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Tackling The Financial Crisis With Antitrust Claims

Law360, New York (January 09, 2012, 1:47 PM ET) -- In 2008, a series of financial market and bank failures triggered a worldwide financial crisis and recession. The crisis effectively halted global credit markets and required unprecedented government intervention.

The U.S. government provided $700 billion in bank bailouts and took over Fannie Mae and Freddie Mac. With extensive write-downs due to the financial crisis, some of the largest banks, including Washington Mutual, Bear Stearns and Merrill Lynch, had to decide whether to fail or be acquired.

Washington Mutual and Bear Stearns were acquired by JP Morgan, Merrill Lynch was acquired by Bank of America, and Lehman Brothers completely collapsed in the biggest bankruptcy filing in history.

Until recently, however, there were no significant allegations of collusion among banks surrounding the financial crisis. But new suits consolidated before Judge Naomi Reice Buchwald in the Southern District of New York argue that some of the most significant banks in the world were conspiring to manipulate and restrain the London Interbank Offered Rate (LIBOR) to their financial benefit.

LIBOR is arguably the most important interest rate in the world. It is used to calculate interest rates on over $350 trillion worth of financial products, including derivatives, corporate debt, mortgages and other types of loan agreements.

LIBOR is available for 10 different currencies, with each currency having a panel of reporting banks. To determine the LIBOR rate for a particular currency, each bank on the panel submits daily data to Thomson Reuters by 11 a.m. London time, reporting what rate the bank believes it would receive to obtain unsecured funding from other banks.

When data submission is complete, Thomson Reuters ranks the rates from highest to lowest, with the four highest and four lowest rates discarded. LIBOR is then based on the average of the remaining rates for the day. By pegging lending rates to LIBOR, banks ensure that the interest rates that clients pay never fall too far below their own cost of borrowing.

Historically, when there is a credit crisis or financial-market uncertainty, LIBOR rates spike because banks are reluctant to provide unsecured loans to each other without a higher premium to accompany the increased risk. This pattern broke in 2007.

Instead of U.S. LIBOR rates sharply increasing with the financial crisis, rates were unusually low. Because of this abnormality, economists Connan Snider at the University of California, Los Angeles, and Thomas Youle at the University of Minnesota began investigating LIBOR and other benchmarks measuring perceived credit risk, including credit default swaps (CDS) and Eurodollar bid rates.[1]

Typically, CDS spreads would mirror increases and decreases in U.S. LIBOR rates. However, after August of 2007, CDS began spiking while U.S. LIBOR rates dipped.

Similarly, banks consistently submitted U.S. LIBOR quotes between 6 and 12 basis points above the Eurodollar bid rate. For the first time in history, U.S. LIBOR fell below the Eurodollar bid rate in 2007, and at times quite drastically.

Further, some banks were submitting lower quotes for U.S. LIBOR than for other currencies. This, plaintiffs argue, is evidence that LIBOR quotes weren't primarily based on differences in credit risk, since an individual bank would have the same credit risk across currencies.

A close examination revealed that U.S. LIBOR quotes were clustering around the day's fourth lowest quote beginning in August of 2007. Clustering would ensure that the quotes used to calculate the average for the daily U.S. LIBOR rate would be artificially low. If the banks had truthfully quoted their costs to calculate U.S. LIBOR, there wouldn't be clustering, LIBOR would be more consistent for a bank across currencies, and the distributions would be similar to changes in CDS and the Eurodollar bid rate.

Artificially low LIBOR rates wouldn't harm borrowers, and may only have a nominal negative impact on lenders who could have charged more for loans. The real incentive to suppress U.S. LIBOR during the financial crisis came from derivatives. Panel banks sell millions of derivatives, and since they control LIBOR quotes and corresponding LIBOR rates, the banks effectively control their rate of return on LIBOR-based derivatives sold.

Because bank revenue could be severely impacted by the credit freeze and financial crisis, significantly underreporting and clustering U.S. LIBOR quotes allowed the banks to reap great profits from LIBOR-based derivatives.

For instance, with a large drop in U.S. LIBOR rates in 2009, JPMorgan saw a 49 percent revenue increase from 2008, a 40 percent increase from 2007 and a 61 percent increase from 2006.

In 2011, the U.S. Securities Exchange Commission, U.S. Commodity Futures Trading Commission, the U.S. Department of Justice (DOJ), the Japanese Financial Supervisory Agency and the United Kingdom's Financial Services Authority opened several investigations against a number of banks for potential LIBOR manipulation.

On July 26, 2011, the DOJ granted UBS Financial Services Inc. leniency from potential violations in return for cooperation in the LIBOR manipulation investigation.

There were also 23 related complaints filed that were consolidated into In Re: LIBOR-Based Financial Instruments Antitrust Litigation MDL No. 2262. The primary allegations are that the defendant banks conspired to underreport, suppress and manipulate LIBOR for financial gain, and restrain trade for LIBOR-based derivatives.

Defendant banks include Bank of America Corp., Credit Suisse Group AG, JPMorgan Chase & Co., HSBC Holdings plc, Barclays Bank plc, Lloyds Banking Group plc, WestLB AG, UBS AG, Royal Bank of Scotland Group plc, Deutsche Bank AG and Citibank NA.

On Nov. 29, 2011, Judge Buchwald ordered that while the plaintiffs in the multidistrict litigation made similar allegations, there should be two proposed classes. Accordingly, the case was split into over-the-counter plaintiffs, with Hausfeld LLP and Susman Godfrey LLP as lead counsel, and exchange-based plaintiffs, with Kirby McInerney LLP and Lovell Stewart Halebian Jacobson LLP as lead counsel.

While the case is still young, it should provide a framework for applying the antitrust laws to the manipulation of financial instruments.

Robins, Kaplan, Miller & Ciresi is actively involved in In Re: Libor Based Financial Instruments Antitrust Litigation MDL No. 2262.

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The opinions expressed are those of the authors and do not necessarily reflect the views of the firm, its clients, or Portfolio Media, publisher of Law360. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

[1] Economic Study: Connan Snider UCLA, Thomas Yule University of Minnesota, Does Libor Reflect Bank's Borrowing Costs? April 2, 2010.

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