Rigging for Profit

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In a process that began almost six months back, the world's leading banks are under scrutiny for rigging a benchmark variable that influences the returns earned by a range of investors. The latter include investors such as pension funds managing the savings of ordinary workers. Agents converting currencies to pay for purchases or invest in assets denominated in currencies other than their own, need to have a relative value (say, Rs.60 to the dollar) to go by. In practice, foreign exchange transactions are undertaken at rates linked to "fixes" that are supposed to reflect the exchange rates at which actual transactions are undertaken. However, ever since the world shifted to floating exchange rates and those rates turned volatile because of large cross border flows of capital, speculation has ensured that the forex market has become too large to monitor. The daily volume of transactions in foreign exchange markets is estimated at more than $5 trillion, of which around $2 trillion consists of spot transactions involving immediate purchases and saes. Given this volume, transactions are conducted on the basis of a range of fixes calculated using a select set of transactions by 'independent' agencies such as Bloomberg, Thomson Reuters and the European Central Bank.

One such fix that is a market leader and at the centre of the current controversy is the WM/Reuters fix, which is a daily rate determined by trades in a 60- second window. WM/Reuters benchmarks are available for 159 currencies. According to one estimate quoted by The Financial Times 90 per cent of currency derivatives, in the form of swaps, options, etc, use the WM/Reuters benchmark. It is to be expected that prices recorded during any window of time are affected by what happens before. If large deals have been undertaken just prior to the window, the prices reflected in those deals would influence the 'fix'. So traders who are in a position to make such large deals have an edge. Moreover, if a group of traders act together to manipulate the fix to their advantage, success is likely.

This is also the case because the foreign exchange market is extremely concentrated. Four banks—Deutsche Bank, Citigroup, Barclays and UBS—account for more than 50 per cent of the market. The euro-dollar currency pair is the most liquid, and that portion of the market accounts for a quarter of all spot transactions. And less than a 100 traders run the spot market. That structure provides the base for collusion among traders.

There is strong suspicion that such collusion has been rampant, enabling the manipulation of benchmarks. At the end of October Barclays suspended it chief currency trade based in London and five other traders operating from locations worldwide on suspicion of fraud. UBS too has reportedly suspended a senior trader. And even traders in banks like the Royal Bank of Scotland that has a relatively minor presence in currency markets are under close scrutiny.

In fact, puzzling movements in exchange rates have been a source of concern to regulators for some time, but given the nature of the foreign exchange market proving collusion and manipulation was seen as difficult. However, after a whistle blower revealed information on what goes on in "chat rooms" involving groups of traders from 'rival banks'—allegedly with revealing names such as "the mafia" and "the cartel"—the UK's Financial Conduct Authority (FCA) launched a probe. That probe has now expanded, with as many as 15 of the world's largest banks under investigation by seven regulators across the world. The core of the investigation relates to the allegation that traders were rigging the fix or exchanging insider information on large trades. This could have resulted in practices such as "banging the close", or pushing through orders during trading windows, or placing bets based on expectations that big trades about which they had privileged information would influence the benchmark. Information from chat room conversations, emails and other sources are to be scrutinised in the coming months. Interestingly, the banks themselves have come forward to cooperate with the regulators, and many have launched internal probes of their own.

Though the allegations may be difficult to prove, a number of factors suggest that there is much basis to the suspicions. To start with, ever since the scandal involving the manipulation of the Libor broke more than a year ago, the big banks and bankers have been seen as capable of rigging benchmarks. In the Libor case, however, reports from traders of what they expected to be charged if they borrowed in the inter-bank market were used to calculate the benchmark. Quotes were aggregated and the highest and lowest dropped, to compute an average. Bankers were found to be misreporting so as to fix the Libor, which in turn affected returns on a range of instruments benchmarked on the Libor. Investigations led to evidence of fraud, leading to a number of traders being relieved of their jobs and banks deciding to pay fines and settle rather than let the investigation continue. Total fines paid in settlements exceeded $3.5 billion at last count.

Second, even though exchange rate benchmarks are set on the basis of prices reflected in actual trades, the structure of the market described earlier, the evidence that most transactions take places outside organised exchanges, and the fact that it is the least-regulated of all financial markets makes it eminently possible for the rate to be influenced or information on likely movement of the rate to be misused.

Third, the decision of the banks to launch their own probes and cooperate with the investigating agencies, to suspend some senior traders, as well as consider banning "chat rooms", suggest that the banks are working to prevent imposition of another set of fines on them by making individual traders responsible for the practice. This is an implicit admission that some manipulation had indeed occurred.

The interest rate and exchange rate manipulation scandals have a number of larger implications. An argument put out by the financial services industry in the aftermath of the 2008 financial crisis was that the crisis was largely a result of acts of omission and the compounding of errors that were likely in any market economy. To the extent that fraud was spoken of at all, it was seen to be a characteristic of individual rogue traders. However market manipulation of the kind alleged in the case of both Libor and foreign exchange rates makes clear that collusion and behaviour akin to fraud, rather than competition and transparency, are essential features of the financial industry.

Second, an argument regularly advanced by advocates of financial liberalisation and much of the financial services industry is that deregulation results in a decrease in instances of fraud. A lightly regulated industry was presented as one in which competition among a large number of institutions and requirements with regard to disclosure, accounting practices and capital adequacy made it by and large a transparent, efficient and robust one. Any effort to go back on deregulation and revert to stringent regulation was therefore seen as damaging. All of these features are now proving to be casualties after liberalisation and deregulation. Collusion prevails rather than competition. Over the counter rather than exchange trading of assets keep transactions off the regulator's radar. Opaque assets created to confuse investors into taking on high risks they cannot assess proliferate. Benchmark rates are manipulated to deliver profits and bonuses to the financial services industry at the expense of investors in assets whose returns are linked to those benchmarks. In sum, it is not just that instances of fraud do not decrease, but fraud turns systemic.

Thus, the case for stringent financial regulation only gets clearer by the day. Yet banks have thus far successfully resisted any significant regulation, financial institutions are the only ones to return to profit after the crisis having been bailed out by governments, and governments and countries have been forced to adopt and be subjected to austerity measures, because the debt they accumulated to address the crisis created by finance is declared unsustainable by the captains of finance. Meanwhile, the millions who have lost out in the process still await justice.

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