.

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TITLE

Dr Tom Kirchmaier is lecturer in business economics and strategy at Manchester Business School and a fellow of the Financial Markets Group at LSE.

The paradox at the heart of the Bank of England is now clear for all to see
Don Conaghan, City AM (City AM Forum), Wednesday 04 July 2012, 12:21 am
http://www.cityam.com/forum/the-paradox-the-heart-the-bank-england-now-clear-all-see

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There is a contradiction at the heart of the Bank of England, which may be laid bare today. It is this: the Bank is above the markets and yet intimately involved in them. The twin spheres – Sir Mervyn King's lofty world of monetary policy and econometrics and his deputy Paul Tucker's world of market-makers, bankers and brokers – occasionally collide. The results are explosive.

The Bank's governor has held up his hands in horror at the behaviour of Barclays' traders. Sir Mervyn called it "shoddy" and "deceitful". The idea that the Bank might have known about, let alone sanctioned, any manipulation or recalibration of LIBOR is anathema. If Sir Mervyn passed Bob Diamond in Threadneedle Street, we are led to believe, he would struggle to recognise him.

The truth, I suspect, is more complex. In fact, the Bank's Markets Division, led by Tucker from 2002 to 2009, knew all about LIBOR and how it operates and, indeed, when it ceases to operate. For the latter, when banks decline to lend to each other in times of crisis, it was no surprise to anyone in the Division that it became, in the jargon, "dislocated from itself".

Nor did such dislocation go unrecorded in Threadneedle Street. The Bank's Money Markets Liason Group, a busy cog in the great machine of the Bank, has met regularly over the years to discuss the ups and downs of LIBOR. Witness its minutes in September 2009, which recorded "errors in the inputting of LIBOR submissions", but that the "fixings would not be recomputed unless the process as a whole had been compromised". These are not minutes with top secret stamped on them, they record the everyday business of the Bank.

Or at least part of it. Sir Mervyn takes a decidedly de haut en bas view of the markets. "He simply regards them as rather grubby", one of the Treasury's highest officials told me recently, leaving some of his colleagues to fight in the trenches.

There is, therefore, a disconnect at the Bank and it is a large one. It has led to confusion and misunderstanding in the markets, in banks like Barclays and its peers.

The LIBOR imbroglio is but one example. Look to the gilts market for another. The Bank's mighty QE programme was unleashed in March 2009 with barely any consultation with gilts traders, let alone with the Debt Management Office. The results: utter chaos on the first day's trading, followed by naked market manipulation which created artificial spikes in the market. The Bank saw everything and did nothing. Whether LIBOR, gilts or, indeed, gold, the Bank needs to decide where it stands in the market and whether it takes responsibility for some of its mistakes.

Dan Conaghan is the author of The Bank – Inside the Bank of England (Biteback Publishing). He has worked in the City for the past 15 years, latterly in the bond market.

The LIBOR scandal may destroy the pre-eminence of the City of London[10]
Andrew Lilico, City AM (City AM Forum), Wednesday 04 July 2012, 12:21 am
http://www.cityam.com/forum/the-LIBOR-scandal-may-destroy-the-preeminence-the-city-london

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The 2007-8 banking crisis was a disaster for London's international position as a banking centre. But financial services is much more than just banking. It includes areas such as insurance (in which London's position is strong internationally, though by no means dominant) and securities and broking – in which London had every prospect of remaining the world's leading player. Even as Asian banks grew, perhaps replacing now part-nationalised British banks in the lists of the world's greats, those emerging banks (along with growing large Asian corporates) would still require wholesale services – which London was extremely well-placed to supply.

The LIBOR scandal threatens to end that hope. LIBOR co-evolved, from the mid-1980s, with London's role in securities and broking. It is the key reference rate, internationally, in areas such as futures contracts, swaps, and currencies, along with many wholesale financial products. As the credit crunch began in 2007, the term LIBOR entered broader public consciousness, as the spread between LIBOR and the bank rate became the most widely-known measure of the financial sector's woes.

