Vol. 6, Issue 24
July 13, 2012

Something to Think About

OAKWORTH CAPITAL BANK

COMMON CENTS

One of the biggest stories in the financial world is the perceived scandal surrounding Barclay's PLC and its supposed manipulation of LIBOR rates. As you may know, LIBOR stands for 'London Inter-bank Offered Rate,' and is essentially where British banks estimate they can borrow money for various time periods leading out to one year.

To make things a little simpler to understand, let me just give you the paragraph from Wikipedia which describes the calculation process:

> "Libor is calculated and published by Thomson Reuters on behalf of the British Bankers' Association (BBA) after 11:00 AM (and generally around 11:45 AM) each day (London time). It is a trimmed average of interbank deposit rates offered by designated contributor banks, for maturities ranging from overnight to one year. Libor is calculated for 10 currencies. There are eight, twelve, sixteen or twenty contributor banks on each currency panel, and the reported interest is the mean of the 50% middle values (the interquartile mean). The rates are a benchmark rather than a tradable rate; the actual rate at which banks will lend to one another continues to vary throughout the day."

As you can tell, LIBOR is: 1) a private sector endeavor, as the BBA is a trade association and not a government entity, and; 2) it is an estimate, and not a hard quote, and; 3) the highest 25% rates and the lowest 25% are presumably not in the calculation process, and; 4) it is meant to be a benchmark, as opposed to an actual tradable rate, and; 5) there are different rates for different currencies since borrowing rates will vary from country, and: 6) importantly, is not a perfect science.

At issue is Barclay's admission it reported false, or not completely accurate, rates to Thomson Reuters, which suggested the bank could borrow at a lower rate than they presumably could have in the open market. Put another way: Barclay's lied about the rates where it could borrow in order to influence LIBOR rates, and protect its exposed positions, or, at the least, attempt to mitigate its downside exposure.

You see, LIBOR rates are the de facto benchmark for many, if not most, variable rate loans around the world. Look at the bank of a credit card application; you are likely to find the rate the credit card company will charge you is set off some LIBOR number. Commercial and Industrial loans are almost always quoted off a LIBOR number or the Prime Rate, increasingly off LIBOR. The same can be said for any number of mortgages, derivative securities, and hedges.

So, if Barclay's was understating its borrowing costs, LIBOR could potentially have been lower than it should have been for years. I say potentially because Barclay's is only one of the firms reporting their borrowing costs, meaning other firms would have to be in cahoots with it to effectively alter it every day.

For instance, if Barclay's reports the lowest borrowing rates, Thomson Reuters will throw them out of the equation. If it reports the highest, well, those get excluded from the calculations as well. That is in a perfect world, because, since Barclay's is such a dominant player in the British banking system, there is the assumption of collusion by everyone else, either wittingly or unwittingly. "If Barclay's can borrow THERE, we might be able to borrow HERE."

Inside this issue:

It is the public scandal that offends; to sin in secret is no sin at all.

Moliere

Something to Think About, *cont.*

Imagine if JP Morgan said it could borrow money at 1%. Do you think any banks throughout the rest of the country would use this as a yardstick to estimate their own borrowing costs? Of course. As such, due to its 800 lb. gorilla position in the British banking system, Barclay's had the presumed capability to manipulate LIBOR rates by intentionally misrepresenting their true borrowing costs.

This, then, affects interest rates around the world, which, obviously, impacts the global financial system. All of this to save a buck or pound or two. Clearly, this is fraudulent, and plaintiffs attorneys have already started the avalanche of lawsuits against the company. After all, people and investors effectively lost money because Barclay's reported inaccurate numbers to Thomson Reuters; they should have been receiving a higher interest rate then they were. Whew. The money lost, huh?

Well, in lenders and investors weren't getting the rate they should have been getting, I guess borrowers weren't paying the rate should have. As an officer of this bank, that stinks, but, as a consumer, I think it's great. In other words, by trying to save its own skin, Barclay's cheated lenders around the world, and helped borrowers. Isn't that what the court of public opinion wants anyhow? Why is everyone so upset? Also, aren't lower interest rates supposed to be good for economic growth? So, we are ticked off at Barclay's for artificially manipulating interest rates to the downside largely during a financial crisis when central banks around the world were slashing borrowing costs anyhow? Hmm. The people that should really be up in arms are those who were predicting higher interest rates, and bet that way, as the world scrambled, and continues to scramble, for liquidity.

Interestingly, while it appears Barclay's might have been misrepresenting data for some a while, the biggest issue with Barclay's fraudulent activity appears to be in 2008, at the height of the financial crisis. Let me give you this one from the BBC; I personally like it:

> "There was a great deal of concern, both within Barclays and the government, as to why Barclays' Libor submissions were higher than other banks at the height of the financial crisis at the end of 2008.
>
> This led some to suspect that - after the part-nationalisations of RBS, Lloyds and HBOS - Barclays would be next, deputy Bank of England governor Paul Tucker told MPs on the Treasury Committee earlier this month.
>
> It was during this period that a senior Barclays executive instructed traders to keep Libor rates low, although regulators suggested that the manipulation attempts had been going on since 2005.
>
> This latest release of emails between the two central bankers underlines that concerns about the reliability and credibility of Libor figures were being discussed at a high level, years before the Libor scandal came to light."

