LYING FOR MONEY

HOW LEGENDARY FRAUDS REVEAL THE WORKINGS OF THE WORLD

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A SCANDAL IN MAYFAIR

'Guys, you've got to hear this,' I said. I was sitting in front of my computer, with one eye on a screen of share prices and the other on a live stream of the House of Commons Treasury Select Committee hearings. As the Barclays share price took a graceful swan dive, I pulled the headphones out of the socket and turned up the volume. My colleagues left their terminals and came around to watch BBC Parliament with me. It didn't take long to realise what was happening. 'We've got to get hold of Tom.' We all agreed. 'Bob's getting murdered.'

Bob Diamond, the swashbuckling chief executive of Barclays, had been called before the committee to explain exactly what his bank had been playing at in the LIBOR scandal. The day before his appearance, he had made things very much worse by seeming to accuse the Deputy Governor of the Bank of England of ordering him to fiddle an important benchmark, then walking back the accusation as soon as it was challenged. He was trying to turn on his legendary charm in front of a committee of angry MPs and it wasn't working.

On our trading floor, calls were coming in from all over the City. Investors needed to understand what was happening and whether the damage was repairable. Tom was our designated expert on Barclays Bank but he was asleep five time zones away in New York. Without waiting to ask him I called his clients, a pretty serious breach of stockbroking etiquette. But it had to be done. The world was changing. Later that day, as Tom tried to keep in touch between meetings, he and I would exchange some harsh words, some of the only ones between us in a long working friendship.

A couple of weeks later, the damage was done. The money was gone, Bob Diamond was out of his job and the market, as it always does, had moved on. Over a glass or two of beer, Tom and I were repairing our fences and asking ourselves the unavoidable question: how did we get it so wrong?

He was the market's top analyst of British banks. I was the team's regulation specialist. Both of us had been aware of 'the LIBOR affair' and had written about it on several occasions over the previous months. But we had assumed that it would be the typical kind of regulatory risk for the banks – a slap on the wrist, a few hundred million dollars of fines, no more than that.

The first puzzle was that, to start with, it looked like we were *right*. By the time it caught the attention of the mainstream media, the LIBOR scandal had reached what would usually be the end of the story – the announcement on 27 June 2012 of a regulatory sanction. Barclays had admitted a set of facts, made undertakings not to do anything similar again, and agreed to pay a fine of £59.5m to the UK's FSA and $160m to the US Department of Justice. That's how these things are usually dealt with. If anything, it was considered quite a tough penalty.

But the LIBOR case marked the beginning of a new process for the regulators. As well as publishing their judgement, they gave a long summary of the evidence and reasoning which led to their decision. In the case of the LIBOR fines, the majority of that evidence took the form of transcripts of email and Bloomberg chat.*

Ahhh, the transcripts.

> Trader C: 'The big day [has] arrived … My NYK are screaming at me about an unchanged 3m libor. As always, any help wd be greatly appreciated. What do you think you'll go for 3m?'
> Submitter: 'I am going 90 altho 91 is what I should be posting.'
> Trader C: '[…] when I retire and write a book about this business your name will be written in golden letters […]'.
> Submitter: 'I would prefer this [to] not be in any book!'

Perhaps it's unfair to judge the LIBOR conspirators on their chat records; few of the journalists who covered the story would like to see their own Twitter direct message history paraded in front of an angry public. Trading is, for all its bluster, basically a service industry, and there is no service industry anywhere in the world whose employees don't blow off steam by acting out or insulting the customers behind their backs. But traders tend to have more than the usual level of self-confidence, bordering on arrogance in much the same way that the USA borders on Canada. And in a general climate in which the public was both unhappy with

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* Bloomberg terminals, the $50,000/year news and financial data servers that every trader uses, have a chatroom function as well as being able to give you prices and transmit news. Financial market professionals are vastly more addicted to this chat than tween girls are to Instagram and many of them failed to realise that if you discussed illegal activity on this medium you were making things easy for the authorities.

the banking industry and unimpressed with casual banter about ostentatious displays of wealth, the LIBOR transcripts appeared crass beyond belief. Every single popular stereotype about traders was confirmed. An abstruse and technical set of regulatory breaches suddenly became a morality play, a story of swaggering villains who fixed the market as if it was a crooked horse race. The politicians could hardly have failed to get involved.

