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On arbitration, arbitrage and arbitrariness in financial markets and their governance: unpacking LIBOR and the LIBOR scandal

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Abstract

Amongst a series of scandals to hit international financial markets in recent years, that surrounding the London Interbank Offered Rate (LIBOR) – a highly influential interest rate benchmark – has attracted particularly intense media scrutiny. This paper seeks to push beyond conventional understandings to unpack critically both LIBOR itself and the scandal involving its manipulation by major international banks. Envisioning LIBOR as a commodity beset by inherent contradictions, the paper mobilizes the tropes of arbitration, arbitrage and arbitrariness to illuminate, respectively: the market-making work performed by LIBOR; its role in enabling the transfer of financial risk, most notably when fraudulently manipulated; and the nature of the regulatory prosecution of such manipulation.

Keywords:

financial markets | risk | calculative practices | manipulation | derivatives | banking

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Notes

1. It is not the only internationally relevant interest rate benchmark; there are several others, of which one, the Euro Interbank Offered Rate (EURIBOR), which serves a comparable role for euro-denominated as LIBOR does for (primarily) sterling- and dollar-denominated instruments, was also caught up in the manipulation scandal we examine in this paper.

2. Here, the notion of legal technology refers to the work that LIBOR performs in anchoring legal relationships, rather than indicating a fundamental relationship to broader systems of legal norms. We will return to the question of LIBOR's normative status in a later section of the paper.

3. Note that the quoted rate is always annualized, however. Note also that until February 2014, and thus throughout the period of the manipulation scandal examined in this paper, LIBOR was estimated for 10 currencies and 15 time periods, making 150 estimates in total.

4. Transfer of LIBOR's administration from the BBA to IBA occurred as part of the wider implementation of the recommendations of the Wheatley Review which was set up following the revelations of attempts to manipulate LIBOR.

5. Up until 1998, submissions were based on a different question: ‘At what rate do you think interbank term deposits will be offered by one prime bank to another prime bank for a reasonable market size today at 11 am?’

6. http://www.bbalibor.com/explained/the-basics(retrieved August 2013).

7. https://www.theice.com/iba_calculation.jhtml (emphasis added) (retrieved March 2014).

8. http://www.global-rates.com/interest-rates/libor/libor-information.aspx (retrieved August 2013).

9. IntercontinentalExchange acquired the right to administer LIBOR when it purchased NYSE Euronext in November 2013; the latter, through its own subsidiary Euronext Rate Administration Limited, had been appointed as the new administrator in July 2013 by the independent Hogg Tendering Advisory Committee.

10. http://trademarks.justia.com/861/83/ice-86183638.html (retrieved March 2014).

11. One way this is expressed is as a correlation between banks’ liquidity risk premiums (measured as the spread between LIBOR and US Treasury rates) and sovereign default risk premiums (measured by sovereign bond yield or credit default swap spreads) (Huang et al., 2012). As a Bank of International Settlements report noted in the context of both 2008 and 2011, ‘indicators of bank stress are closely correlated with the indicators of stress in government securities markets. This demonstrates the close relationship between the perceived solvency of governments and the solvency of their countries’ banks’ (Allen & Moessner, 2012, p. 3).

12. This proprietary value has long been appreciated by the BBA. When, in 2008, The Wall Street Journal reported growing distrust of LIBOR, the BBA responded forcefully. ‘If it is deemed necessary’, spokesman John Ewan said, ‘we will take action to preserve the reputation and standing in the market of our rates’ (Mollenkamp, 2008). IBA, moreover, has been extraordinarily quick to recognize and seek commercially to exploit this value: within days of assuming its administrative role, it informed all LIBOR licensees that their existing licences (with the BBA) would be terminated on 1 July

2014, and hence that new licensing terms would need to be negotiated – at explicitly higher prices that, inter alia, 'better [reflect] the value that clients extract from the LIBOR rates.' See https://www.theice.com/publicdocs/IBA_Licensing_Distribution_FAQ.pdf (retrieved March 2014).

13. The first actions against the bank were brought privately by an Austrian hedge fund (Aldrick, 2012).

14. Furthermore, comparable investigations have been launched into alleged manipulation of benchmark rates in the (even bigger) international foreign exchange (currency) markets, as opposed to the credit markets that LIBOR and kindred rates underpin. Here, the rates in question are the pivotal spot exchange rates such as those compiled and published by WM/Reuters, whose benchmarks for 160 currencies are determined by trades occurring in the 60-second period known, in a glorious irony, as 'the fix', and where the central allegation is of manipulation collectively to concentrate trades within this window to maximize the impact on the published benchmarks. See, e.g., Schäfer and Shotter (2014).

15. Of course, given LIBOR's widespread use as a pricing benchmark, the direct targets represent just one small group of actors potentially impacted by LIBOR arbitrage. We will return to this in the final section of the paper.

16. There is evidence that there was some informal co-ordination among traders and Barclays submitters to avoid the former outcome (FSA, 2012, pp. 20–21).

17. The FSA was merged into the new UK Financial Conduct Authority only nine months after the release of the Barclays Final Order.

18. For instance, Barclays was accused of violating Principle 5 of the FSA, which states that 'a firm must observe proper standards of market conduct' and Principle 3: 'a firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems' (FSA, 2012, p. 39).

19. This allegation was echoed by US Federal Reserve Chairman Ben Bernanke, who testified to a Congressional Panel in mid-2013 that 'the disclosures are troubling and have the effect of undermining confidence in financial markets' (Robertson et al., 2012).

20. These penalties were mitigated based on Barclays' extensive co-operation with the FSA investigation.

21. Which is not to say that individual parties to contracts cannot pursue the bank for alleged damages. A list of plaintiffs seeking compensation for allegedly higher debt service payments due to LIBOR manipulation includes the University of California and the cities of Baltimore (MD), New Britain (CT), Richmond (CA), Riverside (CA) and San Mateo (CA) (Cotchett & McCarthy, 2013; The New York Times, 2013).

22. According to revised DOJ prosecution guidelines '… where the collateral consequences of a corporate conviction for innocent third parties would be significant, it may be appropriate to consider a non-prosecution or deferred prosecution agreement with conditions designed, among other things, to promote compliance with applicable law and to prevent recidivism' (DOJ, 2008).

23. The Wheatley Review of Barclays' LIBOR transgressions, commissioned by the Chancellor of the Exchequer, concluded 'LIBOR manipulation and attempted manipulation is unlikely to constitute a criminal offence which falls under the prosecutorial responsibility of the FSA' (HM Treasury, 2012, p. 18).

24. For instance, 'a firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems … The extent of Barclays' misconduct throughout the Relevant Period was exacerbated by these inadequate systems and controls … Compliance's failures meant that other issues at Barclays relating to the LIBOR and EURIBOR submissions process were allowed to continue' (FSA, 2012, p. 39).

25. For other banks involved in the scandal, this has translated into outright jurisdictional competition. For instance, the Canadian Competition Bureau's investigation of the Royal Bank of Scotland resulted in the bank's characterization of demands for trading data and documents as an 'invasion of the sovereignty of the United Kingdom' (Robertson et al., 2012).

26. Other recent cases involving conflicts of interest between banks' intermediation and proprietary trading functions have invoked similar reforms. See, for instance, Dorn and Levi's (2011) analysis of the ABACUS fraud case involving Goldman Sachs.

Additional information

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