Wall Street Greed and the Corrupt Global Banking Cartel: Too Big to Prosecute? Not for a California Jury

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Sixteen of the world's largest banks have been caught colluding to rig global interest rates. Why are we doing business with a corrupt global banking cartel?

United States Attorney General Eric Holder has declared that the too-big-to-fail Wall Street banks are too big to prosecute. But an outraged California jury might have different ideas. As noted in the California legal newspaper The Daily Journal:

> California juries are not bashful – they have been known to render massive punitive damages awards that dwarf the award of compensatory (actual) damages. For example, in one securities fraud case jurors awarded $5.7 million in compensatory damages and $165 million in punitive damages. . . . And in a tobacco case with $5.5 million in compensatory damages, the jury awarded $3 billion in punitive damages . . . .

The question, then, is how to get Wall Street banks before a California jury. How about charging them with common law fraud and breach of contract? That's what the FDIC just did in its massive 24-count civil suit for damages for LIBOR manipulation, filed in March 2014 against sixteen of the world's largest banks, including the three largest US banks – JP Morgan Chase, Bank of America and Citigroup.

LIBOR (the London Interbank Offering Rate) is the benchmark rate at which banks themselves can borrow. It is a crucial rate involved in over $400 trillion in derivatives called interest-rate swaps, and it is set by the sixteen private megabanks behind closed doors.

The biggest victims of interest-rate swaps have been local governments, universities, pension funds, and other public entities. The banks have made renegotiating these deals prohibitively expensive, and renegotiation itself is an inadequate remedy. It is the equivalent of the grocer giving you an extra potato when you catch him cheating on the scales. A legal action for fraud is a more fitting and effective remedy. Fraud is grounds both for rescission (calling off the deal) as well as restitution (damages), and in appropriate cases punitive damages.

Trapped in a Fraud

Nationally, municipalities and other large non-profits are thought to have as much as $300 billion in outstanding swap contracts based on LIBOR, deals in which they are trapped due to prohibitive termination fees. According to a 2010 report by the SEIU(Service Employees

International Union):

> The overall effect is staggering. Banks are estimated to have collected as much as $28 billion in termination fees alone from state and local governments over the past two years. This does not even begin to account for the outsized net payments that state and local governments are now making to the banks. . . .
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> While the press have reported numerous stories of cities like Detroit, caught with high termination payments, the reality is there are hundreds (maybe even thousands) more cities, counties, utility districts, school districts and state governments with swap agreements [that] are causing cash strapped local and city governments to pay millions of dollars in unneeded fees directly to Wall Street.

All of these entities could have damage claims for fraud, breach of contract and rescission; and that is true whether or not they negotiated directly with one of the LIBOR-rigging banks.

To understand why, it is necessary to understand how swaps work. As explained in my last article here, interest-rate swaps are sold to parties who have taken out loans at variable interest rates, as insurance against rising rates. The most common swap is one where counterparty A (a university, municipal government, etc.) pays a fixed rate to counterparty B (the bank), while receiving from B a floating rate indexed to a reference rate such as LIBOR. If interest rates go up, the municipality gets paid more on the swap contract, offsetting its rising borrowing costs. If interest rates go down, the municipality owes money to the bank on the swap, but that extra charge is offset by the falling interest rate on its variable rate loan. The result is to fix borrowing costs at the lower variable rate.

At least, that is how they are supposed to work. The catch is that the swap is a separate financial agreement – essentially an ongoing bet on interest rates. The borrower owes *both* the interest onits variable rate loan *and* what it must pay on its separate swap deal. And the benchmarks for the two rates don't necessarily track each other. The rate owed on the debt is based on something called the SIFMA municipal bond index. The rate owed by the bank is based on the privately-fixed LIBOR rate.

As noted by Stephen Gandel on CNNMoney, when the rate-setting banks started manipulating LIBOR, the two rates decoupled, sometimes radically. Public entities wound up paying substantially more than the fixed rate they had bargained for – a failure of consideration constituting breach of contract. Breach of contract is grounds for rescission and damages.

Pain and Suffering in California

The SEIU report noted that no one has yet completely categorized all the outstanding swap deals entered into by local and state governments. But in a sampling of swaps within California, involving ten cities and counties (San Francisco, Corcoran, Los Angeles, Menlo Park, Oakland, Oxnard, Pittsburgh, Richmond, Riverside, and Sacramento), one community college district, one utility district, one transportation authority, and the state itself, the collective tab was $365 million in swap payments annually, with total termination fees exceeding $1 billion.