It is not a pleasant thing to see your industry subjected to criticism which is at once overheated, ill-informed and entirely justified. In 2012, the financial sector finally got the kind of enemies it deserved. The popular version of events might have been oversimplified and wrong in lots of technical detail, but in the broad sweep it was right. The nuanced and technical version of events which the specialists obsessed over might have been right on the detail, but it missed one utterly crucial point: a massive crime of dishonesty had taken place. There was a word for what had happened and that word was fraud. For a period of months, it seemed to me as if the more you knew about the LIBOR scandal, the less you understood it.

That's how we got it so wrong. We were looking for incidental breaches of technical regulations, not systematic crime. And the thing is, that's normal. The nature of fraud is that it works outside your field of vision, subverting the normal checks and balances so that the world changes while the picture stays the same. People in financial markets have been missing the wood for the trees for as long as there have been markets. And bankers have ended up in worse swamps than I did.

The Cazique of Poyais

It is common for young men in a hurry to make rash career decisions. Few of us, though, have screwed it up quite as badly as a London banker by the name of Gauger.* In 1822 he was making a career in the City. A good chap from a good family, nevertheless promotion was arriving slowly in the house of Thomas, Jenkins & Co., and so Gauger decided to do what bankers have done for generations: jump a few rungs up the ladder by taking a higher-risk opportunity in an emerging market. The job in question was the role of General Manager of the Bank of Poyais, a new British colony in Central America being established by Sir Gregor MacGregor, the war hero and minor Scottish nobleman. Gauger paid a considerable sum of his family's money to purchase this commission. His trust seemed to have been reciprocated when he took delivery of a chest full of $5,000 worth of newly printed Poyais Dollars to transport to the colony's capital, the fair city of St Joseph.

Several weeks later, up to his knees in a foreign swamp, Mr Gauger must have been having second, if not third thoughts. He would never be the man to run the central bank of Poyais, for there was no such country as Poyais. Despite the engraved pictures of it that had decorated all of MacGregor's marketing material, there was no city of St Joseph. There wasn't even a trading post. The Poyais Dollars in his chest

* Or possibly Gouyer, or possibly Mauger. His name only appears in court records of the litigation arising from this episode, by which time he no longer lived in England (spoiler: this story doesn't end happily for him). I have gone for 'Gauger' as it looks more like a Huguenot name, which would make sense for a banker.

weren't completely worthless: the local Miskito children quite liked the pretty pictures on them. But that wouldn't have been much comfort to Gauger, who had encouraged many other colonists to exchange this absurd scrip for their valuable English and Scottish currency. He had been made the victim of, and party to, one of early capitalism's first and most audacious investment frauds.

Similar disappointments were felt by the other passengers of the *Honduras Packet* and *Kennersley Castle*, which between them had carried around 250 families from Britain to the mouth of the Black River, located in modern Honduras. The voyagers included cobblers (who were never going to be official shoemakers to the Princess of Poyais), musicians (never going to direct the national opera of Poyais) and soldiers (never going to take up their officers' commissions in the army of Poyais). In an even worse plight were the unskilled and agricultural colonists, who quickly realised that their dreams of an idyllic retirement running sugar plantations farmed by Native American labour were unlikely to be realised without significant unplanned work on a patch of land known as the Mosquito Coast. There was real land, but Poyais was not a real country – no capital city, no fertile plains, not much of anything except swamp and thick local rainforest.

The colonists did not take the revelation well. Those who could hitched lifts to Belize. Mr Gauger headed off to seek his fortune in the USA, where he disappears from the records; it is not known what subsequently happened to him, but if he stayed in America, he did not live long enough to appear in the 1850 census under any of his possible names. Many of the other colonists just died from heat, malnutrition, bad rum and suicide.

