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Agenda

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LIBOR damages claims: counterparties and complex counterfactuals

The heavy fines imposed by regulators in Europe and the USA on banks involved in LIBOR manipulation have reopened speculation about the potential volume and value of follow-on damages claims. But what are the key issues that could determine the true liability and amount of damages?

Following several parallel investigations into manipulation of the LIBOR (London interbank offered rate) and similar financial benchmarks, a number of the world's largest financial institutions have, between them, received fines totalling billions of euros—the European Commission alone has so far imposed fines amounting to €1.7bn (see the case study below). However, since findings of wrongdoing, whether under competition law or other legislation, tend to be followed by damages claims, banks and the other institutions involved may face further financial pain. The question is how much, and what are the issues involved in quantifying the level of damages?

LIBOR is designed to reflect the funding costs of major banks active in the London interbank market, and it has counterparts in other currencies, such as EURIBOR.[1] It is used to determine payments made under interest-rate contracts by a wide range of counterparties, including small businesses, large financial institutions and public authorities. For example, an institution might agree to pay interest at a variable rate equal to LIBOR plus 100 basis points.[2] Benchmark reference rates such as LIBOR also affect payments made under a wide range of other contracts, including some loans and mortgages.

Regulatory and competition investigations

LIBOR manipulation has recently been investigated by a number of financial regulators and competition authorities on both sides of the Atlantic.[3] These investigations drew on evidence from 'hot' documents, including records of instant-messaging conversations between traders at different banks, and concluded that traders in different banks had worked together (in some cases with the assistance of broker firms) to manipulate the LIBOR rate in order to benefit their own positions in financial derivatives markets.

The investigations and accompanying widespread publicity have generated debates and policy initiatives to improve the workings of interest-rate benchmarks.[4] This article looks at damages claims arising from findings of past LIBOR manipulation.

Case study: The European Commission's investigation

In 2011, the Commission began to investigate the manipulation of LIBOR and other financial benchmarks by banks, under European treaty rules that prohibit cartels and other anticompetitive agreements (Article 101 TFEU). It found evidence of anticompetitive behaviour by a number of banks and at least one financial broker, relating to the manipulationof LIBOR and the EURIBOR benchmark in the period 2005–10.[1]

At the end of 2013 the Commission fined eight financial institutions a total of €1.7bn as part of a settlement agreement. Three other institutions did not settle with the Commission, and the case against them is continuing. For those institutions that did settle, the level of the fine in each case was based on the Commission's guidelines.[2] These guidelines take into accounta wide range of factors, such as:

- the duration of the infringement;
- the value of sales to which the infringement relates;
- the seriousness of the infringement;
- the combined market shares of the firms involved;
- repeat offending;
- the level of cooperation with the Commission during the investigation;
- whether a particular firm played a leading role in the infringement.

The guidelines require an element of judgement on behalf of the Commission and are subject to discussion with the firms being investigated. In the context of follow-on damages claims, note that the guidance does not require the Commission to assess the level of harm that was caused to customers of firms involved in the infringement. Instead, the focus is on the total value of sales and the duration of the infringement. Therefore, a large antitrust fine does not necessarily equate to a large amount of customer harm, or vice versa.

Note: [1] European Commission (2013), 'Antitrust: Commission fines banks€ 1.71 billion for participating in cartels in the interest rate derivatives industry', press release, 4 December, IP/13/1208. [2] European Commission (2006), 'Guidelines on the method of setting fines imposed pursuant to Article 23(2)(a) of Regulation No 1/2003', September

Where there's an antitrust investigation, follow-on damages claims are never far behind

With $506tn of financial derivatives said to be priced with reference to the LIBOR rate,[5] damages claims against banks arising from infringements of market or competition rules with respect to LIBOR have, on the face of it, the potential to be extraordinarily large. However, getting a handle on the true scale of damages requires a detailed and complex assessment. What are the potential elements of that assessment, and the key issues that need to be established? To put this into context, the investigations in the USA and Europe fall into two distinct groups:

- financial regulators investigating potential manipulation of the LIBOR rate (breach of market conduct rules), where rates were allegedly falsified for two reasons: at an institutional level, to hide financial distress by understating the cost at which a bank could borrow in the interbank lending market; and at the level of individual traders, to make higher profits by seeking to manipulate the LIBOR rate on specific days when their positions would be fixed against that rate;
- competition authorities investigating potential collusion between banks to fix the LIBOR rate, where the alleged infringement is a breach of Article 101 TFEU or equivalent anti-cartel rules.

Damages claims have already been filed in the USA.[6] In Europe, a claim by Guardian Care Homes against Barclays Bank is being seen as a possible test case that could lead to further claims.[7]

Winners and losers

In the case of LIBOR, where the issue was the manipulation of an interest rate, some external parties are harmed but others benefit—this is clearly different from an ordinary case of fraud or cartel behaviour.[8] In simple terms, borrowers benefit from lower LIBOR rates, while savers suffer. Some potential claimants will face both harm and benefit, since they may be party to instruments (e.g. interest rate derivatives) either at different points in time or in different areas of a business, where they will have alternately benefited and suffered from the manipulated rates.

