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Forex Market Rigging: Should We Not Worry?

By J. Soedradjad Djiwandono

Synopsis

The most recent scandal involving banks and trader-bankers has led to record fines against the perpetrators of billions of dollars. Should we not worry about this?

Commentary

AMID PUBLIC anxiety if not confusion over the possibility of Grexit – Greece exiting Eurozone - due to the stalling of negotiations between Greece and its creditors, there have been discouraging news about the record-breaking fines on a number of mega banks found to be involved in foreign exchange market rigging.

Six banks were fined US\$5.6 billion by American authorities in May 2015 and \$4.3 billion by the European authorities last November - all for their involvement in rigging the foreign exchange markets. In 2012 the Libor rigging prompted \$9 billion in fines against a number of banks. According to Martin Wolf writing in the *Financial Times*, from January 2012 to December 2014 the total fines paid by financial institutions to US enforcement agencies amounted to \$139 billion. And this does not seem to be the end of the story.

A conspiracy?

In the May 2015 and November 2014 cases, banks were fined for conspiring among themselves to rig the prices of foreign exchange in the market. These banks were acting like a cartel, making deals in foreign exchange transactions on behalf of their clients but which actually benefitted themselves more. The transactions were considered to be conspiracy in violation of antitrust laws by the Department of Justice (DoJ).

In addition the conspiracy also involved fraud for not providing the right information to their clients or counterparties. These have been done to maximise profit for themselves at the cost of their clients or counterparties in the transactions.

But, how could all this have happened? To be sure, this mind-boggling development has been facilitated by the practice of foreign exchange trade in decentralised, bank-dominated and lightly

regulated foreign exchange markets. It is different from equities largely conducted over the counter. As bank dealers keep trading data as proprietary it is difficult for outsiders to know exactly the correct market price of any currency when putting an order to bid or to offer.

In this constraining environment, the most parties in selling and buying currencies could observe is a set of rates announced in a very limited time set each day - one minute at four pm every day by WM/Reuters, a subsidiary of Thomson Reuters. Due to this limited window in foreign exchange trade, parties buying and selling currencies have to conduct their transactions via the services of a limited number of dealers who operate like a cartel and seem to make money for themselves instead of servicing their clients.

Why bother?

The six banks fined \$5.6 billion by the US authorities in May for rigging the forex market include Bank of America, UBS, RBS, JP Morgan, Citigroup and Barclay. The same banks last November also had to pay \$4.3 billion to financial authorities in the UK, Switzerland and the US. Some of these banks were also taking part in the Libor rigging, which in 2012 led to \$9 billion in fines against them by the authorities.

They are 16 banks altogether, members of the British Bank Association which are entrusted to make submission to the Libor committee every day on what each has to pay for acquiring short term funds from the market. The rates that these banks reported is averaged to determine what would be the Libor rates for different maturities of fund.

The list of the rates is announced daily by Thomson Reuters and used as benchmarks by practically all kinds of financial transactions globally. Any financial transaction would use Libor rates as the benchmark, to determine the rates they would charge in the transaction, that is whether it is at par with Libor rates, or plus or minus Libor rates. Libor rates used to command hundreds of trillion dollars in volume of transactions (up to \$ 800 trillion) while the daily foreign exchange transactions is estimated at around \$5.3 trillion.

From the nominal values of the transactions alone, we can see that both the foreign exchange markets as well as the transactions associated with or related to these legal cases are huge. They are too big to be ignored. As mentioned earlier, the story does not end here. Many transactions which were based on the rigged Libor rates that resulted in losses may ignite civil suits against the banks found committing fraud in the Libor determination in the past.

Get rid of 'incentive for bad behaviour'

The humongous fines have so far been adversely impacting the operations of these banks. However, all these banks seem to have been prepared because they have set up funds as provisions for what they would have to pay to the authorities, just as they put aside funds for bad debts provision or insurance premium.

In addition banks could ask for waiver against criminal suits, known in legal term as non-persecution agreement (NPA), at least in regard to antitrust, though not on fraud. But, this provision of waiver taken casually by both banks and the authorities could easily cause moral hazard. Some would argue that this is partly the reason why it has been very rare for bankers to go to jail.

Some, like maverick Democrat Senator Elizabeth Warren of Massachusetts, have been arguing against the liberal granting of waivers to banks or bankers accused of participating in these scandals. Senator Warren rightly stated that granting waivers to them is like giving incentive for bad behaviour. Limiting the granting of waivers to the perpetrators in these cases is one of the six items in her wish list to reform Wall Street banks.

It's still a very long way to rid the 'greed is good' culture as reflected in the saying among some banker- forex traders that 'if you ain't cheating you ain't trying'. The public would still vote for bankers who put clients' interests as their highest priority.

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