LIBOR UNDER ATTACK: UNDERSTANDING THE CURRENT CONTROVERSIES

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The London InterBank Offered Rate (commonly known as "LIBOR") is the most commonly used benchmark for short-term interest rates both in the international and domestic markets. According to the British Banking Association (the "BBA"), which oversees the calculation and publication of LIBOR quotes, at least $350 trillion of retail and wholesale financial instruments are linked to LIBOR. Over the past three decades, LIBOR has replaced the Prime Rate as the most common index used to determine the interest due under floating rate, short-term commercial loans (such as construction loans and land loans) and most home mortgages. The rate has historically been fairly stable and not subject to sudden, wide swings. That began to change last fall with the collapse of Lehman Brothers and the worldwide credit crunch. The global financial crisis and resulting governmental interventions in the financial sector have raised a number of questions regarding the immediate and long-term viability of LIBOR as a reliable indicator of the interbank lending market and a useful index for banks involved in real estate lending. This article will provide a short refresher on the basics of LIBOR and discuss the current controversies.

Background

In a nutshell:

> [LIBOR] is a benchmark; giving an indication of the average rate a leading bank, for a given currency, can obtain unsecured funding for a

> given period in a given currency. It therefore represents the lowest real-world cost of unsecured funding in the London market.[1]

The first LIBOR rates were published by the BBA for three currencies in 1986. Today, LIBOR is quoted each business day for ten currencies with 15 maturities quoted for each, ranging from overnight to 12 months. Current rate quotes are widely available from a variety of print and on-line sources– interested parties can even sign up for daily updates via Twitter.[2]

Each currency has a panel of eight to 16 banks which are asked the following question:

> At what rate could you borrow funds, were you to do so by asking for and then accepting inter-bank offers in a reasonable market size just prior to 11 a.m.?

Between 11:00 and 11:20 a.m. BST each business day, each panel bank forwards its answers to that question for the appropriate currencies and maturities to Thomson Reuters, the BBA's designated number-cruncher. None of the banks can see the others' information until the final rates are issued. Thomson Reuters uses a "trimmed arithmetic mean process" to determine LIBOR. In other words, it ranks panel submissions in descending order and then drops the top and bottom quartiles. The middle 50% of the quotes are then averaged to create the LIBOR quote. An example from the BBA website:

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[1] British Banking Association, "bbalibor Explained: The Basics," (http://www.bbalibor.com/bba/jsp/polopoly.jsp?d=1627).

[2] Visit http://twitter.com/BBALIBOR to sign up. Currently, only the 3 month British Pound Sterling rate is quoted via Twitter.

~~Barclays Bank plc~~	~~2.15~~	
~~Bank of Tokyo-Mitsubishi UFJ Ltd~~	~~2.15~~	
~~HSBC~~	~~2.12~~	
~~Royal Bank of Scotland~~	~~2.11~~	
UBS AG	2.105	
Abbey National	2.1	
Bank of America	2.1	
Citibank NA	2.1	LIBOR Rate =
Mizuho Corporate Bank	2.1	2.10063
Rabobank	2.1	
Royal Bank of Canada	2.1	
WestLB AG	2.1	
~~BNP Paribas~~	~~2.05~~	
~~Lloyds Banking Group~~	~~2~~	
~~Deutsche Bank AG~~	~~1.95~~	
~~JP Morgan Chase~~	~~1.95~~	

It is important to note that LIBOR is based on the panel banks' best guess of the offered rate, not actual transactions. As the BBA explains, "[s]ubmissions are based upon the lowest perceived rate that a bank on a certain currency panel could go into the inter-bank money market and obtain sizable funding, for a given maturity." Obviously, there is a significant amount of subjectivity in that determination.

