The Other Side July 5, 2012

Lies, Dammed Lies and Investment Banks

The deception starts with the very name –"investment banks". The first word creates an impression of a long term commitment of risk capital to an enterprise, and the second means the acceptance of deposits for the purpose of lending. Investment banks, in general, do neither. The largest proportion of revenue comes from trading activities, and not through underwriting of bonds and equities, let alone any long term investments. In many ways "trading" itself is a euphemism: what they do is not very different from the activities of hedge funds, their big advantage coming from the fact that many of them are "too big too fail" and in effect backed by the implicit promise of a sovereign rescue, should things go bad. Again, the relatively innocuous expression "fixed income trading" used in many balance sheets includes currencies, commodities, derivatives, etc. Recently, J.P.Morgan incurred a loss of $ 5 bn in a unit supposed to be managing surplus liquidity and balance sheet risks! Like one character in *Alice's Adventures in Wonderland,* clearly bankers can make words mean what they desire: they are obviously well read in fables! The business model is that I take speculative positions; if they turn out to be successful I get a huge bonus at the cost of the shareholder; if they go disastrously wrong, the shareholder and the tax payer bear the losses.

The provocation for these thoughts comes from the so-called LIBOR (London Inter-Bank Offered Rate) fixation scandal which seems to involve a large number of banks. Barclays is the first to suffer huge damage to its reputation and a fine by the U.K. and U.S. regulators aggregating almost $ 500 mn! (Barclays' Chairman, the chief executive, and the chief operations officer have all resigned.) LIBOR is the benchmark for by far the largest amount of interest rate exposures. Outstanding LIBOR based USD interest rate swaps are currently estimated at $ 350 trillion**;** most of cross-border bank lending, and even many domestic assets, are priced in relation to the LIBOR with the applicable rate fluctuating every 3/6 months as the case may be. The daily LIBOR is a "polled" rate published by the British Bankers' Association (BBA). And, as the regulators have now found out, Barclays, one of the banks in the polling list, was systematically under reporting the number, since 2007. It seems that so were other banks in relation also to the EURIBOR and the yen rates. (Incidentally, the MIBOR rate in India is also a polled rate but it is understood that the practice is likely to be changed to the actual average transacted rate shortly.)

The chairman of Barclays was also the chairman of BBA, and Barclays' CEO, a leader of the industry. In a speech last year, he claimed that, for him, "*the evidence of culture is how people behave when no one is watching*". Even after the scandal became headline news, in a letter to the chairman of a Parliamentary committee he has claimed that "*I am determined that Barclays plays its role as a full corporate citizen, acting properly and fairly always, and contributing positively to society in everything that we do"*. It would be truly amazing if the CEO really believes in what he has written. The only saving grace seems to be that, during the 2007-08 banking crisis, the Bank of England, and perhaps the U.K. government, knew about the under reporting of the rate, and may have winked at the practice given the crisis situation prevailing – higher borrowing cost for premier banks could well have added to the crisis of confidence in the money market.

Barclays is also involved (along with HSBC, Lloyds and RBS) in another recent case relating to the mis-selling of highly complex, structured products to unsophisticated clients in the U.K. who have, as a result, incurred large losses. "*For many small businesses this has been a difficult and distressing experience with many people's livelihoods affected"* (FSA official). In a settlement with the regulators the banks have agreed to "*a mixture of canceling or replacing existing products, together with partial or full refunds of the costs of those products*". One positive thing about banks' mis-selling of structured derivatives: they do not make a distinction between domestic and foreign clients as a large number of affected businesses in India (and even Irish nuns!) know only too well. (The big difference of course is the generosity of the Indian banking regulator who has merely fined some banks something like Rs. 10 lacs for regulatory transgressions -- not even a rap on the knuckle for banks some of whose dealers in India earn that much every month.) Recently, Barclays has also been involved in creating and marketing highly complex and “abusive” tax avoidance schemes in U.K. and abroad.

George Osborne, the U.K. chancellor, has said in relation to the various incidents *“What happened at Barclays … was completely unacceptable, was symptomatic of a financial system that elevated greed above all other concerns.*” Will anything change? I have my doubts!

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