Rate Scandal Stirs Scramble for Damages

By NATHANIEL POPPER

As unemployment climbed and tax revenue fell, the city of Baltimore laid off employees and cut services in the midst of the financial crisis. Its leaders now say the city’s troubles were aggravated by bankers’ manipulation of a key interest rate linked to hundreds of millions of dollars the city had borrowed.

Baltimore has been leading a battle in Manhattan federal court against the banks that determine the interest rate, the London interbank offered rate, or Libor, which serves as a benchmark for global borrowing and stands at the center of the latest banking scandal. Now cities, states and municipal agencies nationwide, including Massachusetts, Nassau County on Long Island, and California's public pension system, are looking at whether they suffered similar losses and are weighing legal action.

Dozens of lawsuits filed by municipalities, pension funds and hedge funds have been consolidated into a few related cases against more than a dozen banks that are involved in setting Libor each day, including Bank of America, JPMorgan Chase, Deutsche Bank and Barclays. Last month, Barclays admitted to regulators that it tried to manipulate Libor before and during the financial crisis in 2008, and paid $450 million to settle the charges. It said other banks were doing the same, but none of them have been accused of wrongdoing.

Libor, a measure of how much banks must pay to borrow money from one another in the short term, is set through a daily poll of the banks.

The rate influences what consumers, businesses and investors pay on a wide range of financial contracts, as varied as mortgages and interest rate swaps. Barclays has said it and other banks understated the rate during the financial crisis to make themselves look healthier to the public, rather than to make more money from clients.

As regulators and lawmakers in Washington and Europe assess the depth of the Libor abuse and the failure to address it, economists and analysts are already predicting it could be one of the most expensive scandals to hit Wall Street since the financial crisis.

Governments and other investors may face many hurdles in proving damages. But Darrell Duffie, a professor of finance at Stanford, said he expected that their lawsuits alone could lead to
the banks' paying out tens of billions of dollars, echoing numbers from a recent report by analysts at Nomura Equity Research.

American municipalities have been among the first to claim losses from the supposed rate-rigging, because many of them borrow money through investment vehicles that directly derive their value from Libor. Peter Shapiro, who advises Baltimore and other cities on their use of these investments, said that "about 75 percent of major cities have contracts linked to this."

If the banks submitted artificially low Libor rates during the financial crisis in 2008, as Barclays has admitted, it would have led cities and states to receive smaller payments from financial contracts they had entered with their banks, Mr. Shapiro said.

"Unambiguously, state and local government agencies lost money because of the manipulation of Libor," said Mr. Shapiro, who is managing director of the Swap Financial Group and is not involved in any of the lawsuits. "The number is likely to be very, very big."

The banks have declined to comment on the lawsuits, but their lawyers have asked for the cases to be dismissed in court filings, pointing to the many unusual factors that influenced Libor during the crisis.

The efforts to calculate potential losses are complicated by the fact that Libor is used to determine the cost of thousands of financial products around the globe each day. If Libor was artificially pushed down on a particular day, it would help people involved in some types of contracts and hurt people involved in others.

Securities lawyers say the lawsuits will not be easy to win because the investors will first have to prove that the banks successfully pushed down Libor for an extended period during the crisis, and then will have to demonstrate that it was down on the day when the bank calculated particular payments. In addition, investors may have to prove that the specific bank from which they were receiving their payment was involved in the manipulation. Before it even reaches the point of proving such subtleties, however, the banks could be compelled to settle the cases.

One of the major complaints was filed by several traders and hedge funds that entered into futures contracts that are traded through the Chicago Mercantile Exchange and that pay out based on Libor. These contracts were a popular way to protect against spikes in interest rates, but they would not have paid off as expected if Libor had been artificially lowered.

A 2010 study cited in the suit - conducted by professors at the University of California, Los Angeles and the University of Minnesota - indicated that Libor was significantly lower than it should have been throughout 2008 and was particularly skewed around the bankruptcy of Lehman Brothers.

A separate complaint filed in 2010 by the investment firm Charles Schwab asserts that some of
its mutual funds, including popular ones like the Schwab Total Bond Market Fund, lost money on similar investments.

The complaints being voiced by municipalities are mostly related to their use of a popular financial contract known as an interest rate swap. States and cities generally enter into these swaps with specific banks so that they can borrow money in the bond market. They pay bondholders based on a floating interest rate - like an adjustable-rate mortgage - but end up paying their bankers a fixed rate through a swap. If Libor is artificially lowered, the municipality is stuck paying the same fixed rate, but it receives a smaller variable payment from its bank.

Even before the current controversy, some municipal activists have said that banks took advantage of the financial inexperience of municipal officials to sell them billions of dollars of interest rate swaps. Experts in municipal finance say that because of the particular way that cities and states borrow money, they are especially liable to lose out on their swaps if Libor drops.

Mr. Shapiro, who helps cities, states and companies negotiate these contracts, said that if a city had interest rate swaps on bonds worth $1 billion and Libor was artificially pushed down by 0.30 percent, which is what the lawsuits contend, that city would have lost $3 million a year. The lawsuit claims the manipulation occurred over three years. Barclays' settlement with regulators did not specify how much the banks' actions may have moved Libor.

In Nassau County, the comptroller, George Maragos, said in a statement that according to his own calculations, Libor manipulation may have cost the county $13 million on swaps related to $600 million of outstanding bonds.

A Massachusetts state official who spoke on the condition of anonymity because of potential future legal actions, said the state was calculating its potential losses.

"We are deeply concerned and we are carefully analyzing all of our options," the official said.

Anne Simpson, a portfolio manager at the California Public Employees' Retirement System - the nation's largest pension fund - said that the fund's officials "are sifting through the impact, but there certainly is an impact."

In Baltimore, the city had Libor-based interest rate swaps on about $550 million of bonds, according to the city's financial report from 2008, the central year discussed in the lawsuit. The city's lawyers have declined to specify what they think Baltimore's losses were.

The city solicitor, George Nilson, said that the rate manipulation claims meant that the city lost out on money when it needed it the most.

"The injury we suffered during the time we suffered it hurt more because we were challenged budgetarily," Mr. Nilson said. "Every dollar we lost due to illegal conduct was a dollar we
couldn't pay to keep open recreation centers or to pay police officers."