Did You Know that Libor Was Going Away?

And with 20/20 hindsight, how did no one see Libor as a problem?

The manipulation of Libor, a financial benchmark used to set interest rates worldwide for the past 50 years, was a big story. And the fact that it is being phased out is a bigger story – but no one is really talking about it.

Libor is arguably one number that has driven the investment world more than any other – as it is (was) the basis for mortgages, student loans, credit cards, corporate loans and derivative contracts totaling more than $550 trillion around the globe.

According to a New York Times article, of all adjustable-rate mortgages in the U.S., "45% of prime mortgages and 80% of subprime mortgages have interest rates based on Libor." The same Times article says nearly half of variable-rate student loans are linked to it.

So, what happened? And more importantly…

How Did No One See This Coming?

Libor stands for the London Interbank Offered Rate. The British Bankers' Association calculates it daily by taking bids from large banks for how much they would charge to lend to other banks for various periods, ranging from a single day to one year.

But therein lies the problem that no one took issue with – Libor is a number produced daily in response to a *theoretical* question posed to banks: "What interest rate would you have to pay to borrow money from other banks?"

Not "what *did* you pay to borrow?" The question is "what do you *think* you would have to pay to borrow."

See how easy it would be to manipulate?

The Libor Scandal

Back in 2005, Barclays, a large British bank, was accused of submitting false reports to the BBA and allegedly worked with other banks to alter their rates too.

Remember, the BBA was asking the "what do you *think* you would have to pay" question, so traders – employed by the banks – realized that they could manipulate the number. And since these very same bank traders were making high-dollar bets using derivatives whose values were based in part on Libor, they stacked the deck in their favor because they could influence the benchmark they were betting on.

Barclays paid U.S. and British regulators over $450 million to settle a case involving rigging the Libor rate. The company's chief executive officer, who had spent almost 15 years with Barclays, resigned. And traders went to jail.

Libor to be Phased Out

But after all the headlines, headaches, fines, resignations, and prison time, British regulators continue to press the banks to respond to the Libor survey. The regulators fear that eliminating the rate abruptly would cripple the financial system – because there is close to $190 trillion in Libor-linked derivatives and those derivative contracts don't have an alternative benchmark to Libor. That means that those contracts need to be renegotiated.

So, the regulators told the industry that it had until 2021 to prepare for a world without Libor. Which means that the race to replace Libor is on – hopefully with a new benchmark that can't be so easily manipulated.