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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Interest-Rate Ruse: Understanding The LIBOR Scandal

Law360, New York (August 15, 2012, 12:28 PM ET) -- The alleged manipulation of the London Interbank Offered Rate (Libor) has received prominent media coverage this summer, drawing scrutiny of both leading banks and their regulators.

Libor is the average interest rate at which a panel of the world's largest banks report they could borrow unsecured funds from other banks in the London wholesale money market for maturities ranging from overnight to one year. Libor is calculated for 10 different currencies and is a primary interest-rate benchmark used to price numerous financial instruments, including mortgage loans, floating-rate bonds and interest-rate swaps. The value of derivatives and other financial products tied to Libor is estimated as at least $350 trillion.

Between 2007 and 2010, the U.S. dollar Libor panel consisted of 16 banks, including Bank of America, Barclays Bank, Citibank, Credit Suisse, Deutsche Bank, HSBC, JPMorgan Chase, Lloyds Banking Group PLC, Royal Bank of Canada, The Royal Bank of Scotland Group and UBS.

At 11:10 a.m. each morning, each panel bank reported its estimated costs to "borrow funds, were [it] to do so by asking for and then accepting interbank offers in reasonable market size, just prior to 11.00 London time." Libor is calculated by discarding the four lowest and four highest reported rates, and averaging the remaining eight.

Beginning in August 2007, and corresponding with the financial crisis, Libor began behaving erratically and became decoupled from other financial indicators that had historically functioned as benchmarks.

While Libor has historically remained high during times of financial uncertainty — reflecting banks' reluctance to lend unsecured funds to one another without receiving a higher risk premium — the U.S. dollar Libor remained surprisingly low during the financial crisis. This led to concern that Libor's abnormal behavior was the result of manipulation. Economists speculated that both the desire to appear financially sound and the potential to profit from Libor-based holdings incentivized panel banks to artificially suppress Libor.

The United States Department of Justice, as well as regulators in the United Kingdom, Canada and Japan, are investigating the alleged Libor manipulation.

By mid-2011, Swiss bank UBS entered a deal for conditional leniency with the U.S. Department of Justice. UBS has since expanded this leniency with regulators from other countries in return for assisting with the investigation.

In June 2012, Barclays agreed to pay $453 million to U.S. and U.K. regulators for LIBOR manipulation and admitted that "[o]n at least a few occasions from approximately September 2007 through at least approximately May 2009, Barclays submitted improperly low LIBOR contributions."

Even more recently, by the end of June, RBS was reported to have agreed to a fine of $233 million for its role in the Libor scandal. Questions have also surfaced about whether the Bank of England and the Federal Reserve Bank knew of the manipulation as early as 2007, and the investigation has reportedly expanded to several groups of traders from at least nine banks concerning whether they worked together to rig interest rates.

In addition to government scrutiny, numerous civil lawsuits alleging Libor manipulation have been filed against panel banks.

These actions — consisting of both putative class actions and individual suits — have been consolidated into multidistrict litigation proceedings in the United States District Court for the Southern District of New York.

Investors who were purchasers of floating rate bonds or interest rate swaps tied to Libor allege that, in knowingly submitting false borrowing rates, panel banks violated the Sherman Act, the Racketeer Influenced and Corrupt Organizations Act, the Commodities Exchange Act, and numerous state laws.

As the litigation continues, one can expect institutional investors with large claims to opt out of class actions and pursue individual federal and state law claims.

--By Stacey P. Slaughter and Thomas F. Berndt, Robins Kaplan Miller & Ciresi LLP

Stacey Slaughter is a partner at Robins Kaplan Miller & Ciresi LLP. Her practice focuses on complex business litigation, antitrust and trade regulation, and securities and financial litigation practices. She has represented clients in a range of industries including banking, commodities, consumer goods and products, food, logistics, securities, technology, and travel.

Thomas Berndt is an attorney at the firm, representing corporations and individuals in complex commercial disputes with a focus on financial litigation, class actions, and product liability.

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