All around the world, contracts are normed against LIBOR. Investors that would not trust the probity of locally-determined reference rates that might be manipulated for political or corrupt purposes trusted English law, the honour of English gentlemen, the culture of "my word is my bond", the reputation of "as safe as the Bank of England", the excellence and integrity of UK and London regulation.

With the LIBOR scandal, that is very probably now gone. Heads are rolling at Barclays, RBS has fired traders, the government has announced an official inquiry – which may yet mean more heads rolling in more banks – and even the Bank of England has had its probity impugned. The more heads that roll, the broader the scandal; the fewer that roll, the wilder the conspiracy theories will get.

The London interbank offered rate will become a byword for dodgy practice – the word "London" built into an irredeemably toxic term. International investors will develop their own new reference rates for financial contracts – and those rates probably won't be in London. If matters escalate, this could easily turn into an event of a similar order to the end of sterling as a reserve currency, in terms of the impact on Britain's financial role in the world. British securities and broking could be sucked into almost as dismal an outlook of medium-term decline as the British banking sector.

The symbiotic relationship between the UK banks and the government of recent decades has

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been corporatism of a quite shameful and indefensible nature. Implicit bailout promises vested the positions of major firms, closing out proper competition and encouraged lax internal monitoring and risk management, over-merging and excessive, dangerous balance-sheet growth. As tax revenue flowed, lending exploded and jobs grew, the industrial policy goals of governments were met, and the temptation to look the other way, in terms of lax supervisory control and tax forbearance appears, all too often, not to have been resisted.

Bizarrely, however, a common reaction to this cataclysm of mis-regulation and over-involvement of government in the sector has been to call for yet more government. How can so many people continue to fail to see that excess government – bailouts, cosy relationships leading to supervisory laxity that would not occur in other less-regulated sectors, and tax forbearance – has been a central root cause of these problems? It is as if a man with a terrible hangover thinks the solution is to get even drunker once more.

Banking will only achieve probity when there is true accountability to the capital providers and the customers of banks. And they will only monitor banks properly when they are exposed to genuine risk of loss and there are genuine competitive alternatives. The “hair of the dog that bit you”(more regulation) isn’t going to help here, unless your goal is to restore the cosier-than-thou symbiosis of finance and the big state. Only the market can regulate something as large and important and complex as financial services. All else is hubris, delusion, and venality.

Andrew Lilico is chairman of Europe Economics.

Inconvenient truths about LIBOR[11]
Stephanie Flanders, BBC News, Wednesday 04 July 2012, 8:19 am
http://www.bbc.co.uk/news/business-your-money-18701623

We may well see more heads roll at major banks before the scandal surrounding LIBOR is over. But some senior members of the international financial community are increasingly wondering about the future of LIBOR itself.

As one senior international regulator put it to me: "The benchmark is broken. It needs to be fixed. Or perhaps it will just go the way of the dodo. The world has changed." That's because the scandal has shed light on an inconvenient truth about these interbank rates which are used to determine the price of so many hundreds of trillions of dollars worth of global financial contracts.

That inconvenient truth is that even when London Interbank Offered Rates are not "fixed", they may still not bear very much relation to reality - because banks are not actually offering much unsecured money to each other at all.

This has been an open secret among bankers and regulators since the start of the credit crunch in 2007. What any outsider would find surprising is that until now, neither the Financial Services Authority (FSA) nor the Bank of England have really made it their business either to replace LIBOR - or make it more accurately reflect reality.

Interestingly, this is what the US regulator, the Commodities Futures Trading Commission (CFTC), has tried to do in its settlement with Barclays. If and when it ends its investigations of other banks, it will presumably try to do the same with them.

We know that the British bank has been fined £290m ($450m) by the Financial Services Authority and the CFTC for making false claims about the rate at which it was borrowing from other banks - either to make profit or to protect Barclays' reputation at a time when it was seen to be paying more than others to borrow.

There has been less focus on the "undertakings" which Barclays was also forced to make to the CFTC, about how it would calculate and report its interbank borrowing rates in future.

These come into force 14 days from the signing of its agreement with the US regulator and will require the people reporting the bank's cost of borrowing for the BBA to base that report on actual transactions that Barclays has been involved in - in other words, on actual loans it has obtained or made on the wholesale market.

