Did Global Financial Scandal Hit Home?

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A global banking scandal may have cost Illinois taxpayers millions of dollars, according to the Better Government Association.

The BGA found that Chicago, Cook County and the state of Illinois' legal and public finance experts, as well as money managers for the five major state-backed public pensions, are investigating potential losses from the unfolding LIBOR controversy, which centers on accusations that a key interest rate was rigged—potentially affecting any financial transaction linked to it.

The impact of the scandal is still being determined, and it involves a complicated series of financial transactions, so it will be awhile before a clear picture of the total cost emerges, say those calculating the fallout.

Illinois and local government agencies that used interest rate swaps, financial agreements designed to manage exposure to fluctuating interest rates, are checking if they lost money on swaps contracts, which were often tied to the LIBOR interest rate, due to manipulation. Furthermore, public pension fund investment portfolios, which account for billions in assets, likely received less interest on retirees' money.

"This is as big a mess as you can get," says Dale W.R. Rosenthal, assistant professor of finance at the University of Illinois Chicago, who adds that Illinois and local government agencies may have lost millions because of the LIBOR controversy.

The LIBOR scandal centers on accusations that between 2005 and 2011 British-based Barclays and other global banks manipulated a key interbank rate used in determining floating interest rates ranging from adjustable rate home mortgages to complex financial transactions such as derivatives or interest rate swaps.

Already, major cities, states and public pension funds across the country are suing, or considering suing their banks, alleging manipulation of the London Interbank Offered Rate (LIBOR) benchmark. Baltimore is taking the lead suing Barclays and other big banks that set LIBOR, including U.S. institutions J.P. Morgan Chase, Bank of America and Citigroup. Last month, Barclays admitted that some traders and executives tried to fix the London offered rate.

The city of Chicago, which has entered into interest rate swaps hedging almost $2 billion in city-issued bonds over the past decade, is exploring the LIBOR scandal's impact.

"The law department has been studying this issue in order to determine our next steps," says Roderick Drew, a spokesman for the Chicago Department of Law. "We have been and will continue to closely monitor any new developments and we will take the appropriate steps to protect taxpayers."

Indeed, Chicago and other major cities and government entities used interest rate swaps heavily for at least a decade leading up to the financial crisis of 2008, says Peter Shapiro, managing director of New Jersey-based Swap Financial Group L.L.C., which advises government agencies.

The contracts are designed to protect governments from surging interest rates on municipal and other bond issues. Those swaps are often tied to LIBOR, which plunged during the financial crisis in 2008. The lower LIBOR resulted in cities and other issuers allegedly paying more money toward their contracts and suffering financial damage.

Since the 2008 economic meltdown, many cities have pulled back on using the derivatives says Shapiro, who wouldn't talk directly about Chicago because he has previously acted as an adviser to the city.

Illinois officials are in the early stages of examining potential losses but, based on interviews with state officials, the impact on bond issues and investments may be spread throughout various state agency transactions.

"We're aware of the allegations and concerns and are taking them into consideration," says Maura Possley, a spokeswoman for Attorney General Lisa Madigan.

The state has a floating interest rate tied to LIBOR on a $600 million bond issue from 2003, state documents show.

Officials have estimated less than $25 million of investments held by the state are tied to LIBOR, says Bridget Byron, executive director of finance and director of the state's College Savings Program. Cook County is looking at swap agreements on three bonds issues totaling almost $500 million, says Owen Kilmer, a spokesman for Cook County Board president Toni Preckwinkle. But swap contracts on the bonds were ended in 2010 and the county doesn't anticipate more than minimal impact from the LIBOR issue, he adds.

Meanwhile, government pension investments also are a potential area of concern stemming from the LIBOR scandal.

William Atwood, executive director of the Illinois State Board of Investment, says his staff is examining a portfolio that includes $335 million in syndicated bank loans.

Atwood's agency manages $11.5 billion for three state pension funds covering state employees, the General Assembly and judges.

Mortgage backed securities are another potential asset class that may be affected, he says.

"This is the beginning of a very long process," Atwood said.

Investments for the largest public pension fund in Illinois, the Teachers' Retirement System, are managed externally. Fund officials are working with their outside managers to figure out how the investments may have been affected, TRS spokesman Dave Urbanek says in an email to the BGA.

TRS "is working with the System's investment managers to determine any potential impact from the revelations about Libor," he says.

"Managers have the primary responsibility and ready information to assess any potential impact on specific TRS portfolios. "The TRS Board and investment staff will then take appropriate action, if necessary."

TRS manages $37.5 billion in assets.

The State Universities Retirement System also is consulting with its investment managers, spokeswoman Beth Spencer says.

Shapiro predicts the LIBOR fraud amounts to about $1 billion owed to U.S. cities, governments, hospitals and other entities that used rate swaps in the U.S.

Worldwide, the impact of the LIBOR scandal may run into the tens of billions, experts estimate.

U.S. and European regulators are trying to determine the size and scope of the rate rigging.

Barclays has admitted to manipulating rates. If other banks were involved in the fraud, "it would be pretty big," says John Sinsheimer, director of capital markets for the state of Illinois. If losses occurred across the state, the question then become is the money retrievable?

Predicts Rosenthal of the University of Illinois Chicago: "Some people will get some money back."