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Study Casts Doubt on Key Rate

WSJ Analysis Suggests Banks May Have Reported Flawed Interest Data for Libor

By CARRICK MOLLENKAMP and MARK WHITEHOUSE
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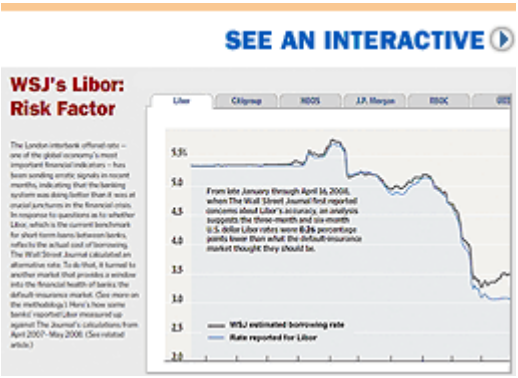
LONDON -- Major banks are contributing to the erratic behavior of a crucial global lending benchmark, a Wall Street Journal analysis shows.

The Journal analysis indicates that **Citigroup** Inc., WestLB, HBOS PLC, **J.P. Morgan Chase** & Co. and **UBS** AG are among the banks that have been reporting significantly lower borrowing costs for the London interbank offered rate, or Libor, than what another market measure suggests they should be. Those five banks are members of a 16-bank panel that reports rates used to calculate Libor in dollars.



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That has led Libor, which is supposed to reflect the average rate at which banks lend to each other, to act as if the banking system was doing better than it was at critical junctures in the financial crisis. The reliability of Libor is crucial to consumers and businesses around the world, because the benchmark is used by lenders to set interest rates on everything from home mortgages to corporate loans.

Faced with suspicions by some bankers that their rivals have been low-balling their borrowing rates to avoid looking desperate for cash, the British Bankers' Association, which oversees Libor, is expected to report Friday on possible adjustments to the system. That report isn't expected to recommend any major changes, according to people familiar with the association's deliberations.

In order to assess the borrowing rates reported by the 16 banks, the Journal crunched numbers from another market that provides a window into the financial health of banks: the default-insurance market. Until recently, the cost of insuring against banks defaulting on their debts moved largely in tandem with Libor -- both rose when the market thought banks were in trouble.

But beginning in late January, as fears grew about possible bank failures, the two measures began to diverge, with reported Libor rates failing to reflect rising default-insurance costs, the Journal analysis shows. The gap between the two measures was wider for Citigroup, Germany's WestLB, the United Kingdom's HBOS, J.P. Morgan Chase & Co. and Switzerland's UBS than for the other

11 banks. One possible explanation for the gap is that banks understated their borrowing rates.

The BBA says Libor is reliable, and notes that the financial crisis has caused many indicators to act in unusual ways. "The current situation is extraordinary," said BBA Chief Executive Angela Knight in an interview. A BBA spokesman says there is "no indication" that the default-insurance market provides a more accurate picture of banks' borrowing costs than Libor.

STUDY METHODOLOGY

Dollar Libor rates are calculated using information provided to the British Bankers' Association by a panel of 16 banks. To get a sense of whether the banks' reported rates reflect their true borrowing costs, the Journal looked to the market for credit-default swaps. **Read the Journal's full methodology**[2] for analyzing Libor.

Representatives of the 16 banks on the Libor panel either declined to comment, didn't respond to questions, or said they provide accurate rates.

The Journal's analysis doesn't prove that banks are lying or manipulating Libor. Analysts offer various reasons why some banks might report Libor rates lower than what other markets indicate. For one, since the financial crisis began, banks have all but stopped lending to each other for periods of three months or more, so their estimates of how much it would cost to borrow involve a lot of guesswork. Also, some U.S. banks, such as Citigroup and J.P. Morgan, have ample customer deposits and access to loans from the Federal Reserve, meaning they might not need to borrow at higher rates from other banks.

The price of default insurance also isn't a perfect indicator of a bank's credit-worthiness. Data provider Markit Group calculates the daily prices based on dealers' quotes, which can be volatile and vary widely in times of market turmoil. But over the longer time periods reviewed by the Journal, the data provide a good picture of investors' assessment of the financial health of banks.