If Barclays hasn't, in fact, obtained or offered such loans, its new rules say it must calculate the rate on the basis of other secured loans that the bank has been involved with (i.e. loans backed by collateral). If there haven't been any of those either, they have to refer to similar transactions that other banks have been involved in which Barclays folk have themselves observed in the market - and so on and so on.

[11] Published with the kind permission of BBC News

The point is that somewhere along the line, there has to be an actual transaction involved - and the system for deriving the Barclays interbank borrowing rate from those transactions has to be entirely transparent.

You might wonder why that is worth an official “undertaking” in a legal settlement with the US regulator. After all, isn’t that what the LIBOR rate is supposed to reflect - the rate at which banks are able to borrow and lend from each other?

The answer to that question is yes, that is what it is supposed to be. The trouble is that it does not - cannot - mean that in an environment in which banks are finding it very difficult to get unsecured loans from anyone for any length of time.

As we keep hearing, that was the situation for large parts of 2007, 2008 and 2009, when some of the “fixing” and attempted manipulation of LIBOR at Barclays was taking place. But, as Robert Peston often reminds us, it is also true of many banks right now - especially across the Channel.

Many banks on the continent - in so called “core” economies like France as well as Spain, Portugal etc - cannot really borrow on the interbank market at all at the moment.

In the City, the borrowing by banks for more than one week is almost entirely happening on a secured basis. Collateral is king.

Many banks in the eurozone are almost entirely dependent on the European Central Bank (ECB) for day-to-day liquidity. And since the ECB started its long-term refinancing operation (LTRO) programme last November, they have been getting quite a lot of longer term funding from that source as well.

And yet, throughout this period, the Euribor - the Euro Interbank Offered Rate, also caught up in the Barclays manipulation scandal - has been faithfully reported, day in day out, by more than 50 European banks. You have to wonder what those rates actually mean.

True, included in that list of 50 are some major global banks who are unlikely to have much trouble borrowing on the wholesale market: Deutsche Bank, for example, and JP Morgan. But you also have banks like the National Bank of Greece, Allied Irish Bank, La Caixa Barcelona and Societe Generale.

We’re not just talking overnight borrowing here. The Euribor rates that are reported include the cost of borrowing for anything from one week, to an entire year. If you ask banking industry insiders how many of those 50 banks are actually getting unsecured loans for a year - or even one month - on the wholesale market they are quite likely to laugh in your face.

So, maybe the Euribor and LIBOR rates correspond to something, but we know for a fact that they do not always, or even usually, correspond to an actual transaction. Nor, if you look at the guidelines for setting LIBOR on the British Bankers’ Association (BBA) website, are they required to. Banks merely have to report the rate at which they “could” borrow funds before 11am, were they to decide to do so. How, exactly, each bank determines the rate is largely up to them.

The CFTC settlement says Barclays had “no internal procedures and controls” determining how the LIBOR

rates were calculated. The BBA does not seem to have had any problem with that.

As it happens, the strangeness of this situation was captured very well by Sir Mervyn King in testimony to the Treasury Select Committee in late November 2008, when he had this to say about LIBOR.

“It is in many ways the rate at which banks do not lend to each other, and it is not clear that it either should or does have significant operational content. I think it is convenient, very often, for people to justify what they do for other reasons, in terms of LIBOR, but it is not a rate at which anyone is actually borrowing. It is hard to see how it can actually have much of an impact.”

And yet, despite their inherent fuzziness and lack of “significant operational content”, despite the lack of formal checks on banks’ internal procedures for coming up with these rates, Euribor and LIBOR are the benchmark for pricing transactions worth trillions of dollars. US dollar LIBOR, for example, is the basis for the settlement of the three-month Eurodollar futures contract, which had a traded volume in 2011 with a notional value of $564 trillion, according to the CFTC.

Many of you will find all of that pretty odd - and pretty shocking. I know most economists would.

We are all understandably interested in what Bank of England deputy governor Paul Tucker and other senior officials may or may not have said about the LIBOR to Bob Diamond or other bankers, at the height of the credit crunch in 2008.

