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Comment: Time to reform deficient market structures

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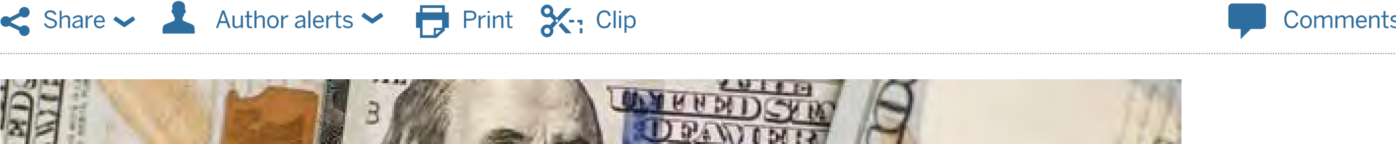

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Regulators around the world have been investigating the manipulation of financial benchmarks for years now. While they will continue, we should also ask what can be done to deter and detect such conduct.

It all started with Libor in 2008, followed by investigations into the rigging in foreign exchange, gold, silver, and swaps, among others. Whether manipulation of a financial benchmark, rate or price will occur depends on whether someone is willing and able to in effect move prices.

The question of willingness is generally outside the control of authorities; it is just human nature. Where authorities and benchmark administrators can, however,

influence the likelihood of manipulation and collusion is in the design and oversight of organisational structures, which reduce the possibilities for abuse.

Let's look at Libor more closely. It is a daily report of the interest rate at which large banks can borrow in the interbank market. Trillions of dollars in transactions and derivatives are tied to the rate, making it one of the most important financial rates in the world and creating an obvious incentive to manipulate it.

What allowed the manipulation of Libor to be as prolonged and successful as it was rests with how it was set.

Historically it was based on a simple trimmed average of rates voluntarily postulated and reported by the participating banks with deeply vested interests in the outcome. It was administered by the British Bankers' Association, the banks themselves. Is it surprising that abuse was rampant?

Unfortunately, these sorts of deficiency are not limited to Libor. The London gold fixing was set twice a day by five competing banks that participated in private, undisclosed calls as part of a selective auction to trade physical gold. The final auction prices determined the morning and afternoon fixings, setting the value of hundreds of billions of dollars of financial contracts around the world.

While participating in the auction, members not only set prices but held private information on price evolution while trading gold derivatives. The benchmark administrator was, again, the banks themselves through the London Gold Market Fixing. Silver worked similarly, with only three banks and one daily fixing.

It can perhaps be dismissed as a mistake of the past. Many of these benchmarks have already been reformed and passed to exchanges such as Intercontinental Exchange and CME Group.

Regulators should be asking what other important structures may present similar deficiencies that them highly susceptible to abuse.

Auction bid rigging can be a common problem in public procurement and other settings. Why? Because many procurement processes are defective, easily enabling co-ordination among a small number of powerful bidders with aligned interests.

This describes the bond auction market even today. New debt is often financed through the issuance of bonds sold to interested parties through auctions, though not all bond issuance is subject to auctions.

Typically a fairly small number of large participants obtain correspondingly large shares of these bonds, all with an obvious interest in buying as cheaply as possible. Nothing wrong with that of course, so long as prices are not artificially manipulated away from market fundamentals.

Last year we learnt of an investigation by the Department of Justice into the possible bid-rigging of

US Treasuries by primary dealers, the financial institutions which, along with other market participants, bid in these auctions.

Primary dealers often keep more than half of the newly auctioned securities and have a common interest in buying them at the lowest possible prices. When dealing with such large volumes, even a very small price movement can generate enormous additional profits. It is not clear that any entity is responsible for screening each auction for possible abuse.

Empirical evidence that I have prepared shows that Treasury auction prices may have been too low for years, and that this effect becomes more pronounced the more primary dealers buy. Notably, these patterns changed when the investigation became public.

While investigations into Treasury auctions are continuing, we should learn the lessons from Libor and recognise deficient structures to proactively reform them, minimising the likelihood of abuse.

And to enhance deterrence and detection of illegal behaviour, we must screen these markets regularly through sophisticated data surveillance and independent oversight.

Indeed, detection methods must become more sophisticated unless we are willing to rely on the wrongdoers to continue leaving incriminatory emails and chat messages. On the contrary, they have likely learned their lessons that their own messages can “hang them”.

Authorities need to face the reality that direct evidence will probably be harder to come by, and that proactive reform of deficient structures is needed, coupled with active market screening. It is past time we learnt our lessons.

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