Not surprisingly, given the "London" bit of "London InterBank Offered Rate," the panel banks are chosen only among those banks active in the London money market. They are chosen based on: (1) the scale of market activity; (2) credit rating; and (3) perceived expertise in the currency concerned. The panels are re-evaluated each year and adjusted as necessary. The panel for the U.S. Dollar was most recently established as of June 1, 2009. It was not changed from last year and currently consists of the following banks:

Bank of America	Lloyds TSB Bank plc
Bank of Tokyo-Mitsubishi UFJ	Rabobank
Barclays Bank plc	Royal Bank of Canada
Citibank NA	Société Générale
Credit Suisse	The Norinchukin Bank
Deutsche Bank AG	The Royal Bank of Scotland
HSBC	UBS AG
JP Morgan Chase	West LB AG

After the panels were last established on June 1, 2009 the BBA issued a press release entitled "Defining the L in BBA LIBOR."[3] Prior to June 19, 2009, quoted rates included the following note: "Contributions [to the rate fixing process] must represent rates formed in London and not elsewhere." The BBA determined that the phrase "formed in London" could be confusing and outdated because many major participants in the London money markets are not physically located in London or do not book trades there. Therefore, the BBA changed the note to read: "Contributions must represent rates at which a bank would be offered funds in the London Money Market." This change has no immediate impact on LIBOR but is seen as a potential liberalization of the panel determination method which will allow banks which had not previously been qualified to join a currency panel to apply to do so. It is also designed to prevent the disqualification of banks that currently participate in the panels because of the closure of London operations by non-British banks.[4] The BBA will next re-evaluate the panels in May 2010, so any impact of this change will not be seen until that time.

[3] The press release can be found at:
http://www.bba.org.uk/bba/jsp/polopoly.jsp?d=145&a=16133

[4] Adam Bradbery, "Libor No Longer Just London," Wall Street Journal (June 19, 2009).

The LIBOR system described above has been subject to serious criticism over the past year because of the impact of several aspects of the global financial crisis and governmental responses to it. Each of these criticisms essentially questions whether LIBOR, as currently formulated, is an accurate measure of the true cost of borrowing in the interbank money market and, ultimately, whether it is a reasonable index to use in consumer lending, particularly commercial and residential real estate loans.

Impact of TARP

James Bianco of Arbor Research recently wrote a piece that observed the behavior of LIBOR panel banks which accepted TARP funds versus those which did not. Analyzing the rates submitted by three TARP banks (Bank of America, Citibank, and JP Morgan Chase) and two Japanese banks (Bank of Tokyo and Norinchukin), Bianco noted that from 2004 to 2007, there was little difference in the rates submitted by the five banks. Since the three U.S. banks accepted TARP funds, however, the difference between the two groups has broadened, with the U.S. banks submitting LIBOR rate quotes significantly below the Japanese banks. To Bianco, this suggests that the TARP program has had an important and skewing impact on LIBOR.[5] The Federal Reserve Bank of San Francisco has recently voiced similar concerns, which Bianco interprets as suggesting that LIBOR no longer reflects real risk in the system because of the guarantees by the U.S. government.[6]

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[5] "The Uselessness of LIBOR," Seeking Alpha (June 22, 2009) (http://seekingalpha.com/article/144506-the-uselessness-of-libor?)
[6] Jens H. E Christensen, Jose A. Lopez, and Glenn D. Rudebusch, "Do Central Bank Liquidity Facilities Affect Interbank Lending Rates?" FRBSF Working Paper 2009-13 (June 2009).

Two-Tiered System

Another criticism of LIBOR which has gained significance since the September 2008 collapse of Lehman Brothers is that it is based on the fiction that there is a single money market in London. There are actually at least two distinct tiers of money markets – banks with low credit ratings have to pay more to borrow cash than do higher-rated ones. That has always been true to a limited extent, but the gap has widened since the advent of the current global economic crisis. In the middle of 2008, according to the BBA, the average difference between the highest and lowest quote submissions from panelists for the one-month euro was 6.9 basis points. By the end of the year, the difference had exploded to 43.9 basis points. For the first quarter of 2009, it had receded a bit to 26.4 basis points. The same trend is generally true for other currencies, especially the dollar, where the impact of TARP may be felt more sharply. One commentator recently observed that "the biggest institutions are able to fund themselves at around Libor levels while smaller institutions have to pay, in some cases, more than 100 basis points above Libor."[7]

The impact of this disparity could be significant for smaller institutions. If a smaller institution made a commercial construction loan at LIBOR plus 250 basis points a year ago, when it could actually borrow funds at LIBOR, but now it is forced to pay LIBOR plus 100 bp to borrow, its modest spread has taken a big hit while, in all likelihood, its risk on the loan has risen.