In London, meanwhile, the self-styled Cazique (from a local native American word meaning 'chief') of Poyais was hard at work, hustling with his bankers for a bond issue on behalf of the Government of Poyais. Sir Gregor MacGregor* was in fact preparing for the *second* London flotation of an issue of Poyais bonds, the proceeds of a previous issue already having been largely wasted. The Cazique was a descendant of Rob Roy who had, like many ambitious officers after the Napoleonic Wars, joined in the independence struggles of Spain's South American colonies and failed to gain either fortune or honour. He returned to London with a highly embellished account of his service and the claim that he had been asked by the Poyais tribe of Native Americans to become their king. On this basis, he appointed brokers to raise sovereign debt and started selling parcels of land and passages on the *Kennersley Castle* and *Honduras Packet*.† We

* Or to give him his full official noble rank, Mr Gregor MacGregor; the knighthood was meant to be a Portuguese order granted during the Peninsular War but was every bit as bogus as the Cazique title. He was a genuine member of the clan and related to Scottish nobility, but his only earned titles were military – a Captain in the British Army (forced to resign for disrespecting superiors) and various titles from Colonel to General in various versions of the Venezuelan and Colombian armies in which he had served as a mercenary. 'General' doesn't mean all that much – Simón Bolívar and Francisco de Miranda tended to hand out promotions instead of pay to officers when times were thin.

† It is more complicated than this. In fact, as far as anyone can tell, MacGregor provided so many assisted places to colonists and advances against their wages in the non-existent thriving Poyaisian economy, that he probably lost money on sales to colonists, which was partly what the funds raised by the sovereign loans were meant to cover. It was not wholly clear, either to his contemporaries or to us with the benefit of hindsight, what he thought he was playing at.

haven't heard the last of him. For now, though, we need to ask the question: how did this fantasist manage to take anyone in?

The shallow answer explains the Poyais fraud historically. In fact, there were plenty of countries raising money on the London market which didn't, in the modern sense, exist. It was the early 1800s and the Spanish possessions in the Americas (which, at the time, still included modern Florida) were going through a series of independence struggles. The revolutionary governments of New Granada and Venezuela, among others, had not been recognised by the British Crown. Their loans were sold at significant discounts to speculators who could expect a windfall if the state lasted long enough to redeem the principal. These were high-risk, high-return investments, generally bought by gamblers who knew what they were getting into.

So much for the financial backers. But even the colonists deserve some slack, incredible as their naïvety sounds at first. If they had checked in the library, they would have found a book called *Sketch of the Mosquito Shore* in which the fertile plains of Poyais and its bustling capital were described – MacGregor had faked it, under the pseudonym 'Thomas Strangeways', copying out all the most favourable bits from almanacs of the West Indies and Latin America and then exaggerating them. He claimed that the soil was so fertile that three or four plantings of rattan would have to be made before it was sufficiently impoverished to be good for sugar cane, and that the native Miskito tribe wanted nothing more in the world than to work for British settlers, preferring to be paid in cheap textiles rather than cash. Presumably in order to sound credible, he restricted himself to saying that the Black

River was full of golden nuggets, rather than claiming they grew from the trees.

If they had gone to the Court of Chancery, they would have found official documents certifying the ownership of the land – MacGregor had sworn false affidavits to have the claim 'inrolled' there, based on a much more limited letter of intent (which did not include the granting of any titles of nobility like 'Cazique', by the way) which he had extracted from the tribal leader of all the Mosquito Coast peoples including the Poyais, 'King George Frederick', whom he had treated to copious amounts of whisky one night while on the run from a previous adventure.* The Poyais bonds were sold and traded on the London Stock Exchange and quoted in the newspapers alongside those of the Bank of England.

Even the usual protection against scams – that if something seems too good to be true, it is – would not necessarily have protected anyone. The small territories of Latin America were at the time often giving substantial incentives to attract

* This also was not necessarily as weird as it seems. Tribal societies did make land deals, and these sometimes involved the granting of royal or equivalent status in the tribal society to foreign land promoters. The ability to sell one's land is an important benefit of owning it, and in the absence of a developed society with land registries and law courts, strange things sometimes have to be done. This sort of consideration was a major part of the motivation for the Treaty of Waitangi, for example, as agreed between colonists and the Māori of New Zealand. By establishing that property rights in land were assigned to chiefs, and that transactions between Maori and colonists would be governed by statute law (at the time, that of New South Wales), the treaty aimed to tackle what was becoming a fairly serious problem whereby small Maori family groups would draw up 'sale' agreements for huge tracts of land with passing opportunistic explorers, who would then demand that the colonial administration enforce their claims.

settlers, particularly Europeans with capital and skills. If it seems fanciful that you could buy valuable land for a pittance and then commandeer nearly costless labour to get incredibly rich developing it, bear in mind that this is exactly what the plantation fortunes of Jamaica and the United States were based on. So it wasn't as easy to see through this mirage as one might think. It was just more difficult to find things out in those days.

