



DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C.

ASSISTANT SECRETARY

November 30, 2012

The Honorable Charles E. Grassley  
Ranking Member  
Committee on the Judiciary  
United States Senate  
Washington, DC 20510

Dear Senator Grassley:

I am writing in response to your recent letter to Secretary Geithner regarding the London Interbank Offered Rate (LIBOR). We share your concerns about the integrity of LIBOR, which is a benchmark rate used for financial transactions throughout the world. Congress has closely examined the key historical events, and both Federal Reserve Chairman Bernanke and Secretary Geithner have testified multiple times about this issue.

Your letter suggests that in 2008, the American public and market participants were unaware of concerns about the reliability of LIBOR and whether banks were reporting their actual costs of borrowing. We respectfully disagree. The concerns were reported widely in the popular press, including in the *Wall Street Journal* and the *Financial Times*,<sup>1</sup> as well as in reports by banks and market commentators.

In response, the Federal Reserve Bank of New York (FRBNY) took a number of actions. The FRBNY raised the issue with U.S. regulators and other government officials, including the key agencies with responsibility for market manipulation and abuse. In May 2008, Secretary Geithner—who was President of the FRBNY at the time—personally raised the issue with the President's Working Group on Financial Markets. The meeting included leaders from the Commodity Futures Trading Commission (CFTC), Securities and Exchange Commission (SEC), Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, the Federal Reserve Board of Governors (Federal Reserve), and Treasury.

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<sup>1</sup> For example, see Carrick Mollenkamp, "Bankers Cast Doubt On Key Rate Amid Crisis," *Wall Street Journal*, April 16, 2008, and Gillian Tett and Michael Mackenzie, "Doubts over Libor widen," *Financial Times*, April 21, 2008.

As your letter notes, the FRBNY also raised concerns with the Bank of England and pushed for reforms to the LIBOR process. In May 2008, then-FRBNY President Geithner raised concerns with the Governor of the Bank of England, Mervyn King. Shortly thereafter, he sent Governor King a memorandum with specific recommendations to address the problem. The Bank of England responded favorably and pledged to act on the recommendations. FRBNY staff continued to communicate with British authorities in the weeks and months that followed.

### *Enforcement Actions*

At approximately the same time, in 2008, the CFTC began an investigation, which ultimately involved the SEC, the Department of Justice, and a number of foreign regulators. The CFTC's multi-year investigation resulted in a civil settlement with Barclays—announced earlier this year—that included substantial fines and other measures.

We strongly support the CFTC's action. U.S. enforcement and regulatory agencies are continuing to conduct coordinated investigations into this matter, and we trust they will pursue whatever remedies are appropriate based on the facts, each agency's jurisdiction, and the law. It is critical that these agencies have the resources they need to prevent, investigate, and punish financial fraud and manipulation. Moreover, Secretary Geithner has asked the Financial Stability Oversight Council to consider how enforcement agencies can more effectively share information that may have systemic implications. This is challenging, because enforcement agencies protect the confidentiality of information obtained during their investigations.

### *Potential Effects*

Your letter raises a series of questions about the potential effects of the submission of inaccurate LIBOR rates on state, municipal, and local governments. Your letter, however, appears to conflate two separate and distinct issues—the potential effects on borrowing cost, and the potential effects on investment return.

In general, if LIBOR had been understated at any specific time, it would have reduced borrowing cost, for all financial markets participants. In other words, an artificially lower LIBOR would have *reduced*—not increased—the debt burden on state, municipal, and local governments. The precise effects from the alleged manipulation, however, are extremely difficult to measure or estimate.

For example, dollar LIBOR rates are based on submissions by a panel of 18 banks. The four highest and four lowest submissions are excluded before the rate is calculated. Accordingly, it is difficult to determine if underreporting by any individual bank had any effect on the published rate during any particular period. It would be even more difficult to calculate the precise magnitude of any such effect. Even if it were possible to quantify a LIBOR distortion over a particular time period, the effects on individual borrowing costs would be complex to calculate, and would require an enormous amount of data from particular borrowers.

Your letter references several recent press articles that cite potential LIBOR-related losses incurred by state, municipal, and local governments. These potential losses do not appear to be related to increased debt burden, as your letter suggests. If anything, the borrowing costs of these entities may have been reduced, for the reasons described above. Instead, the articles appear to be citing claims that financial market participants—including state, municipal, and local governments—may have received lower returns on investments tied to LIBOR. As the articles note, market participants are pursuing these claims in court.

Whether these legal claims will succeed is difficult to predict and will depend on the facts and circumstances of each case. For example, a particular market participant may have received lower investment income due to an artificially lower LIBOR, but that same participant also may have enjoyed reduced borrowing costs.<sup>2</sup> Our judicial system exists to adjudicate these types of complex claims. It would not be appropriate for us to comment on specific cases. But we strongly believe that any individuals or entities responsible for fraud should be held accountable for their actions.

#### *Small Business Administration*

Your letter references the use of LIBOR in the loan guaranty programs administered by the Small Business Administration (SBA). We understand that the SBA introduced the use of a LIBOR-based index in 2008, pursuant to its authority under Section 7(a) of the Small Business Act. Treasury does not have authority over the 7(a) program. Nonetheless, a publicly available SBA Procedural Notice describes the basis for the SBA's decision.

The Notice states that due “to the globalization of the financial markets, many SBA lenders’ source and cost of funds [were] partially or completely based on the London Interbank Offered Rate (LIBOR) rather than the Prime Rate . . . .”<sup>3</sup> Moreover, market turmoil had caused spreads between the Prime Rate and LIBOR to narrow such that lenders were unable to profitably make SBA loans based on the Prime Rate. As a result, lenders “substantially reduced or eliminated their SBA lending” leading to “severely reduced small business access to capital . . . at a critical juncture for the U.S. economy.” Following discussions with lenders, the SBA “concluded that allowing lenders to use an adjusted thirty day (one month) LIBOR rate as a base rate for pricing SBA loans [would] ameliorate several of the factors . . . impeding small businesses’ access to capital through SBA’s guaranteed loan programs.”<sup>4</sup>

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<sup>2</sup> Note that if LIBOR were artificially higher, the reverse likely would be true. Market participant likely would be subject to increased borrowing costs, but they also would enjoy higher investment returns. The net effect would be similarly difficult to determine.

<sup>3</sup> Procedural Notice 5000-1081, *available at* [http://www.sba.gov/sites/default/files/bank\\_5000-1081.pdf](http://www.sba.gov/sites/default/files/bank_5000-1081.pdf). *See also*, 73 Fed. Reg. 67,101 (2008).

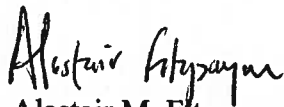
<sup>4</sup> *Id.*

### *Reform Efforts*

Finally, your letter proposes the creation of an American-based interest rate index. A broad global effort is underway to consider reforms to LIBOR and to explore potential alternatives. In the United States, the Financial Stability Oversight Council and the relevant U.S. regulatory authorities—including the CFTC, the SEC, and the Federal Reserve—are in the process of considering how best to address the potential implications of this issue for the financial system. In particular, they are assessing actions that could be taken to address the vulnerabilities of LIBOR, examining strengths and weaknesses of other survey-based measures, evaluating alternative benchmarks, and assessing the potential financial impact of a transition to a new benchmark. We would be happy to meet with you or your staff to discuss the current status of these efforts.

Thank you for your letter and your attention to this important issue. We look forward to working with you in the future.

Sincerely,



Alastair M. Fitzpayne

Assistant Secretary for Legislative Affairs

Identical letter sent to:

The Honorable Mark Kirk