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Another financial scandal

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Banks caught in the LIBOR scandal in 2010-12 are involved again in another scandal.

It is now the rigging of foreign exchange rates

Earlier it was the rigging of LIBOR

LIBOR is an acronym for London Interbank Offered Rate. It has no connection with the interbank lending rate, fixed by a central bank, around which interest rates charged by commercial banks revolve. Also known as Fed Funds rate in US or Official cash rate, it is determined through open market operations by the central bank.

LIBOR coexists with benchmark interest rates of central bank.

The LIBOR is set by a panel of 18 banks for ten currencies and for 15 maturities. It is fixed each day by taking estimates from the panel what they would have to pay to borrow if they needed money. The top four and bottom four estimates are discarded. LIBOR is the average of those It is announced each day at 11.45 GMT. It is used as the reference point for financial instruments including variable mortgages, small business loans, student loans and credit cards.

LIBOR's influence is wide and large as the daily dealings are about US$360 trillion per day.

Rigging of LIBOR

Much before the 2008 financial crisis began, the banks found it convenient to submit false estimates instead of honest estimates. By doing so, they can gain or lose money depending on the level at which LIBOR was set each day. Weak banks would not like submitting honest estimates of the high price they would have to pay to borrow. Richer banks tried to influence the final LIBOR fixing to increase profits (or reduce losses).

So, there was incentive for rich or weak banks to lie.

The rigging went unnoticed until 2010. Those paying interest on loans were benefited from lower LIBOR rates. Savers and investors, such as pension funds and hedge funds lost out.

With the collapse of Northern Rock in England in 2007, with central bank concerns on liquidity, LIBOR received due attention. The rigging was detected and banks were identified by investigations conducted by Financial Services Authority of UK. The Barclays eventually admitted. That led to UK and USA governments imposing fines totaling £290 million.

Legal interpretation was different. A US court held participation of 16 banks in a panel was only a cooperative process. Banks provided daily estimates. The price quoted was not a bid and nothing was bought. So, the decision was that competition laws did not apply.

Maybe that was the reason behind former Bank of England (BoE) Governor Mervin King's description of LIBOR rigging as "spot fixing", and not as serious as "match fixing"!

LIBOR rigging did not affect Fiji or any Pacific island country (PIC), as there has been no interbank borrowing across the border. PICs have exchange controls. Their currencies are not traded.

Latest scandal

The rigging of foreign exchange market is worrisome.

World merchandise trade is around $20 trillion per year. The foreign exchange market is huge, dealing with more than US$ 4.5 trillion worth of currencies every day, 40 percent of which is in London.

The exchange rate rigging has been detected in the very chat rooms of traders who fixed LIBOR!

The BoE Governor Mark Carney was upset, when he heard that one of his own staff knew but failed to report it.

Besides suspending the employee, the Governor announced a shake-up and created a new position of deputy governor responsible for banking and markets. Last week, the Swiss competition commission began investigation into Swiss, British and U.S. banks, including Citi, Morgan, UBS and Credit Suisse.

The BoE does not regulate the forex market.

Its objective is to ensure the stability of the pound with appropriate monetary policies. Values of floating currencies, including the pound are determined by market forces of supply and demand.

How to deal with exchange rate rigging is a question before all advanced countries.