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The Next Wall Street Mega-Scandal Has Arrived

By SHAH GILANI

Well, it looks like the major financial institutions can't learn a lesson. They're neck deep in yet another financial scandal of global proportions.

U.S. and international securities regulators investigating manipulation of LIBOR, the world's most important set of benchmark interest rates, have uncovered another price-rigging scheme, this one in the $379 trillion market for interest rate swaps.

$379 Trillion, not Billion. Trillion.

The Commodity Futures Trading Commission (CFTC) has already issued subpoenas to Wall Street's biggest banks and is interviewing a dozen former and current brokers from the Jersey City, NJ, offices of ICAP Plc.

For investors in the big banks, new revelations may put an end to the upward push to the groups' stock prices, whose earnings of late have been helped by reductions in reserves meant as a cushion against future asset hits and litigation expenses.

Blackbeard's Legacy

According to a former broker from London-based ICAP's Jersey City swap desk, nicknamed "Treasure Island" for the huge commissions and pay packages traders there are accustomed to, brokers routinely manipulated prices on behalf of bank clients to benefit bank trading desks.

On the other side of the banks' trades are tens of thousands of counterparties who may have lost hundreds of billions of dollars as a result of having to pay more interest, or may have received less interest, on swaps whose prices were manipulated.

ICAP, formerly Intercapital Brokers, initially hit regulators' radar as part of the LIBOR scandal. According to the July 7th, 2012 print edition of the Economist,

"Court documents filed by Canada's Competition Bureau have also aired allegations by traders at one unnamed bank, which has applied for immunity, that it had tried to influence some LIBOR rates in cooperation with some employees of Citigroup, Deutsche Bank, HSBC, ICAP, JPMorgan Chase and RBS."

Far from being in a shady corner in the world of derivatives, interest rate swaps are a mainstream financing tool used by tens of thousands of corporate treasurers worldwide.

Interest rate swap prices are used to set the value of over $550 billion of commercial real estate collateralized bonds and are used to calculate pension annuity values and benefits. (Other examples of where swap rates are used, from the ISDA website, are in the sidebar.)

Big Banks in Big Trouble, Again?

Mega-banks primarily facilitate interest rate swaps by initially taking the other side of customers' trades and are responsible for establishing pricing of these instruments in conjunction with a handful of brokers.

Similarly to how LIBOR is calculated, the ISDAFIX, the benchmark series of rates used to price interest rate swaps for U.S. dollar denominated swaps, is convened by a "panel" of banks.

The panel, according to the International Swaps and Derivatives Association consists of: Bank of America Corp., Barclays, BNP Paribas SA, Citigroup Inc., Credit Suisse AG, Deutsche Bank AG, Goldman Sachs Group Inc., HSBC Holdings Plc, JPMorgan Chase & Co., Mizuho Financial Group Inc., Morgan Stanley, Nomura Holdings Inc., Royal Bank of Scotland, UBS and Wells Fargo & Co.

The banks submit their quotes for a range of maturities to ICAP through a secure screen connection. ICAP then forwards those data points to Thompson Reuters, who calculates the actual swap rates. Rates are then disseminated to over 6,000 viewers.

An Easy Con in an Era of Regulation

Manipulation of rate pricing is easy. ICAP posts rates, supposedly based on transactions and bid and offer quotes it receives and enters manually into what's known as the 19901 screen (named for the Reuters screen page number). Banks don't have to submit their own rates as part of the panel; they can use the suggested rates ICAP posts. Or they submit their own rates to ICAP to be forwarded to Thompson Reuters who calculates the final numbers.

ICAP sits in the middle, entering by-hand prices and rates from the transactions that occur through their brokerage desk, which average a staggering $1.4 trillion a day.

Not only can banks ask ICAP brokers to post whatever quote benefits the bank's internal trading book, whether it's to affect a positive mark-to-market closing price for accounting and profit and loss (bonus) calculations, or manipulate an entry price on a new trade with a counterparty, they allegedly ask ICAP brokers to delay entry of actual transactions until after ISDAFIX rates are disseminated.

The delay can easily create a beneficial entry price on a trade that would otherwise be priced based on fresh data. Manipulation of prices and rates has huge profit and loss and mark-to-market implications in terms of capital reserve ratios and other bank balance sheet metrics.

Of course, these allegations have yet to become indictments, and nothing may come out of any of this but a few little fines and some slapped wrists. And if the past is actually prologue, we can rest assured that no criminal charges will ever be tossed into the casino, since none ever are.

After all, the tumbling dice always favor the house, and we know whose house it is.

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