It is unlikely that traders at financial institutions that manipulated LIBOR would have tried to push LIBOR in only one direction; rather, they would be likely to have desired a higher or lower rate depending on their net long or short position on any given day.

On the other hand, the institutional motivation (disguising financial distress) would always be to keep LIBOR submissions low in order to suggest that the institution was not a high-risk borrower; the impact on LIBOR would not in itself have been of interest for this purpose, only the level of the institution's own submission. This manipulation occurred in a context where widespread efforts were being made to avoid a catastrophic collapse of the financial system. Calculating the 'net harm' to claimants in these circumstances will be complex.

A for effort, D for achievement?

While the investigation by the UK Financial Services Authority (FSA, now split into the Financial Conduct Authority and the Prudential Regulation Authority) into Barclays Bank found evidence of attempts to manipulate the LIBOR rate,[9] in its decision the FSA did not establish that the LIBOR rate was actually affected:[10]

> Barclays *could have* benefitted from this misconduct to the detriment of other market participants' [emphasis added]

The FSA decision of June 2012 imposed a £59.5m fine on Barclays for LIBOR-related breaches of market conduct rules.

By contrast, the US Department of Justice (DoJ) investigation into Barclays, the results of which were also published in June 2012, did establish that attempts to move LIBOR had been successful. It concluded that:[11]

> When Barclays swaps traders made requests of Barclays rate submitters in order to influence Barclays's benchmark interest rate submissions, and when the submitters accommodated those requests, the manipulation of the submissions affected the fixed rates on some occasions.

However, the DoJ's report does not provide evidence about the number of occasions on which the manipulation of Barclays' submissions affected the overall LIBOR fixing, nor how far the overall LIBOR level was raised or lowered as a result. Therefore, the extent to which efforts to manipulate were successful remains to be seen. In order to determine this, it would be necessary to carry out a detailed empirical analysis to construct the counterfactual, since whether a bank's individual LIBOR submission affected the reference rate on a given day depended on whether it was included in the final sample.

How LIBOR is calculated and how it was manipulated

The price-setting process involves collating the submissions data from each submitting bank and excluding the highest and lowest submission groups (known as 'trimming') before producing an average of the remaining rates. Where a bank's submissions are outlying observations from the average, they are excluded from the final sample (see Figure 1a). However, the exclusion of one bank's submission implies the inclusion of another bank's submission that would not have been included in the 'but-for' world—and therefore excluded submissions are not irrelevant to determining effect (see Figure 1b). Given the sampling process, unilateral attempts at manipulating LIBOR could be less successful than coordinated attempts involving more than one bank.

Figure 1a How LIBOR is calculated

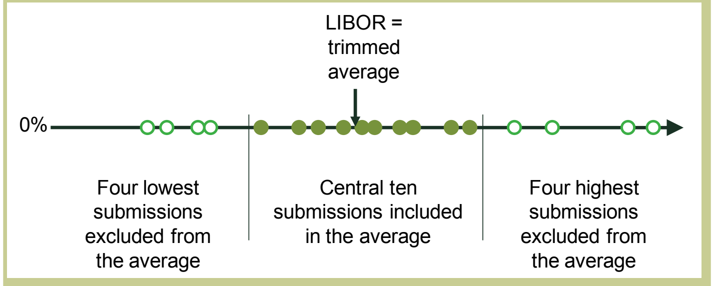
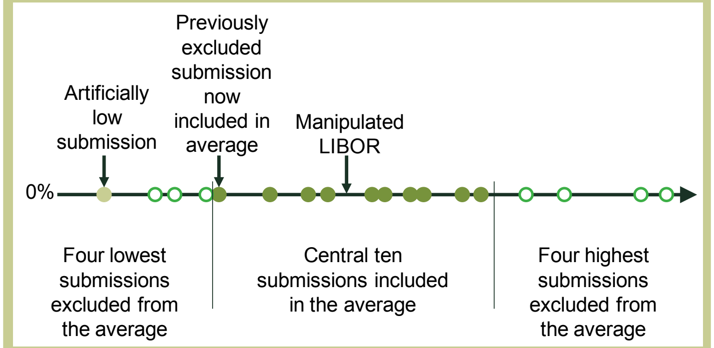


Figure 1b The impact on LIBOR of an artificially low submission[1]



Note:[1] Since 1 February 2014, responsibility for the administration of LIBOR has passed to Intercontinental Exchange Benchmark Administration. A number of measures have been introduced to prevent and detect manipulation. See https://www.theice.com/iba.jhtml.
Source: Oxera, based on information from the British Bankers Association, which administered LIBOR at the time of the manipulations.See http://www.bbalibor.com/explained/the-basics.

During the period affected by the manipulations, LIBORwas administered by the British Bankers Association. After concerns about manipulation, a review of the system was carried out by Martin Wheatley (now CEO of the FCA) and published in 2012. Following the recommendations of this review, administration of LIBOR passed to Intercontinental Exchange Benchmark Administration on 1 February 2014. A number of measures have been introduced to prevent and detect manipulation, such as a new governance framework,a new code of conduct, and a post-publication surveillance system designed to assess the credibility of LIBOR submissions and rates (see https://www.theice.com/iba.jhtml).

