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ANALYSIS

The financial crisis has been followed by financial scandals, and allegations of rigging the foreign exchange market could be the biggest of them all. Ashley Potter talks to former FX trader Mark Taylor about a solution

Fixing the fix

"Part of the folklore of the foreign exchange market, is that every day you would see the rates spike around 4pm. The spikes would last a few minutes and then go back down again," says Taylor.

Now Dean of Warwick Business School, Taylor was a Senior Currency Manager at BlackRock for four years before becoming Dean, and says there was a widespread understanding that the markets would spike at the time of the London 4pm fix.

Over the last year a global investigation into collusion in the foreign exchange markets (FX) has centred on the London 4pm fix – a benchmark rate that clients use to buy and sell currencies. Were these spikes a natural phenomenon of the markets? Or were traders working together to push up the price in the $5trillion (£3.13trillion) a day market to benefit themselves and rob millions of dollars from their clients?

Regulators from around the world have suspended or fired more than 20 traders with banks as big as JP Morgan, Barclays, UBS, Deutsche Bank, and Citigroup embroiled in the growing scandal, while even the Bank of England has suspended an employee.

It follows the Libor scandal that saw banks all over the world fined millions of dollars for manipulating the inter-bank lending rate and some analysts are predicting the FX rigging probe could be even worse.

The London 4pm fix, which was set up in 1994 and run by WM Company and Reuters, is the most popular benchmark used. It is made by taking an average of the exchange rate in currency trades 30 seconds before and after 4pm in the London market. The benchmark rate for a range of currencies – including major exchange rates like dollar-sterling, dollar-yen and dollar-euro–is used to value trillions of dollars of assets, and is the rate at which some big investors agree with their bank to exchange currencies to settle their accounts at the end of every day.

So, if the benchmark rate can be pushed up artificially, then the banks could charge their clients a higher rate than the rate at which the bank is able to cover the trade in the market a few minutes later, with the difference representing a profit for the bank. Some of the trades involved are huge – literally billions of dollars: if traders can move the benchmark rate just a tiny amount it could represent a profit of millions of dollars.

That profit is not only good for the bank but for the trader as well, as their bonus at the end of the year will be decided on by how much profit they have made, and that can run into millions of pounds.

"There is no law against trading at 4pm rather than at 3pm," says Taylor. "It's a grey area; there can be some quite legitimate lumpy trades around 4pm that will move the rate. The question is: were they legitimate 'normal business' or were they put through deliberately to affect the rate in order for the bank to make a profit from its customers? That, though, is going to be hard to prove."

That is why regulators are sifting through thousands of emails and messages in the Bloomberg and Reuters chat rooms that traders use, to find evidence of collusion between traders. Deutsche Bank, Citigroup, Barclays, and UBS account for more than half of what is an opaque market with few regulations.

"If some of the big players in the market got together and put through some very large trades – billions of dollars each – then that could affect the market," says Taylor.

"It would take a huge amount of money to move the market but, the way the benchmark rate is measured, you only have to move the market a small amount for a very short period in order to affect it – and that could be worth millions of dollars of profit for the banks."

Using a fixed point in the day to decide on the price of currencies almost encourages the practice of 'front-running' where a trader drives up the rate with a big order or 'banging the close' where a high number of orders are placed around 4pm to move the price.

Bank of England Governor Mark Carney has vowed to look into how the foreign exchange market works and regulators around the world are wondering how to fix the fix.

Taylor is of the firm belief that regulations alone won't work, because banks and traders would find a way around them; the former Bank of England Senior Economist believes taking away the incentive to manipulate the 4pm fix would be a better route.

"Regulating this kind of behaviour would be very difficult," says Taylor, who has also worked as a Senior Advisor for the International Monetary Fund (IMF). "As always in financial markets, it's much better to take away the incentive to cheat rather than just regulate against the cheating.

"One solution worth investigating would be to take away the temptation to rig the benchmark rate by taking the average over an hour – so 30 minutes either side of 4pm rather than 30 seconds. It's a simple, workable solution because it would be a lot harder, if not impossible, to move a market as big as the FX market long enough to affect the average over an hour.

"Removing the incentive to cheat is much better than regulation because of the global, decentralised nature of the foreign exchange market.

"One solution worth investigating would be to take away the temptation to rig the benchmark rate by taking the average over an hour – so 30 minutes either side of 4pm rather than 30 seconds"

"Another method that could be explored would be to take a random one-minute interval between 3pm and 4pm over which to calculate the average to use as the 4pm benchmark rate. There is no need to tell the traders when it would be each day.

"The incentives for traders are so big, with billions of dollars involved, that it would be a surprise if they weren't tempted to 'front-run' or 'bang the close'. The London 4pm fix has pushed the behaviour of traders in this direction and we need a solution that will nudge them in a fairer direction."

Practises like this, along with 'hunting the stops' – buying or selling to move the exchange rates to a level where orders to automatically sell at a certain price kick in – have long been suspected, and it is something Taylor believes the Bank of England should have acted upon before now.

"They should have clamped down on it a few years earlier," says Taylor. "Although putting through big orders around the 4pm fix is not of itself illegal, if there was evidence found of collusion to do this specifically in order to affect the benchmark rate then that would be illegal. That's why chat room evidence is crucial, if there is written recorded proof of traders working together to move the 4pm fix that would be very serious.

"It would strike at the heart of business ethics and be yet another blow to the integrity of the banks. Our pension funds invest billions of pounds in the financial markets and if they are being cheated in this way then it affects every one of us.

"This needs to be tackled and so I applaud Carney's appointment of Minouche Shafik from the IMF as the new Deputy Governor for Markets and Banking, charged with carrying out a root and branch review of how the Bank conducts due diligence in its handling of market intelligence. We awarded Dr Shafik an honorary degree in 2012 in recognition of her achievements and I expect her to get to the bottom of this issue. The markets will be watching with interest." ■

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