ONEY & INVESTIN

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Why Libor Defies Gravity

Divergence of a Key Global Rate Points to Strain

By IAN MCDONALD
And ALISTAIR MACDONALD

THE FEDERAL RESERVE could cut short-term interest rates in the weeks ahead, but right now one key rate is going in exactly the opposite direction something that could have a big impact on markets and the economy.

That rate is the London interbank offered rate, or Libor. It is an important benchmark for everything from adjustable-rate mortgages in the U.S. to giant floating-rate bank loans taken out by global corporations.

CREDIT MARKETS

Credit-market turmoil has pushed the Libor higher, even as other short-term interest rates, such as the interest rate on Treasury bills, are falling.

"Higher Libor rates affect the whole economy by tightening the budgets of borrowers large and small," says Lou Crandall, chief economist with Wrightson ICAP in New York. "It hurts corporate profits and tightens household budgets, too."

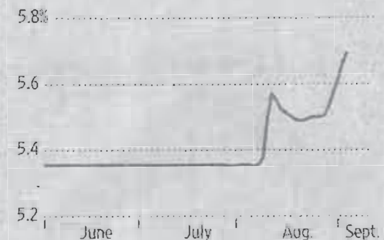
The disjointed movement in Libor and other short-term interest rates underscores the turmoil that persists in money markets more than two weeks after central banks in the U.S., Europe and Asia sought to settle short-term lending by injecting massive amounts of cash into the global financial system. (How small investors are easing back into bonds. Article on page D1.)

It also shows how financial trouble now ricochets around the world. Many European banks have been stung by exposure to U.S. subprime mortgages; some U.S. borrowers, in turn, could get stung by upward pressure on Libor rates set in Europe.

Expensive in London

Libor, or London Interbank Offered Rate, the rate banks charge each other on short-term loans.

3 month U.S. dollar Libor: **5.69813%**



Sources: British Bankers' Association; Reuters

Libor is an interest rate charged by banks for short-term loans to each other. It is set daily by a bank

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Why Rise in Libor Reflects Credit-Market Turmoil

Continued from the prior page
trade association in London. The loans can be in U.S. dollars, euros, British pounds or other currencies.

U.S.-dollar Libor rates usually closely track the federal-funds rate, which is the overnight lending rate managed by the Federal Reserve. But the two rates are now parting ways, complicating matters for the Fed as it tries to manage the global credit crisis and pushing up many short-term interest rates for borrowers.

CREDIT MARKETS

For the first eight months of this year, the U.S.-dollar Libor rate for three-month loans between banks nudged between 5.34% and 5.36%. Yesterday, the rate hit 5.7%, marking the rate's fastest rise in several years. The Libor hasn't been this far above the base short-term rates set by central banks since the Enron and WorldCom collapses in 2001, according to the British Bankers' Association, which sets the rate.

One reason the Libor is trading so high: Banks, many of them in Europe, have heavy commitments tied to struggling commercial-paper markets. They are reluctant to lend out dollars, and that is driving up short-term borrowing rates. Some are also worried that their counterparties in these trades, other banks, might be too weak to pay back the loans.

The Libor could well settle in the weeks ahead, limiting the impact of the recent moves. Moreover, the impact is muted because other short-term interest rates, such as the interest rate on Treasurys, are falling. Treasurys are also used as a benchmark for many forms of borrowing. But if Libor rates don't settle down, it could have a large impact.

When Chrysler and its finance unit borrowed $20 billion from banks in July as part of the auto maker's acquisition by Cerberus Capital Management, its loans were indexed to Libor interest rates. That means its interest costs go up and down as the Libor rises and falls, though some of the exposure could be hedged.

Lou Barnes, partner of Boulder West Financial Services, a Colorado mortgage bank, has three Libor-linked mortgages of his own, valued at more than $800,000 in all. Because his own loans don't reset for several years, he isn't worried about being hit. But he says he does worry that many other U.S. consumers have fortunes tied to this interest rate that few understand.

"They don't know how to pronounce it. They don't know what it means," Mr. Barnes says.

According to HSH Associates, a New Jersey mortgage-information company, the interest rate on a three-year adjustable-rate mortgage taken out in 2004 and tied to the Libor could be more than a half-percentage point higher than a similar mortgage tied to U.S. Treasurys, whose yields have been falling. On a $200,000 mortgage, that is a difference of about $1,000 a year in interest payments, though many adjustable-rate mortgages include caps that limit how much interest payments can go up in any single year, softening the pain.

A host of credit derivatives are also pegged to the Libor, as are many short-term commercial-paper loans used by banks—$3 trillion globally. Financial contracts with values of about $150 trillion are indexed to the Libor, according to a paper published in May last year by Donald MacKenzie, a sociology professor at the University of Edinburgh.

"There is no two ways about it, this is bad news for economic growth and for confidence in the financial system," said Teun Draaisma, head of European equity strategy at Morgan Stanley.

The Libor became popular because in the 1980s the world needed a short-term rate on which to benchmark the costs for loans between banks. At the time, the interest rates banks charged other banks and big companies lacked a universally accepted basis. British bankers' stab at one took hold faster than others, and it is now a benchmark for many globally traded debt securities.

—Cynthia Koons and Jon E. Hilsenrath contributed to this article.