Libor reforms will not stop collusion

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Proposals for the reform of the Libor system, which determines the interest rates in financial transactions worth hundreds of trillions of dollars, will do little or nothing to purge the outright criminality that lies at the very heart of the global financial system.

The reform measures, announced last Friday, were drawn up by Martin Wheatley, the managing director of Britain's Financial Services Authority (FSA), after it was revealed that global banks had been manipulating the system in order to rake in billions of dollars and protect their own positions. The much-vaunted "free market" was revealed to be a shell game run by bank executives, big investors and financial traders.

Libor, the London Interbank Offered Rate, is an interest rate set every day based on reports from major international banks. The banks estimate how much they would be charged for short-term loans from other major banks. The average of these estimates then becomes the basis for interest rates throughout the global financial system. It is calculated that financial products worth around $800 trillion are linked either directly or indirectly to Libor.

The corruption at the heart of the system came to the surface last June when the British bank, Barclays, the fourth largest by assets in the world, admitted to wrongdoing in submitting its Libor rate. Barclays paid a fine of $450 billion as a result of a case brought by American financial authorities.

It was subsequently revealed that Barclays was only one of about 20 banks under investigation for trying to manipulate the Libor rate to their own advantage.

The proposals for what Wheatley called "a complete overhaul" of the Libor system involve a cutback in the number of rates on offer, the appointment of an administrator, and tighter regulatory oversight. The British Bankers' Association, which has operated Libor, has announced that it will now withdraw.

While the changes will make it more difficult to rig the system, Wheatley's overriding concern was not the removal of the criminality that had been so dramatically revealed last June, but to give the appearance of initiating tough measures in order to assuage public outrage.

The Libor system, he said, needed to "get back to doing what it is supposed to do, rather than what unscrupulous traders and individuals in the banks wanted it to do." But the involvement of at least 20 major banks in the scandal, as well as evidence that regulators were aware of the malpractices before they came to light publicly, shows that the rigging is not the outcome of the activities of a few "rotten apples."

Speaking on the BBC's "Today" program, Wheatley indicated that bankers found guilty of manipulating Libor could be jailed in the future. "Society has lost confidence in banks, in finance, in the whole system, and we need to restore that. Society wants the people who commit these sorts of crimes to pay the price and if that includes jail for the most extreme fraud in the system, then that's what should happen."

The obvious question is why is it not happening now? The answer is contained in the nature of the Wheatley inquiry itself.

The terms of the review stated that it would "not consider any issues relating to the actions or alleged actions of specific financial institutions" in attempting to manipulate Libor or other benchmark rates. The investigation of these matters would be left to the FSA and other regulatory bodies around the world.

The attitude of these bodies has already been made clear. Despite Barclays' open admission that it had broken the law, the US Justice Department granted the bank immunity from criminal prosecution and did not name any executives or traders in exchange for the financial settlement. Given that the $450 million fine was a slap on the wrist in comparison with its annual revenue of $50 billion, Barclays was more than happy to pay up.

Despite the tighter regulations, the essential foundations of the Libor system will remain intact. Wheatley said that given the extent of the contracts for which the Libor rate provides the foundation, it was not possible to scrap it entirely. In other words, all the avenues for manipulation remain open.

This is because the banks will still be involved in setting the interest rates that determine the profits they make from transactions in global financial markets based on those same rates.

The sums involved are enormous. For example, on a $50 billion portfolio of derivatives contracts, a bank stands to gain or lose $1.25 million on each movement of just one basis point (a basis point is one one-hundredth of 1 percent). Multiply that several times and then, as the saying goes, a billion here and a billion there and fairly soon you are talking about big money.

It will now be somewhat more difficult to organise such manipulations, but as one trader commented to Reuters, the reforms “may just create a better thief.”

The incentive for fraud and the opportunities to carry it out will increase during a financial crisis when, as the events of 2008 showed, the banks stop lending to each other. Under such conditions, as the Bank of England governor, Sir Mervyn King, has acknowledged, the banks could rely on “some degree of judgement” rather than real trades in setting rates.

That is, when the pressure is greatest for the banks to try to protect their position through fraud, the reforms will be least effective.

Moreover, as any informed student of international finance knows, the history of the global system is bound up with the efforts of the banks and financial institutions to circumvent the attempts by governments and regulatory authorities to impose controls.

The Libor system is a case in point. It had its origins in the development of the so-called Eurodollar market in the 1960s. The Eurodollar market itself arose out of the efforts of British and US banks to counter the efforts of the American administration, which had imposed controls on financial transactions in order to try to sustain the system of fixed currency exchanges established by the Bretton Woods Agreement of 1944. Those efforts failed, leading to the decision of President Nixon to remove the gold backing from the US dollar on August 15, 1971, thereby setting in motion the processes that led to the creation of the present-day global financial system.

The rampant corruption and criminality revealed in the Libor scandal, through which banks, investors and traders have benefited at the expense of billions of people the world over, will not be ended by reforms, but only by expropriating the banks and finance houses and establishing the foundations for the development of a planned socialist economy on an international scale.