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BANKERS GONE WILD

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In order to work well, markets need a basic level of trust. As Alan Greenspan said, in 1999, "In virtually all transactions we rely on the word of those with whom we do business." So what happens to a market in which the most fundamental assumptions turn out to be lies? That is the question in a scandal that has roiled the banking industry all summer. The LIBOR (London Inter-bank Offered Rate) index is the most important set of numbers in the global financial system. Used as a benchmark for interest rates around the world, it's assembled by asking a panel of big banks to estimate what it would cost them to borrow money today, if they had to. Hundreds of trillions of dollars in derivatives, corporate loans, and mortgages are pegged to these rates. Yet we now know that for years LIBOR rates were rigged. Barclays has agreed to pay nearly half a billion dollars to regulators for its manipulations, and a host of other big banks are under investigation for similar misdeeds.

Rigging LIBOR was shockingly easy. The estimates aren't audited. They're not compared with market prices. And LIBOR is put together by a trade group, without any real supervision from government regulators. In other words, manipulating LIBOR didn't require any complicated financial hoodoo. The banks just had to tell some simple lies.

They had plenty of reasons to do so. At Barclays, for instance, traders were making big bets on derivatives whose value depended on LIBOR; changing rates by even a tiny bit could be exceptionally lucrative. In the years leading up to the financial crisis, these manipulations were, in the words of the Commodity Futures Trading Commission, "common and pervasive." And, once the crisis hit, banks had a new incentive to distort LIBOR: if their estimates were higher

than their peers' (meaning that it would be expensive for them to borrow money), investors, creditors, and regulators would worry that they were about to go under. So the banks sent LIBOR downward in order to make themselves look stronger than they were. The result was that, instead of reflecting what was real, LIBOR reflected what the banks wanted us to believe was real.

The most striking thing about this scandal is that it was predictable—the way LIBOR was designed practically invited corruption—yet no one did anything to stop it. That's because, for decades, regulators and people in the financial industry assumed that banks' desire to protect their reputations would keep them honest. If banks submitted false LIBOR estimates, the argument went, the market would inevitably find out, and people would stop trusting them, with dire consequences for their businesses. LIBOR was supposedly a great example of self-regulation, evidence that the market could look after itself better than regulators could.

But, if recent history has taught us anything, it's that self-regulation doesn't work in finance, and that worries about reputation are a weak deterrent to corporate malfeasance. To begin with, traders at a bank are typically rewarded according to how much money their trades make, not on whether they enhance the bank's reputation. Bank C.E.O.s, meanwhile, are now paid so lavishly that even when they wreak havoc on a bank's good name they can still walk away with immense amounts of money. What's more, it's not clear how good the market is at sniffing out and punishing bad behavior before serious damage is done. During the housing bubble, the stock prices of the banks that were making hundreds of billions of dollars in bad loans soared instead of falling. Once the crisis hit, the market did a great job of slamming the barn door. But it did nothing to stop the horses from escaping in the first place.

Even in the absence of market discipline, self-regulation could work if institutions had strong internal safeguards against corruption. But while every institution says that it has these norms—that's why scandals like LIBOR are always blamed on a "few rogue traders"—the track record of the banking industry over the past two decades doesn't inspire confidence in its devotion to the truth or to the public interest. The Barclays traders, for instance, sent e-mails casually thanking their colleagues for lying, and sometimes talked with their supervisors about their plans, revealing a culture in which deception was simply part of how things got done. As the behavioral economist Dan Ariely writes in his new book, "The Honest Truth About Dishonesty," cheating is contagious—when we see others succeed by cheating, it makes us more likely to cheat as well. So when institutions tolerate, and even reward, bad behavior, all that self-regulation gets you is bankers gone wild.

How do we rein them in? We could start by making it harder for the banks to game the system—LIBOR, for instance, should be revamped so that it reflects actual market rates, not self-

serving guesses. Then we need to admit that fraud is a crime and throw some people in jail. That shouldn't be too hard in the case of LIBOR, which involves no complicated debates about who knew what when. Bankers were asked a simple question, and they lied in response. Most important, though, we need an attitudinal shift on the part of regulators, who need to recognize that their gentleman's-club ethos is ill-suited to today's financial world, and who need to be aggressive not just in punishing malfeasance but in preventing it from happening. (For some tips on how to do this, they might look to the way that American police forces have dramatically lowered big-city crime rates.) This new approach would be intrusive and overbearing, and would make it harder for bankers to do what they want. In other words, it's exactly what the financial industry needs. ♦

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