EDWARDS WILDMAN

CLIENT ADVISORY

edwardswildman.com

July 2012

The LIBOR Situation – A Public Finance Perspective

Background

On June 27, 2012, the British Financial Services Authority, the US Commodities Futures Trading Commission and the US Department of Justice imposed fines aggregating more than $450 million against a leading London-based bank to settle allegations of LIBOR manipulation. Similar proceedings are pending against other banks as well. Reports suggest this may be the opening salvo in a potential torrent of regulatory action and civil litigation related to LIBOR rigging, which could have broad implications for financial markets around the world, including participants in the U.S. public finance community.

LIBOR, the "London interbank offered rate", is an interest rate benchmark indicating the average rate at which a participating bank estimates it can obtain unsecured funding in the London interbank market for a given term, in a given currency. It is considered to be the leading reference for short term interest rates in the world and is used in a wide range of financial instruments, including debt securities, interest rate swaps, futures contracts and adjustable rate mortgages. Reports indicate that the current value of these LIBOR-pegged financial instruments may be as great as $800 trillion. In light of the recent allegations of manipulation, the Federal Reserve Chairman, Ben Bernanke, has referred to LIBOR as a "structurally flawed" benchmark, and the Governor of the Bank of England has called on the heads of the world's central banks to come up with proposals to "reform" LIBOR.

Although the extent of LIBOR manipulation is not yet fully known, it appears that manipulative activity may have occurred over a period of years, including, most critically, during the height of the world financial crisis—2007 through 2009. At the heart of the allegations are efforts by an unspecified number of banks during that time to artificially depress the LIBOR rate. To put this into perspective, the process of establishing LIBOR is subjective in nature and not necessarily based on actual transactions. The process involves asking up to 18 "contributor banks" the following question – "*At what rate could you borrow funds, were you to do so by asking for and then accepting inter-bank offers in a reasonable market size just prior to 11 am?*" Based on the responses from the contributor banks, LIBOR is set by excluding the highest and lowest quartiles of submissions and taking the arithmetic average of the remainder. When credit markets started to freeze up in the middle of 2007, certain banks had an incentive to keep the LIBOR rate artificially low to give the impression that they were not weaker than their peers and to increase profits (or reduce losses) on their derivative exposures. It is this latter motivation that has troubled regulators and may have adversely impacted many in the public finance community.

Public Finance Perspective

Since the late 1990s many state and local governments that issued variable rate bonds entered into interest rate swaps to hedge their exposure to increases in variable interest rates. Similarly, many not-for-profit institutions and other parties entered into interest rate swaps in connection with projects financed with "conduit" tax-exempt variable rate obligations. Initially, many of these swaps were "bond rate" swaps or tied to a tax-exempt interest rate index such as the Securities Industry and Financial Markets Association Index ("SIFMA"). However, over time, most interest rate swaps tied to tax-exempt bonds came to be based on LIBOR, whereby the bond issuer or conduit borrowers would receive payments from time to time based on a percentage of the prevailing LIBOR rate specified in the swap (*e.g.*, 67% of one-month LIBOR) in exchange for making fixed rate payments. Many understood that this trend toward LIBOR-based swaps developed because the worldwide market for LIBOR-based instruments could produce more efficient swap pricing for bond issuers and conduit borrowers, compared with the relatively small domestic market for tax-exempt instruments.

When the financial crisis hit in 2007, the market for Auction Rate Securities (a popular vehicle for issuing variable rate debt) collapsed and the demand for other municipal variable rate obligations began to dry up. Issuers that entered into LIBOR swaps found that while the interest rates they were paying on their bonds skyrocketed (sometimes to punitive levels), the swap payments they were receiving remained low. If the allegations of LIBOR manipulation are true, the artificial depressing of LIBOR would have exacerbated this gap, forcing many issuers to come out-of-pocket for the difference.

Furthermore, to cope with a credit market that had become adverse to variable rate debt, many entities were forced to refinance their floating rate bonds with fixed rate debt. In the process of this restructuring, it was frequently necessary to terminate a related LIBOR swap with the payment of "termination" or breakage fees. In more than a few cases, these termination fees were substantial, and, a depressed LIBOR rate may have artificially increased the amount of such fees.

Going Forward

At this time, it is difficult to assess the potential fallout of LIBOR manipulation. To date, at least five state attorneys general (New York, Connecticut, Massachusetts, Florida and Maryland) are conducting investigations tied to the manipulation of LIBOR. It is likely that more will follow. Additionally, the US Department of Justice has announced it is opening criminal investigations. A number of lawsuits have been filed as well on various theories seeking recovery for individual and class claimants.

We at Edwards Wildman Palmer LLP are actively monitoring developments relating to the LIBOR manipulation situation. Please feel free to contact the Edwards Wildman lawyer responsible for your public finance matters or one of the authors linked below if you have any questions regarding these matters.

This advisory is for guidance only and is not intended to be a substitute for specific legal advice. If you would like further information, please contact the Edwards Wildman Palmer LLP lawyer responsible for your matters or one of the lawyers listed below:

Mark-David Adams, Partner	+1 561 820 0281	madams@edwardswildman.com
Antonio D. Martini, Partner	+1 617 239 0571	amartini@edwardswildman.com
Walter J. St. Onge III, Partner	+1 617 239 0389	wstonge@edwardswildman.com

EDWARDS WILDMAN