But, perhaps we should also be asking why those senior officials and regulators continued to allow LIBOR to play such an iconic role in global financial contracts - when even the governor of the Bank of England knew quite well that they did not paint a remotely accurate picture of reality. Even when everyone was playing by the rules.

Trust has lost all of its value in our state-regulated financial markets[12]
Philip Booth, City AM, Thursday 05 July 2012, 12:21 am
http://www.cityam.com/forum/trust-has-lost-all-its-value-our-state-regulated-financial-markets

The spotlight in the LIBOR rate-fixing scandal has moved. Questions are being asked about the culpability of the FSA, which may well have ignored repeated warnings about LIBOR calculations from market participants. The role of the Bank of England and the Treasury is also being questioned.

Of course, regulators are not to blame for the actions of those at Barclays and elsewhere. However, we need to question the narrative that this problem all began with “deregulation” and then the development of “light-touch regulation” under Gordon Brown.

Given the millions of paragraphs of financial regulation and the existence of more than 3,000 compliance officers at large banks such as HSBC, we can dismiss the idea that we have light-touch regulation. But, those who suggest that there has been deregulation are not wholly wrong. More things are permitted these days – but those things that are permitted are more highly regulated.

The key question though is not how much regulation there is, but “who regulates?” Perhaps the most important change in the 1980s was not deregulation, but a move from regulatory institutions that emerged within the marketplace to statutory regulation.

When Elinor Ostrom, the late Nobel Laureate, visited the Institute of Economic Affairs last March, she was interested in the analogy between financial regulation emerging in the market and community management of environmental resources. She was fascinated by the fact that, when the stock exchange first started in a coffee shop, those who did not settle their accounts were put on a board under the heading “lame duck”; the exchange expelled people for bad behaviour; and it made the rules for companies that wanted a listing and for individuals and companies involved in trading. In order to prevent conflicts of interest, on the London exchange, companies could not trade on their own book and also give advice to clients. The motto became “my word is my bond” and the untrustworthy would not get business. This all ended with a transfer of regulatory authority to the state.

Other such mechanisms developed in banking. Mutual societies, trustee savings banks (TSB) and unlimited liability partnerships all developed to promote trust in an era where there was often no regulation and no protection. Trust and reputation were very important when promoting a brand. Governance mechanisms that led firms to be technically inefficient were often valued because they promoted trust.

There is evidence that the development of deposit insurance and the greater government oversight of the activities of financial institutions undermined the attractiveness of these institutions so that, when they were free to turn into proprietary banks, they did so. Some of these institutions were literally destroyed by government. The TSB had no defined ownership, so had to be nationalised in order to be privatised.

A reputation for prudence came to have no market value and, naturally, most institutions became big,

[12] Published with the kind permission of City AM

remote, shareholder-owned institutions operating at the level of maximum technical efficiency – nothing else mattered. Of course, any institution that is “too big to fail”, and which is therefore able to take one-way bets with other people’s money, also attracts exactly the wrong sort of people into the industry.

We must reverse the trend. We should abolish deposit insurance and ensure that the providers of capital suffer the losses when banks fail. Prudence must matter when we decide to whom we give our money. Financial regulation must again be allowed to evolve within the market. A start could be made if politicians resisted regulation of new sectors such as peer-to-peer lending. Economist Tim Congdon has also suggested that the Bank of England could be the regulator of the banking system on a contractual basis in return for lender of last resort facilities: those not wishing to avail themselves of that facility could be unregulated. This may help too.

The polycentric institutions of governance that grew up in financial markets have been destroyed. Starting again will be difficult, but the alternative of statutory regulation is not working.

Professor Philip Booth is editorial and programme director at the Institute of Economic Affairs and Professor of insurance and risk management at Cass Business School.

Why we really don't want state control of banks and their lending[13]
Tim Worstall, Adam Smith Institute Blog, Sunday 08 July 2012
http://www.adamsmith.org/blog/money-banking/why-we-really-dont-want-state-control-of-banks-and-their-lending

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I think we'd all agree that Britain's banking sector is not exactly covering itself in glory at present. From going bust (variously, from excessive lending to mortgages, from overpaying for a rival bank, by being caught in a wholesale banking run, no, no one went bust because of doing silly things in their investment banks) through to what I'm sure will turn out to be everybody fiddling LIBOR, it's not been a great few years. Yet let us not forget that there is no problem, no situation, which government cannot make worse.