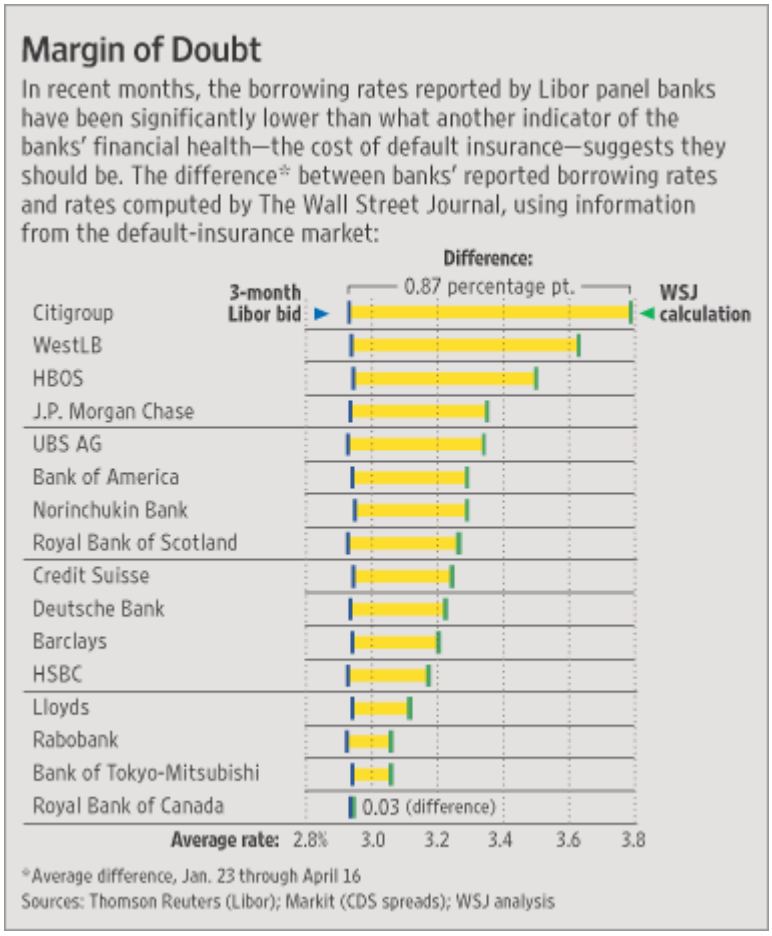
Confidence in Libor matters, because the rate system plays a vital role in the global economy. Central bankers follow it closely as a barometer of the banking system's health, and to decide how much to adjust interest rates to keep their economies growing. Payments on nearly $90 trillion in dollar-denominated mortgage loans, corporate debt and financial contracts rise and fall according to Libor's movements.

Impact on Payments

If dollar Libor is understated as much as the Journal's analysis suggests, it would represent a roughly $45 billion break on interest payments for homeowners, companies and investors over the first four months of this year. That's good for them, but a loss for others in the market, such as mutual funds that invest in mortgages and certain hedge funds that use derivative contracts tied to Libor.

At about 11 each morning in London, traders at the 16 banks on the Libor panel report what it would cost them to borrow money for lengths of time ranging from overnight to a year. **Thomson Reuters** Corp., a news and information provider, makes those rates public, and uses them to calculate the day's Libor.

When posting rates to the BBA, the 16 panel banks don't operate in a vacuum. In the hours before the banks report their rates, their traders can phone brokers at firms such as Tullett Prebon PLC, ICAP PLC and Compagnie Financière Tradition to get estimates of where the brokers perceive the loan market to be. (The bank traders also factor in other data when estimating borrowing rates.)



At times of market turmoil, banks face a dilemma. If any bank submits a much higher rate than its peers, it risks looking like it's in financial trouble. So banks have an incentive to play it safe by reporting something similar -- which would cause the reported rates to cluster together.

In fact, the Journal analysis shows that during the first four months of this year, the three-month borrowing rates reported by the 16 banks on the Libor panel remained, on average, within a range of only 0.06 percentage point -- tiny in relation to the average dollar Libor of 3.18%.

Those reported rates "are far too similar to be believed," says Darrell Duffie, a Stanford University finance professor. Mr. Duffie was one of three independent academics who reviewed the Journal's methodology and findings at the paper's request. All three said the approach was a reasonable way to analyze Libor.

At times, banks reported similar borrowing rates even when the default-insurance market was drawing big distinctions about their financial health. On the afternoon of March 10, for example, investors in the default-insurance market were betting that WestLB, which was hit especially hard by the credit crisis, was nearly twice as likely to renege on its debts as Credit Suisse Group, a Swiss bank that was perceived to be in better shape. Yet the next morning, for Libor purposes, WestLB reported the same borrowing rate as Credit Suisse. A WestLB spokesman says the bank provides accurate data.

In addition to borrowing from other banks, banks can borrow in the commercial-paper market, where they issue short-term IOUs to investors such as mutual funds. In mid-April, UBS, which has suffered some $38 billion in write-downs on investments gone bad, was offering to pay an annual rate of about 2.85% to borrow dollars for three months in the commercial-paper market, according to a person familiar with the matter. But when it reported for Libor purposes on April 16, UBS said it could borrow for three months from other banks at 2.73% -- in line with all the other panel banks. A UBS spokeswoman declined to comment.

Out of Whack

To gauge how much the borrowing rates reported by the 16 banks on the Libor panel might be out of whack, the Journal calculated an alternate "borrowing rate" for each bank using information from the default-insurance market.

