Book Reviews

Holding Bankers to Account: A Decade of Market Manipulation, Regulatory Failures and Regulatory Reforms
Oonagh McDonald
Manchester, UK: Manchester University Press, 2019, 288 pp.

How could a small clique of derivatives traders manipulate some of the world's most important financial benchmarks for their own enrichment? In general, global capital markets are much too liquid, competitive, and integrated for any individual participant to materially alter outcomes. Opportunities to gain a sure profit from market inefficiencies are hard to come by and quick to disappear.

Yet, starting in 2008, evidence that prominent banks were rigging the London Interbank Offered Rate (LIBOR) began to surface, potentially affecting financial contracts worth hundreds of trillions of dollars. Subsequent investigations by British and American regulators confirmed these suspicions and revealed additional manipulation of the markets for foreign exchange and precious metals, ushering in large fines and considerable new regulation. The scandal has had long-term implications, with the main LIBOR watchdog now encouraging financial institutions to use alternative reference interest rates.

The collusion between banks that enabled this manipulation, and the regulatory response, are the subject of *Holding Bankers to Account*, a forensic new treatment by Oonagh McDonald. McDonald is a veteran of financial regulation who has authored

Cato Journal, Vol. 39, No. 2 (Spring/Summer 2019).

books on the failure of government-sponsored mortgage giants Fannie Mae and Freddie Mac, as well as the collapse of Lehman Brothers. From 1993 to 1998, she served as a director of the Securities and Investments Board, the agency then overseeing Britain's capital markets.

Despite her insider status, McDonald does not avoid discussing the regulatory failures that enabled market manipulation. Painstakingly, she documents how traders and other bank staff worked together to rig reference rates for their own gain, and how regulators procrastinated as evidence of malfeasance accumulated. Her tone, however, is dispassionate and removed, leaving the reader to decide how to allocate the blame.

Most books on the LIBOR scandal have tended to focus on the personalities of the people involved, notably Tom Hayes, the erratic Londoner who as a yen trader for UBS and Citigroup made millions for himself and his employers by recruiting brokers and other traders to get the benchmark where he wanted it. McDonald's is decidedly not one of those books. She rarely mentions individuals by name, focusing instead on institutions and practices. One might think that a few references to the characters involved would have increased the book's appeal to the lay public, who are otherwise prone to eschew dry analyses like this one for less scholarly journalistic pieces. But that is probably not McDonald's target audience anyway.

More than half of the book is devoted to the manipulation of LIBOR, which was created in 1969 as a dynamic benchmark for banks' funding costs. Minos Zombanakis, a Greek merchant banker looking to make a loan to the shah of Iran, needed a measure that would periodically adjust to reflect changes in banks' cost of capital. His solution was to ask a group of large banks to submit regular estimates of their cost of borrowing and use those submissions to derive an interest rate that would change every three to six months. Zombanakis's benchmark proved a rapid success in the burgeoning market for syndicated loans. In 1986, the British Bankers' Association began to publish LIBOR rates for loans in U.S. dollars, pound sterling, and Japanese yen. Thereafter, LIBOR grew to become the reference measure for more than $550 trillion worth of financial contracts, including retail mortgages and interest-rate swaps.

Despite this growth, LIBOR continued to be set daily by what can only be described as a cozy cartel. Each day at 11am London time, officers at Barclays, Deutsche Bank, UBS, and other large banks—but never more than 16 of them—would submit estimates of their short-term cost of unsecured credit. LIBOR submissions were meant to reflect the terms a bank could negotiate on the market, but with no-one assessing them for accuracy, submitters had much leeway to diverge from the true rates.

It was the financial crisis that signaled to market observers something might be amiss. Despite widespread worries that many financial institutions, including LIBOR submitter banks, faced potential solvency problems, the benchmark showed no sign of stress. An April 2008 study published in the *Wall Street Journal* compared LIBOR rates to those implied by default insurance on LIBOR-submitting banks, finding discrepancies of as much as 0.87 percent for Citigroup and 0.42 percent for UBS. Banks seemed to be "lowballing" their LIBOR submissions, lest their true, higher cost of borrowing be interpreted as a sign of impending failure.

The implications for financial stability of suspected lowballing prompted regulatory scrutiny from 2010 onward. In the course of their investigations, regulators uncovered evidence of manipulation going back to 2005, mostly aimed not at hiding potential vulnerabilities but at altering submissions for the benefit of banks' trading books. LIBOR is derived from taking daily rates from the 16 reference banks, dropping the four highest and four lowest values, and averaging the rest. One bank's attempt to manipulate could therefore not easily succeed, as a submission that diverged significantly from those of other banks might be ignored or, in the best of cases, offset by other submissions. Thus, rigging the benchmark necessitated the collusion of submitters and traders *across* banks—and they did collude, enlisting brokers to help with communication.