The results emerging from the economic literature are mixed, with some authors claiming to find evidence that the LIBOR price was moved, and others saying that attempted manipulation appears to have been ineffective.[12]

It is not surprising to see mixed results, given the difficulty of constructing the counterfactual LIBOR price (which can be attempted in various ways, but inevitably with a margin of error). In particular, as the calculation of LIBOR is not based on actual market transactions between banks, but rather a bank's estimate of what its borrowing cost *would be* at a certain size, the counterfactual of banks' LIBOR submissions and resulting LIBOR rates would require careful analysis. The issue of creating a realistic counterfactual is even more difficult when the period covered involves the height of the financial crisis, when banks virtually stopped lending to each other—leading to a lower number of actual transactions to observe for comparison purposes.

Magnitude of the manipulation

It would appear from the FSA decision that traders were typically looking for movement in the LIBOR in the order of one or two basis points (0.01–0.02%). Traders were also interested in the LIBOR rate only on certain dates—the settlement price for many of the relevant interest-rate futures contracts was linked to only four days each year (one per quarter).

The order of magnitude will affect the pattern of any damages claims, since many potential claims could be relatively uneconomic to litigate for the sake of a movement of 1 basis point.

Potentially, the manipulation of LIBOR in the interests of hiding financial distress could be at a more significant magnitude, but this appears to have occurred only at a time of illiquidity, when it would be more difficult to predict the counterfactual rate. In the context of follow-on claims relating to the competition decision, there could be a further question of whether and how direct claimants may have mitigated losses by passing on any LIBOR 'overcharge' to their own customers. Finally, the current discussion around 'umbrella' claims may be relevant in relation to LIBOR damages. An umbrella claim is one in which the claimant did not deal directly with the cartelists, but is nevertheless suing for damages because the prices it paid were inflated by the actions of the cartel. Further claims may therefore arise where LIBOR was used as a benchmark in a financial transaction between two third parties not involved in the manipulation.

Conclusion

Claims for damages as a result of LIBOR manipulation may end up being large and numerous, but they are likely to be unusual in terms of the complexity of determining a reliable damages quantum. There will be an abundance of data on financial transactions, assuming that claimants are able to force banks to disclose it, and hence sophisticated economic analysis may turn out to be useful in modelling the counterfactual scenario that can then be compared with the factual (infringement) scenario.

As such, the counterfactual and quantum are likely to become the focus of the debate in coming years. Drawing a parallel with cartel damages cases, thus far LIBOR has been mostly a matter of investigating an object (per se) infringement of the rules, without determination of the actual effect of the behaviour. The next stage of damages actions, which necessarily involves an effects-based analysis of harm, will be complex, but will also generate further insightful economic analysis into LIBOR manipulation.

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[1] In this article, 'LIBOR' can generally be read as a reference to any of the affected reference interest rates.

[2] A basis point is one-hundredth of 1%.

[3] Oxera advised a global financial institution during the European Commission's investigation.

[4] For example, a number of recommendations were made in Wheatley, M. (2012), 'The Wheatley Review of Libor', September, including switching the administration of LIBOR from the British Bankers Association to another body.

[5] *Financial Times* (2012), 'Understanding Libor'.

[6] See, for example, Hausfeld (2012), In re: LIBOR-Based Financial Instruments Antitrust Litigation MDL 2262, U.S.D.C., Southern District of New York, May.

[7] Guardian Care Homes is suing Barclays for up to £37m over the alleged mis-selling of interest rate swaps, and also the claim that Barclays acted in breach of Article 101 TFEU as a result of its involvement in EURIBOR manipulation. See *Graiseley Properties Ltd & Ors v Barclays Bank Plc & Ors*, Court of Appeal Judgment [2013] EWCA Civ 1372.

[8] Indeed, one could ask whether LIBOR manipulation should be treated as a form of cartel, since LIBOR itself is a financial benchmark and not in a market as such. There is no competition over the setting of LIBOR itself, and therefore any manipulation of LIBOR cannot logically be said to be a restriction of competition. The LIBOR rate affects settlement prices in interest-rate derivatives markets where those involved in the manipulation were also active, although any manipulations could be upwards or downwards.

[9] Financial Services Authority (2012), 'Final Notice', 27 June.

[10] Financial Services Authority (2012), 'Final Notice', 27 June, para. 11.

[11] US Department of Justice (2012), 'Statement of facts' [agreed between the United States Department of Justice, Criminal Division, Fraud Section, and Barclays Bank PLC], para. 30.

[12] See, for example, Gyntelberg, J. and Wooldridge, P. (2008), 'Interbank fixings during the recent turmoil', *BIS Quarterly Review*, March, pp. 59–72; and Abrantes-Metz, R.M., Kraten, M. and Metz, A.D. (2008), 'LIBOR Manipulation?', mimeo, August.