In mid-March, the bank borrowing rates calculated using default-insurance data rose sharply amid growing fears about the financial health of banks, which culminated in the collapse of Bear Stearns Cos. But Libor actually declined.

Between late January and April 16, when the Journal first reported concerns about Libor's accuracy, Citigroup's reported rates differed the most from what the default-insurance market suggested. On average, the rates at which Citigroup said it could borrow dollars for three months were about 0.87 percentage point lower than the rate calculated using default-insurance data, the Journal's analysis shows. A Citigroup spokesman says, "We continue to submit our Libor rates at levels that accurately reflect our perception of the market."

The difference was 0.7 percentage point for WestLB, 0.57 point for HBOS, 0.43 for J.P. Morgan, and 0.42 for UBS. Royal Bank of Canada's reported rates came closest to the market-based calculation -- there was no significant difference. A HBOS spokesman says the bank's Libor quotes are a "genuine and realistic" indication of its borrowing costs. J.P. Morgan and UBS declined to comment.

Overall, in the first four months of this year, the three-month and six-month dollar Libor rates were about a quarter percentage point lower than the borrowing rates suggested by the default-insurance market, the analysis shows. After banks adjusted their Libor rates following news of the BBA review in mid-April, the difference shrunk to about 0.15 percentage point.

Mikhail Chernov, a finance professor at London Business School who reviewed the Journal's methodology, says it is an appropriate way to assess the reported Libor rates. David Juran, a statistics professor at Columbia University who also reviewed the methodology, says that for almost all of the 16 panel banks, the calculations show "very convincingly" that reported Libor rates are lower than what the market thinks they should be, well surpassing the threshold statisticians use to assess the significance of a result.

Beginning late last year, some bankers began to suspect Libor wasn't high enough. Questions about the rate arose at meetings held in November and April by a Bank of England money-market committee that includes banks and the BBA. The minutes of the committee's April 3 discussions say that "U.S. dollar Libor rates had at times appeared lower than actual traded interbank rates."

Citigroup interest-rate strategist Scott Peng raised similar questions in an April 10 report, writing that "Libor at times no longer represents the level at which banks extend loans to others." The BBA complained to the bank and asked about having the report withdrawn, according to people familiar with the situation. Citigroup declined. A BBA spokeswoman says reports published by member banks are not a matter for the BBA.

After the Journal reported on April 16[3] that bankers suspected rivals of intentionally understating their borrowing rates, the BBA said it was speeding up a review of Libor. It said it would kick out any bank found to be reporting inaccurate rates. Over the next two days, banks raised their reported rates, causing dollar-denominated Libor to log its biggest jump since August.

That increase surprised some homeowners, including Bill Petit, a real-estate broker with a

$470,000 adjustable-rate mortgage on his Del Mar, Calif., home. "It doesn't seem natural," he says. "If it would have done this over a month or so, I could have understood it." He says the move caused his monthly mortgage payment to jump by $98 more than he was expecting, raising it to $2,056.25.

Sudden Shifts

Hedge-fund manager Narayan Prasad says he uses Libor-based contracts known as interest-rate swaps to protect his investors from sudden shifts in the relationship between short-term and long-term interest rates. "You expect total integrity with respect to how it is computed," he says. If Libor is off by as much as some analysts have estimated, he says, it has cost investors in his fund, Anchor Capital Group, some $500,000 in the first four months of this year.

The questions about Libor have caused Robert Fuller, head of New Jersey's Capital Markets Management LLC, to begin thinking about using other benchmarks. Mr. Fuller, who consults with hospitals, schools and governments about interest-rate swaps, says he is considering using the federal-funds rate -- the rate at which banks loan to each other overnight -- in swaps contracts.

"I am thinking very carefully about how to proceed, and I do think most of the swap community is doing the same," he says. "I would definitely consider doing something like fed funds or anything else that the industry has that's nonmanipulable."

London brokerage ICAP is in the process of launching a new way to measure the rate at which banks borrow money -- an anonymous survey of some 40 banks it plans to call the New York Funding Rate. Participating banks wouldn't have to worry about the stigma of reporting high rates. The planned survey would cover a wide range of markets, not just interbank loans.

But plugging a new benchmark into trillions of dollars of securities and loans would require a big restructuring of the financial system -- something unlikely to occur in the near term.

The BBA recently held a meeting for about 10 market participants, including some of the banks that submit quotes for dollar Libor. People familiar with the discussion say the BBA isn't planning a radical redesign of how Libor is calculated.

Ms. Knight, the BBA chief, says there's no need to replace Libor, which has been used widely as a benchmark for more than two decades. "I see no reason suddenly to up sticks and change a process that has actually served the financial community world-wide extremely well for a very considerable number of years," she says.

Write to Carrick Mollenkamp at carrick.mollenkamp@wsj.com[4] and Mark Whitehouse at mark.whitehouse@wsj.com[5]

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