Omitted from the sample was the University of California system, which alone is reported to have lost tens of millions of dollars on interest-rate swaps. According to an article in the Orange County Register on February 24, 2014, the swaps now cost the university system an estimated $6 million a year. University accountants estimate that the 10-campus system will lose as much as $136 million over the next 34 years if it remains locked into the deals, losses that would be reduced only if interest rates started to rise. According to the article:

> Already officials have been forced to unwind a contract at UC Davis, requiring the university to pay $9 million in termination fees and other costs to several banks. That sum would have covered the tuition and fees of 682 undergraduates for a year.
>
> The university is facing the losses at a time when it is under tremendous financial stress. Administrators have tripled the cost of tuition and fees in the past 10 years, but still can't cover escalating expenses. Class sizes have increased. Families have been angered by the rising price of attending the university, which has left students in deeper debt.

Peter Taylor, the university's Chief Financial Officer, defended the swaps, saying he was confident that interest rates would rise in coming years, reversing what the deals have lost. But for that to be true, rates would have to rise by multiples that would drive interest on the soaring federal debt to prohibitive levels, something the Federal Reserve is not likely to allow.

The Revolving Door

The UC's dilemma is explored in a report titled "Swapping Our Future: How Students and Taxpayers Are Funding Risky UC Borrowing and Wall Street Profits." The authors, a group called Public Sociologists of Berkeley, say that two factors were responsible for the precipitous decline in interest rates that drove up UC's relative borrowing costs. One was the move by the Federal Reserve to push interest rates to record lows in order to stabilize the largest banks. The other was the illegal effort by major banks to manipulate LIBOR, which indexes interest rates on most bonds issued by UC.

Why, asked the authors, has UC's management not tried to renegotiate the deals? They pointed to the revolving door between management and Wall Street. Unlike in earlier years, current and former business and finance executives now play a prominent role on the UC Board of Regents.

They include Chief Financial Officer Taylor, who walked through the revolving door from Lehman Brothers, where he was a top banker in Lehman's municipal finance business in 2007. That was when the bank sold the university a swap related to debt at UCLA that has now become the source of its biggest swap losses. The university hired Taylor for his $400,000-a-year position in 2009, and he has continued to sign contracts for swaps on its behalf since.

Investigative reporter Peter Byrne notes that the UC regent's investment committee controls *$53 billion* in Wall Street investments, and that historically it has been plagued by self-dealing. Byrne writes:

> Several very wealthy, politically powerful men are fixtures on the regent's investment committee, including Richard C. Blum (Wall Streeter, war

> contractor, and husband of U.S. Senator Dianne Feinstein), and Paul Wachter (Gov. Arnold Schwarzenegger's long-time business partner and financial advisor). The probability of conflicts of interest inside this committee—as it moves billions of dollars between public and private companies and investment banks—is enormous.

Blum's firm Blum Capital is also an adviser to CalPERS, the California Public Employees' Retirement System, which also got caught in the LIBOR-rigging scandal. "Once again," said CalPERS Chief Investment Officer Joseph Dear of the LIBOR-rigging, "the financial services industry demonstrated that it cannot be trusted to make decisions in the long-term interests of investors." If the financial services industry cannot be trusted, it needs to be replaced with something that can be.

Remedies

The Public Sociologists of Berkeley recommend renegotiation of the onerous interest rate swaps, which could save up to $200 million for the UC system; and evaluation of the university's legal options concerning the manipulation of LIBOR. As demonstrated in the new FDIC suit, those options include not just renegotiating on better terms but rescission and damages for fraud and breach of contract. These are remedies that could be sought by local governments and public entities across the state and the nation.

The larger question is why our state and local governments continue to do business with a corrupt global banking cartel. There is an alternative. They could set up their own publicly-owned banks, on the model of the state-owned Bank of North Dakota. Fraud could be avoided, profits could be recaptured, and interest could become a much-needed source of public revenue. Credit could become a public utility, dispensed as needed to benefit local residents and local economies.

Ellen Brown is an attorney, founder of the Public Banking Institute, and a candidate for California State Treasurer running on a state bank platform. She is the author of twelve books, including the best-selling Web of Debt and her latest book, The Public Bank Solution, which explores successful public banking models historically and globally.

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