So, in order to not only save its own skin BUT also to stave off speculation London would nationalize the company, Barclay's senior management told its traders to understate its true borrowing costs. Shoot; the British government was worried Barclay's cost of capital was higher than everyone else's. Now, they are upset Barclay's misrepresented its true borrowing costs to be more in line with everyone else? Maybe Parliament was just going to be upset with Barclay's no matter what; you think?

More than that, since Barclay's is the fourth largest bank in the WORLD, how do you think the global financial system would have reacted at that time to an effective bankruptcy? How would have the British taxpayer? You know the answer to these questions; not well. However, that really isn't even the crux of the matter.

Who effectively sets borrowing costs for US dollars? Is it a handful of British banks? Is it the Japanese? The Chinese? Mitt Romney? Who does it? Why, the Federal Reserve does, right? It sets the overnight lending target between US member banks, and the discount rate at the Fed.

If a Fed member bank is having difficulty borrowing overnight money at the Fed Funds target, it can always go to the Fed window and get some scratch. And if US banks are supposed to charge each other only X, what is the likelihood borrowing costs for US dollars is going to be X + 5% in the United Kingdom. I will answer that for you: zero. If a British bank like Barclay's needs to borrow dollars, it can go to other British banks or it can even go to a US bank. In the former, it borrows money from, say, HSBC, and HSBC gets its dollars from its US subsidiary who can get them for whatever the Fed Funds target it.

As a result, as you can imagine, short-term LIBOR rates for US dollars typically don't stray too, too far from where the Fed wants member banks to lend to one another. Remember, we aren't talking about Nepalese or Burmese banks. We are talking about the British banking system, which is pretty much on par with ours, if not even more liquid historically.

I would argue the Fed sets short-term US dollar borrowing costs either directly or indirectly, and the global financial markets sets its US dollar costs off the Fed funds target whether it likes it or not. With that in mind, I guess it would be beneficially to see the correlation between LIBOR and the Fed Funds target rate, and maybe even the spreads.

Thanks to the Bloomberg's functionality, this is relatively easy to do. So, I went back to the day 3-Month LIBOR came into existence, and ran the numbers. It seems the historical spread between this measure of LIBOR, arguably one of the most widely used if the most widely used, and the Fed Funds target is, get this, 0.9935...almost perfect correlation, and so close you could say it is. The spread? It is a miserly 0.28%.

Since the Federal Reserve sets the Fed Funds target rate, this means you could sensibly argue the Fed sets the borrowing costs for US dollars, which makes sense, and indirectly sets the spread between domestic and global US dollar borrowing rates. As such, it is the Fed which sets LIBOR, and not Barclay's. Didn't we sort of already know that?

But...but...during the financial crisis in 2008 and even beyond, Barclay's understated their true borrowing costs which had a depressing effect on LIBOR. Well, true, and I suppose that hurt some lenders. However, you have to go back to that time. 3-Month LIBOR peaked in the second half of 2008 at 4.81875% on 10/10. At that time, the Fed Funds target was 1.50%. Obviously, this is a spread in excess of 3%, which is significantly higher than the 0.28% of the last 28 years. So, British banks, and presumably Barclay's, were indeed reported their US dollar borrowing costs were significantly higher than the domestic costs, in both relative and absolute terms.

Could have Barclay's, or any other British bank, really have borrowed money at close to 5% during the worst of it? Who knows? No one was lending anything to anyone. So, yes, LIBOR could have, and should have, probably been higher, but to what? 6%? 7% 8%. If we arbitrarily decide it should have been 7%, what would that have meant? Probably very little, as everyone who had adjustable rate debt, and could have refinanced, would have done so at more advantageous rates than 3-Month LIBOR plus, well, really anything. As US banks could borrow all day at 0.25%, they could make a nice spread at a floor rate of 5%, or so, and that is exactly what they did...when they made loans, which wasn't often back in those days.

Besides, if you argue Barclay's was at fault for misreporting their borrowing costs, your opponent will argue trying to come up with true borrowing costs during a credit freeze is a sticky wicket AND that the Fed sets US dollar borrowing costs anyhow. Finally, who really got the rook?

