Submission to
Financial Committee of the Bundestag
for the hearing on 28 November 2012 concerning
LIBOR Manipulation

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It has recently become public knowledge that the London Interbank Offered Rate (Libor) has been misreported by banks. Such misreporting is generally thought to have begun in about 2005. In fact, such misreporting has been common since at least 1991. Moreover, corruption in the interest-rate markets has been aided and abetted by official institutions.

Introduction

In 1991, I began trading for an investment bank, Morgan Stanley, in London. I was trading bonds, derivatives, and related securities. One of those securities was based on the 3-month Libor rate, i.e. the interest rate at which banks can borrow money for 3 months, on the interbank market. Morgan Stanley does not trade on the interbank market; so I could not directly borrow or loan money at Libor rates. What I could do, however, was trade a "futures contract" on the 3-month Libor rate.

As an example of how a futures contract works, consider the following. Suppose that we are concerned about 3-month Libor rates increasing in the future; in particular, we are concerned about what the 3-month rate will be in September. If that 3-month rate is currently, say, 1%, we can contract today to effectively lock in that rate. If, come September, the actual 3-month rate is 2%, then our contract will ensure that we can still borrow at 1%. Such a contract is a *futures contract*.

Trading the futures contract

Futures contracts on 3-month Libor were, and are, heavily traded on the London International Financial Futures Exchange (Liffe, now part of NYSE Euronext). There was a standard contract for the month of September. That contract had its rate settled on the third Wednesday of the month, at 11 AM.

In 1991, I had live trading screens that showed the Libor rates. In September of that year, on the third Wednesday, at 11 AM, I watched those screens, to see where the futures contract would settle. Shortly afterwards, Liffe announced the settlement rate. The announced rate was different from what had been shown on my screens, by a few hundredths of a percent.

As a result, I lost money. The amount was insignificant for me, but I believed that I had been defrauded, and I complained to Liffe. Liffe explained that the settlement rate was not determined by what rates actually were in the market. Instead, the British Bankers' Association polled selected banks, asking them what the rates were. The highest and lowest reported rates were discarded, and the rest were averaged, giving the settlement rate. Liffe explained that, in doing this, they were adhering to the terms of the contract.

I talked with some of my more experienced colleagues about this. My colleagues told me that the banks misreported the Libor rates in a way that would generally bring them profits. I had been unaware of that, as I was relatively new to financial trading. My naivety seemed to be humorous to my colleagues.

Simply put, then, misreporting of Libor rates has been common practice since at least 1991. Although the difference between the reported rate and the actual rate might seem small, the total amount of money involved is material, given that Libor rates affect contracts worth hundreds of trillions. Also important is what such misreporting says about the culture.

During 1991, at the London office of Morgan Stanley, the head of interest-rate trading was a person who is now at the center of the current scandal: Bob Diamond. I do not recall discussing Libor misreporting with Diamond, but since the misreporting was common knowledge among traders, Diamond was presumably aware. (That, however, is not a criticism of Diamond: what could he have done about this?)

Current investigations

Note that there have been two distinct motivations for banks to misreport Libor rates. One motivation is discussed above: to directly increase profits. The other motivation arose during the 2008 financial crisis: to mask liquidity problems.

Libor misreporting has been going on for decades. Why have investigations only recently begun? It seems highly implausible that all the investigating agencies could have been unaware for decades. Indeed, those agencies have a reputation among traders of being like Potemkin villages. I suspect what has happened is that, after the financial crises of 2008, the agencies decided they ought to perform more of their stated duties. That would also explain why the investigations are ignoring any misreporting in years prior to 2005: to cover up the illusoriness of their earlier work.

One of the investigations is being undertaken by the House of Commons Treasury Committee. I telephoned the Committee on July 3rd, and spoke with a Committee Specialist. I told the Specialist about the foregoing, and said that I was willing to testify under oath.

The Specialist seemed extremely interested. The Specialist said that they were about to have a meeting about the Libor scandal, and they would call me back afterwards. I did not hear back, however; so I telephoned to ask what was happening. My testimony was not wanted, the Specialist told me, because it "contradicts the narrative" that the Committee had adopted.

Banking environment

Libor rates are very strongly influenced by the rate at which the Bank of England (BoE) lends money to other financial institutions. The rate at which the BoE lends is known as the "base rate".

One day, shortly after I began trading, a colleague told me that base rates were about to be lowered. I asked my colleague how he knew that—forthcoming changes in base rates are supposed to be secret. My colleague replied that several British banks were suddenly very active in the interest-rate market: all those banks were essentially betting that rates would be lowered. Those banks would only be doing that if they had information about an imminent rate change. My colleague added that he had seen such things happen before.

The banks could only have gotten information about a rate change from the BoE or possibly the UK Treasury (which then had responsibility for setting rates). In other words, my

colleague was telling me that the BoE/Treasury was colluding with British banks, so that the British banks could profit.

I said that I did not believe that the BoE/Treasury was so corrupt. My colleague and I then made a small wager, about who was right. Roughly an hour later, the BoE lowered the base rate. I thereby lost the wager. My colleague initially declined to accept my paying him, as he had been taking advantage of my innocence. I pressed him though, and he then accepted, saying "It's a good lesson for you".

Current investigations have found that bankers were colluding with each other in misreporting Libor rates. Such collusion is not surprising, though, given that the BoE/Treasury was colluding with some banks on base rates. In other words, the Libor misreporting occurred in an environment that abetted such actions.

The banking environment has been largely created by official institutions, e.g. the BoE, the Treasury, and to a lesser extent, the Treasury Committee. It is those institutions that should bear primary responsibility for the lack of integrity.

Official responses

The first 800 words of this essay were edited and published as an op-ed piece in the *Financial Times*, on 27 July 2012. That same day, I received an e-mail from the Clerk of the Treasury Committee, claiming that the Committee's "staff do not recall the particular point you mention in the [op-ed piece] about us not taking evidence from you because it 'contradicts the narrative'". The staff member with whom I had spoken (on July 3rd) had given me their full name, direct e-mail address, and mobile phone number. So I telephoned the staff member. The staff member acknowledged that the two of us had spoken, but denied using the phrase "contradicts the narrative". I explained that I had written the phrase down immediately after we had spoken; moreover, the phrase is unusual for me—it is not something that I would say.

I then telephoned the Clerk. I told the Clerk the name of the staff member, noted that there were records to prove that I had made the call on July 3rd, and said that I was willing to sign a sworn affidavit about being told the phrase. The issue of the phrase, though, seems to be a distraction. The phrase does indeed add spice to the story. The meat of the story, though, is that Libor has been misreported for decades and the Treasury Committee—which was supposed to be investigating the scandal—refused to consider my evidence for this. The Committee's refusal is indisputable.

On 10 September 2012, I received a letter from the Chairman of the Treasury Committee, Andrew Tyrie. A copy of the letter is attached. The letter claims, in particular, that the Committee staff "had no preconceived idea of what would emerge from [the Committee's] inquiry, and nor was such an impression conveyed to you".