Crushing Interest Rate Swaps and LIBOR Manipulation

The plight of state & local municipalities

By Ross Ruthenberg

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An unreported dimension of the ongoing financial disaster is the process of state and local municipalities entering into interest rate swap contracts, finding themselves on the "short end of the stick", with bankers holding the long end and taxpayers the losers.

There are about $200 trillion in notional value interest rate swaps in existence in the U.S. and about double that in the world. That's right, trillions, not billions! These synthetic derivatives (i.e. created from nothing) are used to swap interest rates with counter parties, with the notional value being some agreed on amount that the interest rate payments would be based on.

Typically, the swap contract would involve the exchange of a variable interest rate for a fixed rate. For example, we might create a contract that stipulates a $1 million notional value, with me paying you a fixed rate, say 5% per year, and you paying me a variable rate. Of course, we would start with the rates roughly equivalent, such that no net profit or loss occurs between us.

This is basically gambling, with me speculating that future variable rates, that I will receive payments based on, will average higher than the fixed 5% rate I am paying, while the opposite is true for my counter party, let's say a bank. Assuming it's a bank is quite reasonable in that about 95% of all interest rate swaps in the U.S. are owned by the top big five banks, JPMorgan Chase, Citibank, Bank of America, Goldman Sachs, and HSBC. Also, "A large chunk of this business is made up of "over the counter" (OTC) swap contracts with local governments." [1]

This might also be considered as "hedging" if I already have a loan outstanding that I have to pay a variable rate of interest on. Let's say I'm a state agency that sells a $100 million road-building 30 year bond and that I choose to sell it carrying a variable interest rate, since that is currently less expensive to me than a fixed rate (which is often the case with economically stressed municipalities) and that initially the variable rate is, say, 5%.

However, the variable rate makes me nervous and makes it difficult to budget future costs. Big banker (BB, perhaps the one I paid a hefty fee to to sell my bond) suggests an interest rate swap contract, one in which he will pay me a variable rate to "cancel out" the variable rate of my bond, while I will pay BB a fixed rate, which lets me sleep at night. The variable rate will be based on some well-known industry rate and 6 month LIBOR (London Inter-Bank Offered Rate) is recommended by BB. The year is 2006 and LIBOR rates have been increasing for years to its present 5% rate, so I conclude rates are going to continue up for the foreseeable future. BB and I cut the deal and in the following year I pay him fixed 5%, he pays me variable 5% and I pay out the variable 5% on my bond. All is good and I get a little salary increase for being so wise. [Stay with me here if you're detecting some potential flies-in-the-ointment.]

Unfortunately, things conspire against me and the 2008 economic crash sees LIBOR rates drop like a stone, along with other rates, falling to around 3%. Though my variable bond rate that I have to pay also decreases, I'm left paying the 5% fixed rate to BB, who returns me 3% –i.e. I'm out 2%/ year on $100 million or $2 million per year.

Then it gets worse. LIBOR stunningly drops to 0.5% at the start of 2010 and BB pays me the 0.5%. But the variable rate I pay on my bond, while also falling, only drops to 2.5%, as it's pegged against a different benchmark than LIBOR, say 30-year T-bonds. So I'm out 2% on the variable side and out another 5% on the fixed rate payment to BB… an unmitigated disaster that is now costing me a net 7% or $7 million/yr in interest payments (which would have been only $2.5 million/yr without the swap)! BB is happy as he is getting 5% and giving 0.5% for a net gain of $4.5 million/yr.

How on earth could this have happened?! I conclude that the "Fed", working with our government, has engineered rates downward, and while penning my letter to Ben Bernanke to complain of the low rates, bemoan the fact that I would have been sending him a congratulatory letter for the low rates, had I not gone gambling with BB!

And then, it gets worse again! Before I can mail my letter, I learn that the LIBOR rates are so low, costing me big bucks, because they have been manipulated downward, by BB and his banker buddies in Europe! [2]

This is a developing story but one that resonates with the old saw, "the house never loses".

Of course, the taxpayers and employees are on the hook for these unplanned banker payments, meaning that taxes will have to be increased, employees will have to be fired and/or their pensions and health benefits cut, or the roads won't be built.

Postscript: The only good news, if there is some, is that the LIBOR manipulation scandal impacts almost unfathomable amounts of moneys around the world, including variable-rate or sub-prime mortgages, futures, options, interest rate swaps, etc., such that it might be possible to sue to recover some losses. On the flip side, lawsuits go on forever and bankers get protected, with nobody going to jail. In any case, LIBOR is now so discredited it will have to be replaced with something else.

Ross Ruthenberg *is a Chicago area political analyst, rossersurf@comcast.net*

Notes

[1] The Swap Crisis, http://www.dollarsandsense.org/archives/2012/0512bondgraham.html
[2] See for instance: Analysis: What did Libor manipulation cost you?
http://www.fow.com/Article/3053878/Features/26522/Analysis-What-did-Libor-manipulation-cost-you.html and
The LIBOR probes, http://www.economist.com/node/21552586

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