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[7] David Oakley and Michael Mackenzie, "Fall in Libor fails to paint a true picture," Financial Times (June 3, 2009).

The BBA's decision to expand the "L" in LIBOR may permit smaller banks to participate in the currency panels, which should theoretically have the impact of raising LIBOR to reflect the true borrowing cost for the middle tier of banks.[8] However, some commentators point out that this will further distort LIBOR by raising the average rates above the "true" cost of borrowing for the top tier of banks, which will raise the cost to borrowers (including, ultimately, consumers) and potentially increasing the profit spread for banks that can borrow money more cheaply.[9] So long as there is a great disparity between the borrowing power of large and small institutions, but a single index which attempts to capture both ends of the spectrum, this problem will persist.

Oversight of Panels

A final criticism levied against LIBOR is that the process allows panel banks the potential to understate their true costs of borrowing in order to avoid the appearance that they are experiencing funding difficulties. In December 2008 the BBA took steps to address this concern by establishing a three-step disciplinary procedure to punish banks that inaccurately report rates. Of course, given that the banks are supposed to quote the rates that they perceive are correct, rather than reporting rates used in recent transactions,

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[8] Id.

[9] Lucy Tobin, "Revealed: How the Banks are Profiteering from Lending," Evening Standard (August 10, 2009) ("Banks were thrown into fresh controversy over excess profits today after it emerged that the spread between their cost of borrowing and the interest rates they levy on businesses and homeowners has rocketed to new highs. Figures compiled by the Evening Standard reveal the difference between the three-month Libor, the London inter-bank offered rate, and the average interest rate charged on mortgages has shot up to 3.7%, almost seven times higher than the difference recorded this time last year. . . . The picture is even worse for business customers, where the spread can commonly be as high as 7.12%. Critics said the staggeringly large number shows how easy it is in the current environment for banks to make huge profits at the expense of customers.")

it is unclear whether the BBA's actions will have the intended impact. The optimal solution, according to Jan Misch, a money market trader at Germany's biggest state-owned bank, is to require the panel banks to "prove they can transact at the rates they submit to the BBA."[10] There is no indication that the BBA is moving to adopt such a change to the LIBOR determination process.

The Future of LIBOR

It has been suggested by a number of analysts that LIBOR's inadequacies, brought to light by the current financial crisis, mean that it should be replaced by another index. That seems unlikely in the near term, as there is currently no consensus on an alternative index. Instead, it is more likely that the BBA will attempt to preserve the viability of LIBOR by continuing to tweak the system to respond to criticisms by analysts and banks.

The current controversies surrounding LIBOR may have no immediate impact on how real estate attorneys draft loan documents, but they may help illuminate changing term sheets. Lenders, particularly smaller institutions, are much more likely to design a floating rate based on LIBOR to include a floor. For example, the rate for a loan may be 30 day LIBOR plus 250 basis points, provided that 30 day LIBOR shall not be less than 1.5%.

In light of recent changes to LIBOR by the BBA, it may also be a useful exercise for attorneys to revisit the definitions of LIBOR used in form loan documents to ensure

[10] Ben Livesey and Gavin Finch, "Libor to Be Set by More Banks as BBA Boosts Scrutiny," Bloomberg.com (June 10, 2008) (www.bloomberg.com/apps/news?pid=20601087&sid=alj8baVXsFA8&refer=home)

that any future changes made by BBA to the methods of calculation will not have unintended consequences.