That, in my view, is the shallow explanation of how it happened.

The deeper explanation is that it only looks ridiculous to us because we have different blind spots today to the ones that people had at the start of the nineteenth century. And the troubling corollary of that is: there are always blind spots.

The Canadian Paradox

Some places in the world are what they call 'low-trust societies'. The political institutions are fragile and corrupt, business practices are dodgy, debts are rarely repaid and people, rightly, fear being ripped off on any transaction. In the 'high-trust societies', conversely, businesses are honest, laws are fair and consistently enforced and the majority of people can go about their day in the knowledge that the overall level of integrity in economic life is very high. With that in mind, given what we know about the following two countries, why is it that the Canadian financial sector is so fraud-ridden that Joe Queenan, writing in *Forbes* magazine in 1985, nicknamed Vancouver the 'Scam Capital of the World', while ship owners in Greece will regularly do multimillion-dollar deals on a handshake?

We might call this the 'Canadian Paradox'.* There are different kinds of dishonesty in the world. The most profitable kind is commercial fraud, and commercial fraud is parasitical on the overall health of the business sector on which it preys. It is much more difficult to be a fraudster in a society in which people only do business with relatives or where commerce is based on family networks going back for centuries. It is much easier to carry out a securities fraud in a market where dishonesty is the rare exception rather than the everyday rule.

The existence of the Canadian Paradox suggests that there is a specifically *economic* dimension to a certain kind of crime of dishonesty. Trust – particularly between complete strangers, with no interactions beside relatively anonymous market transactions – is the basis of the modern industrial economy. And the story of the development of the modern economy is in large part the story of the invention and improvement of technologies and institutions for managing that trust. In other words, many things about the way the business world is organised make a lot more sense when you realise that they exist because of the constant drive for countries to become less like Greece and more like Canada.

And as industrial society develops, it becomes easier to be a victim. In *The Wealth of Nations*, Adam Smith described how prosperity derived from the division of labour – the eighteen distinct operations that went into the manufacture of a pin,

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* Am I being unfair to the Canadians? Is this kind of fraud really more prevalent in Canada than in other countries? Criminological and statistical issues with respect to defining, detecting and categorising fraud as a crime more or less guarantee that a proper answer to this question is impossible. But Canada, and particularly its regional stock exchanges, does have a reputation.

for example. While this was going on, the modern world also saw a growing *division of trust*. In previous eras when people set out across continents to discover new worlds, they had known that they were stepping out into the unknown, but Mr Gauger was at the cutting edge of a new reality. Already, he belonged to a class of people whose natural assumption was to take things on trust, to assume that the fact that an offer was extended publicly meant that it was probably legitimate. Nearly 200 years later, his equivalents in the City of London were no more likely to expend personal effort on checking things for fraud than to throw their own pots and sew their own trousers. The more a society benefits from the division of labour in checking up on things, the further you can go into a con game before you realise that you're in one. In the case of Mr Gauger, he ended up to his knees in brackish water. In the case of several dealers in the LIBOR market, by the time anyone realised something was crooked, they were several billions of dollars in over their heads.

The LIBOR Scandal

With the perspective of a few years' hindsight, the system was always a shoddy piece of work. Some not-very-well-paid clerks from the British Bankers' Association called up a few dozen banks and asked 'If you were to borrow, say, a million dollars in [a given currency] for a 30 day deposit,* what would you expect to pay?'. They would throw away the

* A short-term loan from one bank to another. Due to the inconvenient habit of customers to borrow from one bank and put the money in an account at another, banks are always left either with surplus customer deposits, or short

highest and lowest outliers and calculate the average of the rest, which would be recorded as '30 day LIBOR' for that currency. The process would be repeated for three-month loans, six-month loans and any other periods of interest, and the rates would be published. You would then have a little table recording the state of the market on that day – you could decide which currency you wanted to borrow in and how long you wanted the use of the money, and the LIBOR panel would give you a good sense of what high-quality banks were paying to do the same.