Was it the common man or borrower? No, as their borrowing costs were arguably lower than they should have been. Was it lenders during the credit freeze? Probably not so much, as banks weren't making terribly many loans back in those days, and quality credits wouldn't have had demanded a rate set off Prime anyhow. Besides, lenders were stuck with whatever rate they had until the next reset date anyhow, so a short-term spike in LIBOR wouldn't have dramatically impacted the entire loan portfolio in any event...or any security floating off of LIBOR either. Why? Because in a declining interest rate environment investors want LONG reset periods, as opposed to short ones. This means demand would have been weak for any security coming out with a daily or weekly or even monthly coupon reset. As such, investors really wouldn't have been able to lock in any of the spike in interest rates EVEN if borrowers were willing or able to pay them in the first place.

So, I suppose the people hurt most by this were those on the wrong side of an interest rate swap, and the domino effect from there, but, remember, LIBOR DID go up relative to the Fed Funds target...to its highest spread EVER on 10/10/2008. As such, those folks on the other side of the swap should have done okay, just maybe not as okay as they would have IF British banks had accurately reported their true borrowing costs which they, themselves, probably didn't even really know.

Here is my bottom line(s) to this scandal: 1) the Fed manipulates LIBOR more than any one British bank, and; 2) borrowers benefit from an understated LIBOR, and; 3) lenders weren't, or haven't been, as detrimentally impacted as plaintiff attorneys would lead you to believe, and; 4) instead of potentially having to bail out the world's 4th largest bank, the

Something to Think About, *cont.*

British government has been able to actually impose a fine on it, and; 5) even if a lender were able to quantitatively prove its damages to the penny, could Barclay's produce the borrower's savings as a defense, and; 6) finally, what good would it really, really do to go after Barclay's during such a weak economic environment?

I suppose you could say I am more ambivalent than I should be on all of this. Was Barclay's fraudulent? Sure, but it isn't the real player when it comes to setting US dollar borrowing/lending rates. Were some people 'cheated' out of some potential money? Yeah, but the other side of the equation came out ahead; besides, those who were cheated probably really weren't as enriched as they believe. Finally, is ANY benchmark perfect? No, and no one every said LIBOR was. As such, this scandal is kind of a smokescreen, in so many ways, as it presents a field day for outraged politicians who should probably be focusing on more pressing matters.

While I am sure there are plenty of people who will disagree with me on this, I would say this scandal, if you want to call it that, is bigger in perception than it is in reality.

Important Economic Releases

Release	Survey	Actual	Prior	Comments
Consumer Credit (May)	$8.500B	$17.117B	$9.950B	Let me sum up this week's short list of economic releases, virtually all of them secondary: next.
NFIB Small Business Optimism	93.3	91.4	94.4	
Trade Balance (May)	-$48.6B	-$48.7B	-$50.6B	
Initial Jobless Claims	372K	350K	376K	
Producer Price Index (June)	-0.4%	0.1%	-1.0%	
U of Michigan Confidence (July P)	73.5	72.0	73.2	

Tables & Data Points

STOCKS	Dow Industrials	S&P 500	NASDAQ	Russell 2000	Nikkei 225 (¥)	DJ STOXX 50 (€) Price
12/31/10	11,577.51	1,257.64	2,652.87	783.65	10,228.92	2,792.82
12/31/11	12,217.56	1,257.60	2,605.15	740.92	8,455.35	2,216.55
6/21/12	12,573.57	1,325.51	2,859.09	764.83	8,824.07	2,199.42
6/28/12	12,602.26	1,329.04	2,849.49	775.89	8,874.11	2,157.62
7/4/12	12,943.82	1,374.02	2,976.08	818.49	9,104.17	2,312.41
7/12/12	12,573.27	1,334.76	2,866.19	789.62	8,720.01	2,228.01

BONDS	3-Mo UST	6-Mo UST	2-Yr. UST	5-Yr. UST	10-Yr. UST	30-Year UST
12/31/10	0.13	0.19	0.60	2.01	3.30	4.34
12/31/11	0.01	0.06	0.24	0.83	1.88	2.90
6/21/12	0.08	0.15	0.30	0.72	1.62	2.69
6/28/12	0.08	0.16	0.30	0.69	1.58	2.68
7/4/12	0.08	0.15	0.30	0.70	1.63	2.74
7/12/12	0.10	0.15	0.26	0.62	1.48	2.56

OTHER	Prime	Fed Funds	3-Month LIBOR	Gold/troy oz.	Oil—WIT/brl.	$/Euro	JPY/$	$/GBP	CAD/$
12/31/10	3.25	0.25	0.30	1,421.40	91.38	1.337	81.19	1.559	0.994
12/31/11	3.25	0.25	0.58	1,566.80	98.83	1.296	76.99	1.551	1.017
6/21/12	3.25	0.25	0.47	1,564.50	78.20	1.254	80.28	1.559	1.030
6/28/12	3.25	0.25	0.46	1,550.40	77.69	1.244	79.45	1.552	1.033
7/4/12	3.25	0.25	0.46	1,621.80	87.66	1.253	79.88	1.559	1.013
7/12/12	3.25	0.25	0.46	1,565.30	86.08	1.220	79.31	1.543	1.019

Disclosure