It is easy to find fault with the regulatory response in hindsight. But McDonald shows sympathy for the view, expressed by top UK regulator Lord Turner soon after the scandal broke, that watchdogs' focus on shoring up financial stability during the crisis blinded them to banks' LIBOR shenanigans. Even when regulators managed to spot anomalies, however, they misdiagnosed the problem. The Bank of England's Paul Tucker, giving evidence to the UK Parliament's Treasury Select Committee, said that the Bank "thought [LIBOR] was a malfunctioning market, not a dishonest market." In fact, Tucker himself had cautioned Barclays chief executive Bob Diamond in October 2008 about the perils of paying high rates for short-term loans.

Yet excusing regulatory forbearance at the height of the meltdown cannot hide the failure to spot manipulation before the crisis. McDonald argues that the supervisory powers of the regulator over LIBOR were insufficient to pose an adequate deterrent against wrongdoing. A key merit of her book is showing that the privilege bestowed upon a small clique of banks to set LIBOR for everybody else was a remnant from a bygone era. While an old boys' network ran the City of London, capital markets were subject to strict exchange controls. The governor of the Bank of England knew the heads of all supervised institutions by their first name, and the system of LIBOR submissions could perform adequately. But as financial market liberalization from 1986 spurred the entry of scores of foreign players, setting the stage for a dramatic growth of derivatives and currency trading, opportunities for LIBOR manipulation increased—and so did the rewards.

Rigging of foreign exchange and precious metals markets marched to the same tune. In both cases, as with LIBOR, a small group of banks took advantage of their position as price-setters to benefit themselves rather than submit measures reflective of prevailing market conditions.

A benefit of the LIBOR scandal has been to hasten regulators' efforts to replace it with benchmarks that are less dependent on the judgment of submitters, who are interested parties, and are based instead on market transactions. In July 2017, Andrew Bailey, who as chairman of the UK Financial Conduct Authority oversees LIBOR, indicated that the regulator would seek a gradual transition away from the old benchmark, arguing that the market for term loans between banks—on which LIBOR was designed to be based—"is no longer sufficiently active." Bailey's counterparts in the United States and the eurozone have similarly sought to replace LIBOR with market-based measures, typically overnight wholesale loans, either unsecured or with government bonds as collateral.

McDonald is skeptical that a single short-term rate can replace the term structure of interest rates that LIBOR offers. However, benchmark rates are just that: a baseline to which premiums may be added for various kinds of risk, including term risk. While it may take time for a liquid market for contracts using non-LIBOR benchmarks to develop, transaction-based reference rates are clearly preferable to judgment-based ones, particularly when the latter are the private province of a few banks and regulators.

While acknowledging that post-2012 regulation—aimed at prescribing the expected conduct, reporting procedures, and enforcement against wrongdoing—is "expensive and time-consuming," McDonald is optimistic that the benefits of the new regime will outweigh its compliance costs. Her discussion of the new rules, however, is mostly descriptive, and she spends little time telling the reader quite why he should be confident that the same regulators who failed to spot and address malfeasance last time will get it right this time. Is it because senior bankers now have "skin in the game," discouraging them from pleading ignorance of their underlings' bad behavior? Have new regulations sufficiently increased the information and enforcement powers available to regulators? Do regulators now have stronger incentives to act on suspicions of manipulation? Again, it is up to the reader to decide.

McDonald's book gives a detailed account of how LIBOR and other benchmark rates came about, how manipulation could take place, and the attempts to eschew the benchmarks' weaknesses and improve oversight after the scandal. Yet, on a topic as complex as this one, her experienced voice as a former regulator and constant observer of events is too often missing. Most accounts of the LIBOR scandal leave readers with the impression that nothing could have gone wrong were it not for greedy bankers. McDonald shows compellingly that only institutions and incentives can explain why manipulation took place here, and not elsewhere. Alas, her book is not the place to find out what the way forward should be.

Diego Zuluaga
Cato Institute

The Future of Capitalism: Facing the New Anxieties
Paul Collier
New York: HarperCollins, 2018, 248 pp.

Paul Collier, Professor of Economics and Public Policy at the Blavatnik School of Government, Oxford University, acknowledges that writing *The Future of Capitalism* was intellectually "daunting, my proposition being that what was needed was a synthesis of moral philosophy, political economy, finance, economic geography, social psychology and social policy." In presenting a comprehensive case for what ails capitalism and his "remedies that address our new anxieties,"