

## BBSW – too dumb to understand?

Written by The Conversation USA

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The reactions of [ANZ](#) and [Westpac](#) management to recent legal actions by ASIC alleging manipulation of the Bank Bill Swap Rate (BBSW) benchmark are instructive of the attitudes of the major banks.

ANZ wheeled out its Chief Risk Officer to [argue](#) that it believed the allegations ASIC were based on:

“A misunderstanding of how bank bill issuance and interest rate risk management operates and the limited case law which applies to this area.”

Claiming that ASIC staff and lawyers have just misunderstood the markets is, of course, sheer arrogance and can be rephrased as, “you are dumb” and (shades of Enron) “we are the smartest people in the room.”

Westpac took the [same tack](#) , but were a little more polite:

“We disagree with ASIC’s interpretation of the communication between employees referred to in the court documents and their assessment of trading activity given the complexity of strategies involved.”

However, it is same message – you just don’t understand the complexity of what we do, do you?

But is what the banks did with regards to the BBSW benchmark really rocket science? An analogy might help.

Assume you are an auctioneer and spot a house coming up for auction that would suit your daughter/son soon to be married. It would be nice to start off married life with as small a mortgage as possible, and you resolve to help them get a bargain.

So you dampen down the seller's expectation of the price achievable, you schedule the sale at the end of the auction when most buyers have already left. You are not overly enthusiastic when introducing the property, pointing out some of the problems. You start the bidding low and go up in small increments and you slam the gavel down quickly to end the sale. Everyone's happy, except the seller, who should have got more but didn't because the sale was rigged.

Of course, such a situation would never happen in real life, because auctioneers are covered by a [Code of Ethics](#) that requires them to act on only on behalf of their client, and to disclose any conflicts of interest.

By the way, if the situation was reversed and the child wished to sell a property, the auctioneer could help. They could, for example, set a high reserve, schedule the sale early with eager buyers, talk up the property, prolong the auction as the price inches up and drag out banging the gavel. In neither case, could the auctioneer guarantee a fixed price but their actions would certainly 'nudge' the price in the direction required.

And, of course, the stratagem might fail, if someone else spots the bargain and gets in first. But that's life and there will definitely be another opportunity coming along soon.

In non-exchange markets that use benchmarks, such as BBSW, [Foreign Exchange \(forex\)](#) and [LIBOR](#), it just so happens that large banks (so-called 'prime banks') are both auctioneers and buyers/sellers. The potential for conflicts of interest is enormous and is recognised in the industry's many codes of conduct.

In the [LIBOR](#), [Forex](#), and [BBSW](#) scandals, there is copious evidence that some auctioneers colluded with buyers and sellers (inside their own firms) to nudge market prices in a particular direction. You scratch my back and I will send round a crate of bubbly.

Such behaviour not only broke the industry's code of conduct, it became standard market practice – everyone's doing it, as ANZ claimed:

“Our practices in the BBSW market were consistent with Australian market practices in wholesale financial markets and we reject ASIC's characterization of the transactions in question.”

This bluster is a thinly veiled warning - just try taking us all on! ASIC deserves praise for doing just that.

It is also worth asking the question - why would the auctioneers and buyers and sellers bother, what was in it for them?

This isn't rocket science either.

Over the past 25 years, the Interest Rate Swaps (IRS) market has exploded and is estimated to be worth some US\$ 300 trillion (yes trillion). Everyone in the industry now uses IRS to manage their exposures to interest rate changes. But IRS have a quirk.

Typical IRS contracts last for years but the rates are reset on regular schedule, typically every quarter on the anniversary of when the IRS was sold. So each day, a number of IRS will come up for a reset, in the Australian market most often at today's BBSW rate.

As the IRS market has grown the value of the resets on any day has grown apace. This has meant that, on any one day, an interest rate trader may have to “roll over” billions of dollars of IRS contracts and often the bank may be in danger of making a loss because rates have moved against them. There is a tremendous temptation for traders to limit that damage and, in the situation where the bank is in profit, to increase that profit.

In just one example from Westpac in April 2010, a trader knew he would be “short” about \$14 billion of a particular “tenor” on a particular day so he bought about \$1.85 million bank bills through brokers. These purchases totally dominated the market and, as planned, drove the BBSW price down.

He then “sold” the \$1.85 million next day and bragged about the \$2 million trading profit on the deals. The size of the market has become so huge that an unscrupulous trader can make a motza by just prodding prices in a particular direction.

The masters of the universe were not even subtle about the skulduggery. One genius emailed a colleague over a few days (in a rare exchange without foul language but with the usual jargon):

“...stock is going to be used to affect a rate set that I have tomorrow ... will see how it goes [And on the next day]...So by me selling bills, I’m adding supply of bills into the market, right...which then pushes the yield higher...I’ve pushed BBSW today to 512... Now I would have lost money on the bills. However, if my rate set is larger ... than 715mil, say it’s \$2bn. I’ve pushed that rate set 6 points on \$2bn. I might have lost on 715mil, 6 points ... but net – net I’m still better off.”

This is as if an auctioneer pulled forward the sale of a property just to influence the price of another property due for auction on a particular day.

Now is this as complex as ANZ and Westpac claims?

Patently not, traders are able to do such trading not because they are smart but because they have access to a huge honeypot - the savings of ordinary Australians - which they can use to play games like buying ‘stock’ that is not needed just to force down a price. And when the unwanted stock is sold later, it is not the trader who suffers but the bank’s investors.

But manipulation of a benchmark is a so-called “victimless crime.” The traders don’t see the people they are defrauding except through the windows of their sports cars as they zip past the

bus stops.

This is not smart - but is out and out deceit. Nor is this behaviour complex but merely stand-over tactics by people who just happen to have muscle (actually paid for by the people getting beaten up).

In anticipation of the latest regulatory action, the industry body, the Australian Financial Markets Association (AFMA), has recently issued a shiny new [Code of Conduct](#) . It is somewhat churlish to point out that AFMA, also was (and still is) the administrator of the BBSW benchmark, and the shiny new code replaces an older one that was in place when the alleged misconduct was taking place. Maybe the new colour scheme will get traders to read it this time?

In previous Codes of Ethics and Conduct, a lot was made of conflicts of interest, such as manipulation.

“Members and Representatives shall be sensitive to potential conflicts of interest, and always appropriately disclose or manage them, even if this requires removing oneself from a transaction that leads to a conflict. Members and Representatives shall not misuse their position, or information they acquire by virtue of their position, for personal or corporate gain.”

In addition to the codes of conduct there were also so-called Best Practice guides for BBSW. In managing contributions to BBSW, before it was re-organised in 2013, AFMA required record keeping of instances of potential Conflicts of Interest

“The Supervisor (manager) shall keep a record of situations which give rise to a conflict of interest for the Contributing Officer (trader) and any advice given to the officer in this regard. Such records shall be provided on a regular basis to the Contributor Entity’s (the bank’s) compliance or legal function.”

Since in theory there could be a potential for a conflict of interest on any day there was an IRS

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rate reset, this means that there must be tens of thousands of such records across the industry and available to boards of directors and regulators, through compliance functions.

If they exist, these documents should be produced immediately and would surely put an end to the expensive charade of a trial one way or another.

If not available, then banks should clearly state why not and produce the equivalent documents that would show proper management of conflicts of interest.

If such documents don't exist then banks may be in breach of their licence conditions and regulators and industry bodies should be investigated as to why such essential documentation of proper controls is missing.

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