Compared to the amount of time and effort that goes into the systems for nearly everything else banks do, not very much trouble was taken over this process. Other markets rose and fell, stock exchanges mutated and were taken over by super-fast robots, but the LIBOR rate for the day was still determined by a process that could only slightly unfairly be termed 'a quick ring-around'. Nobody noticed until it was too late that hundreds of trillions of dollars* of the world economy rested on a number compiled by the few dozen people in the world with the greatest incentive to fiddle it.

It all fell apart in the immediate aftermath of the collapse of Lehman Brothers in 2008, when banks were so scared that they effectively stopped lending to each other. Although the market was completely frozen, the daily LIBOR ring-around still took place, and banks still gave, almost entirely

of funds. The 'London Interbank' market is where they sort this out by borrowing from and lending to each other, at the 'Offered Rate' of interest.

* Yes hundreds, and yes trillions. LIBOR, as a measure of 'the general state of short-term interest rates' was an incredibly useful number to have, and so it became the industry standard benchmark for floating rate loans, of which there are a lot.

speculatively, answers to the question 'If you were to borrow a reasonable size, what would you expect to pay?'.

But the daily quotes were published, and that meant everyone could see what everyone else was saying about their funding costs. And one of the tell-tale signs of a bank in trouble is that its funding costs start to rise. If your LIBOR submission is taken as an indicator of whether you're in trouble or not, you really don't want to be the highest number on the daily list. Naturally, then, quite a few banks started using the LIBOR submission process as a form of false advertising, putting in a lowballed quote in order to make it look like they were still obtaining money easily when they, in fact, could hardly borrow at all. And so it came to pass that several banks created internal message trails saying, in effect, 'Dear Lowly Employee, for the benefit of the bank and its shareholders, please start submitting a lower LIBOR quote, signed Senior Executive'. This turned out to be a silly thing to do.

All this was known at the time. There was an article in the *Wall Street Journal* about it. I used to prepare PowerPoint slides with charts on them that had gaps for the year 2008 because the data was 'somewhat hypothetical'. The regulators held a 'liaison committee' meeting so that representatives from the banks could discuss the issue of LIBOR reporting, and even published its minutes on the Bank of England website. What nobody seemed to realise is that an ongoing crime was being committed, and the name of that crime is fraud. There was a conspiracy to tell a lie (about the bank's true cost of funding, to the LIBOR phone panel), in order to induce someone to enter into a bargain at a disadvantage to themselves. If one looks back to the Ten Commandments or to the oldest common law, it's in the book – thou shalt not bear false witness. This was, in fact, how the majority of the LIBOR offences were eventually tried. And the general public caught onto all this a lot quicker than the experts did, which put the last nail in the coffin of the already weakened trust in the financial system. You could make a case that a lot of the populist politics of the subsequent decade can be traced back to the LIBOR affair.

As I found myself reflecting over coffee in Maddox Street, LIBOR teaches us a valuable lesson about commercial fraud – that unlike other crimes, it has a problem of denial as well as one of detection. There are very few other criminal acts where the victim not only consents to the criminal act, but voluntarily transfers the money or valuable goods to the criminal. And the hierarchies, status distinctions and networks which make up a modern economy also create powerful psychological barriers against seeing fraud when it is happening. White-collar crime is partly defined by the kind of person who commits it: a person of high status in the community, the kind of person who is always given huge helpings of the benefit of the doubt.

Trust and its abuses

In terms of financial damage, LIBOR was massively worse than Poyais, although nobody directly died from it. But the thread that links the two of them is that the blind spots are built into the system, and only become glaringly apparent once the whole thing has collapsed and people are watching the sun set over a pestilent swamp where a capital city ought to be. The problem is that whenever you're creating an