How Will the LIBOR Scandal Affect Bank Shares?

By Gene Kirsch *Thu, Aug 16, 2012*

A Weiss Ratings bank analyst estimates the damage that the LIBOR scandal could do to the share values of the banks that are implicated.

Note: *This article first appeared at Weiss Ratings, and the original, including charts that the story below references, can be found there.*

The LIBOR rate-rigging scandal threatens to engulf some of the major banks in the world including JPMorgan Chase and Citigroup in the U.S. and, of course Barclays, plc in the United Kingdom.

LIBOR is an acronym for London Interbank Offered Rate. It's a benchmark interest rate that affects how consumers and companies borrow money across the world. The LIBOR rate is set each week by the British Bankers' Association (BBA) an industry group in London. Each weekday, leading banks around the world submit a rate estimate for borrowing funds from other banks. The BBA throws out the highest and lowest 25% of submissions and averages the remaining rates. This establishes the LIBOR which is then calculated for 10 different currencies and 15 borrowing periods or terms such as for one-month, three-months or one-year rates.

LIBOR is the benchmark used to set interest rates for an estimated $350 trillion financial instruments globally, including derivative swap transactions, futures contracts, home mortgages and even some credit cards. Lenders use the LIBOR as a base and add additional interest to cover anticipated borrower credit risk. They may also add additional interest to reach the bank's own profit targets. Many variable mortgage and credit card interest rate adjustments are triggered and set based on changes in the LIBOR rate. When the LIBOR goes up, rates and payments on loans tied to it, rise too.

A majority of variable-rate commercial loans are tied to the LIBOR. In fact, about 45% of prime mortgages and 80% of subprime adjustable rate mortgages in the United States have interest rates based on the LIBOR. And, about half the variable-rate private student loans are tied to the LIBOR.

While it is not clear exactly what caused regulators to investigate Barclays Bank, plc now, there have been suspicions for some time that banks were submitting false rates to increase their own profits. In fact, regulators may have known as far back as 2008, but it has taken this long for them to close in on what was going on.

What Barclays did was have its trading unit convince employees responsible for submitting LIBOR rates to alter the bank's rates based on their derivative trading positions. Traders even coordinated with other banks to lower rates as well. During the height of the financial crises, Barclays submitted artificially low rates to give the impression that the bank could borrow money more cheaply and was healthier than it was. The three-month Libor was set at or above 5.25% during the crises, but might have been higher in reality. The current three-month LIBOR is at 0.47%, as of July 18, 2012.

Barclays was investigated, and in June the bank was found guilty and fined over $450 million for manipulating the LIBOR as far back as 2005. The Barclays settlement does not include potential civil litigation by investors and others that may occur as the result of the fraud.

While there has been no official mention of the banks suspected to be involved in the scandal or being investigated for possible wrong doing, it is clear Barclays did not act alone. So, other banks are likely to face regulatory scrutiny for similar price collusion and rate manipulation. Looking at the table above, you can see the banks that might have more exposure based on the number of currency panels they sit on. For example, Barclays, Deutsche Bank, HSBC and Lloyds Banking Group sit on all 10 currency panels and may have a higher risk of investigation and also a higher probability or incentive to manipulate the LIBOR rate.

For those banks that may have the most exposure, let's look at the potential hit to earnings based on regulatory fines and potential civil litigation. The earnings-per-share (EPS) hit could translate to a drop in stock price if the institution is implicated in the scandal.

For banks with fewer shares outstanding, the impact of fines and civil litigation on earnings per share (EPS) might be more severe. For example, Barclays, with more than 12.2 billion shares outstanding, would take an $0.11 per share hit on earnings (U.S. dollars) compared to the $2.42 per share hit on earnings for Deutsche Bank with only 929.5 million shares outstanding.

Barclays incurred price depreciation in the vicinity of 19% since the scandal was announced on June 28. If other banks are implicated, you may expect similar stock price depreciation for those institutions with the highest risk. The table above estimates what the resulting lowest stock price would be after depreciating 19% from its June 28 price, then compares it to the closing price on July 20 to project how much further the price could fall on a percentage basis.

There may be more damage from the fallout than from the rate manipulation itself. Once again, we see that there is little backstop to keep banks from acting in their own self-interest, often at the expense of their own clients. The very foundation of our faith in the integrity of the financial system and regulatory oversight has been badly shaken — yet again. And the financial impact of fines and penalties loom large for the banks and investors in the financial sector.

This scandal, even if it remains primarily outside the United States and the Federal Reserve's control, will undoubtedly produce a major overhaul in the process to calculate the LIBOR rate. While it may take some time to overhaul the process, today's sophisticated technology should make it possible to calculate the LIBOR based on actual bank data from existing contracts while tapping a broader base of banks to be in on the process than the 23 that are currently involved. This should make it more difficult for banks to skew results going forward. We also hope there have been many lessons learned by regulators that will translate to a more even playing field for banks, customers and investors.

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