Take, as an example, what is happening in Argentina.

Fernandez, a center-leftist, is embracing increasingly unorthodox economic policies as she seeks to sustain activity, which analysts say is vulnerable to insufficient credit.

"We're going to tell the 20 principal banks... they have the obligation to lend for production and for investment," Fernandez said in a televised speech.

"The central bank's going to establish the conditions," she said, adding that state-run banks should not have to shoulder the entire responsibility for business loans.

She said the loans would carry a maximum interest rate of the Badlar reference rate, which was 11.9pc per year for private banks in June, plus 400 basis points. The minimum loan period would be three years.

With inflation at 25% that's an immediate loss of some 30% for the lending banks. And just as a thought, who would want to be increasing the money supply, the availability of credit, when inflation is 25%? As Uncle Milt taught us, inflation is always and everywhere a monetary phenomenon after all.

Now we don't have anyone advocating this in the UK, not yet. But we do have plenty of people calling for a State owned investment bank. The only reason for such being to insist upon financing going to things which the market unadorned will not finance: that's the whole point of having the State part. And by definition if money is to be forced into politically approved lending then it will be at a lower price than the market will provide: the Argentinian point writ small.

For the problem to become as bad as it is in Argentina we would need our own policy to be determined by increasingly unorthodox leftists. Fortunately, such are limited to nef, Anne Pettifor, Richard Murphy, Neal Lawson, Compass, half the Trade Unions, Seumas Milne and a goodly portion of the Labour Party. I hope you find that as comforting as I do.

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Barclays isn't the only one engaged in the manipulation of interest rates[14]
Anthony J. Evans, City AM (Forum), Tuesday 10 July 2012, 12:16 am
http://www.cityam.com/forum/barclays-isn-t-the-only-one-engaged-the-manipulation-interest-rates

It has recently emerged that a UK bank has been manipulating a key interest rate. The only disappointment I have is that people are wasting so much energy on the wrong bank and the wrong interest rate. The Bank of England has far more influence over the banking system than Barclays – it is, after all, the central bank. And the Bank rate, the interest rate that the Bank of England sets each month, is in many ways a hugely more important benchmark than LIBOR.

One might even argue that Barclays was doing us a favour. If it emerges that it was keeping interest rates higher than they otherwise would have been, this would have reduced the scale of the asset bubble that the Bank of England's artificially low rates were creating. If only other financial institutions had been offsetting the main cause of the financial crisis.

And if it was keeping rates lower, it was merely adopting government policy and keeping mortgage costs low. My recollection of 2008 was that a spiking LIBOR was being actively dampened by policy-makers, although exactly what happened hasn't been revealed yet. One thing we do know is that LIBOR needs to be calculated properly, without relying on a sample of individual firms' reported data. This always made it prone to abuse.

Of course, the main difference between what Barclays is accused of doing and what the Bank of England routinely does is democratic legitimacy. In short, the Bank is allowed to manipulate interest rates. But a vital issue remains unresolved.

There is a severe knowledge problem. Manipulating interest rates – like manipulating any market price – deprives us of truth.

On Twitter recently, Danny Blanchflower, former member of the Monetary Policy Committee and Andrew Lilico, the chairman of Europe Economics, debated what the "natural interest rate" currently is. This is the interest rate that would generate sustainable economic growth with a balance between people's desire for savings and investment. It is the reference point around which loose or tight monetary policy can be defined.

Blanchflower thought it was -3 per cent, while Lilico thought it was around +3 per cent. The problem is that none of us really know. Whether it's the Bank of England manipulating the Bank rate, or Barclays manipulating LIBOR, we aren't even attempting to use markets to learn about reality. It's almost like we've forgotten that interest rates can tell us something new, rather than simply reflect what we wish them to be.

In reality Barclays is a minor player because the whole monetary system is built on the desire of central banks to impose their wishes on the market. But to kill an octopus you don't trim its tentacles. You need to cut off its head.

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