How Banks Cheat Taxpayers

By Matt Taibbi, Rolling Stone
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A good friend of mine sent me a link to a small story last week, something that deserves a little attention, post-factum.

The Bloomberg piece is about J.P. Morgan Chase winning a bid to be the lead underwriter on a $400 million bond issue by the state of Massachusetts. Chase was up against Merrill for the bid and won the race with an offer of a 2.57% interest rate, beating Merrill's bid of 2.79. The difference in the bid saved the state of Massachusetts $880,000.

Afterward, Massachusetts state treasurer Steven Grossman breezily played up the benefits of a competitive bid. "There's always a certain amount of competition going on out there," Grossman said in a telephone interview yesterday. "That's good. We like competition."

Well … so what, right? Two banks fight over the right to be the government's underwriter, one submits a more competitive bid, the taxpayer saves money, and everyone wins. That's the way it ought to be, correct?

Correct. Except in four out of five cases, it still doesn't happen that way. From the same piece [emphasis mine]:

Nationwide, about 20 percent of debt issued by states and local governments is sold through competitive bids. *Issuers post public notices asking banks to make proposals and award the debt to the bidder offering the lowest interest cost. The other 80 percent are done through negotiated underwriting, where municipalities select a bank to price and sell the bonds.*

By "negotiated underwriting," what Bloomberg means is, "local governments just hand the bid over to the bank that tosses enough combined hard and soft money at the right politicians."

There is absolutely no good reason why all debt issues are not put up to competitive bids. This is not like defense contracting, where in some situations it is at least theoretically possible that X or Y company is the world's only competent manufacturer, say, of armor-plated Humvee doors, or some such thing. It's still wrong and perverse when companies like Halliburton or Blackwater get sole-source defense contracts, but at least there's some kind of theoretical justification there.

But this is a bond issue, not rocket science. In most cases, all the top investment banks will offer virtually the same service, with only the price varying. Towns and cities and states lose billions of dollars every year allowing financial services companies to overcharge them for underwriting.

It gets even worse in the derivatives markets, where banks routinely overcharge state and local governments for things like interest rate swaps, for one very obvious reason - swaps are not traded on open exchanges, so only the banks know how to price them.

Imagine what NFL gambling would be like if the casinos didn't publish the point spreads every week, and you'll get a rough idea of how the swap market works. If you couldn't look it up, how many points would you give the Dolphins against the Jets next week? Two? Five? Seven? The big casinos know, because they're taking all that action, that the real number is one point.

In the same vein, exactly how accurately do you think some local county treasurer might be able to guess the cost of an interest rate swap for his local school system? Answer: he'd probably do about as well as you or I would, guessing the odds on a Croatian soccer match.

The big banks know this, which is why there should never, ever be non-competitive bids for those sorts of financial services. In a sole-source contract for a swap deal, you're trusting a (probably corrupt)

Too-Big-To-Fail bank to give you a good deal for a product whose price is not publicly listed anywhere.

There have been numerous investigations and lawsuits across the world connected with this sort of systematic overcharging, from Erie, Pennsylvania to the notorious Jefferson County, Alabama case, to Milan, Italy (which sued Chase and four other banks for misleading them about derivative prices).

In the Erie case, Chase recommended to the locals that they hire a financial adviser to review the deal. What they didn't tell the local government was that Chase had paid a fee to this adviser, a firm called Investment Management Advisory Group Inc., or IMAGE. They pulled the same scam with the school district of Butler County, Pennsylvania.

And in the oft-discussed Jefferson County case alone, Chase reportedly overcharged the locals $100 million for the crooked swap deals that, in a completely separate outrage, will probably leave Birmingham bankrupt for the next generation.

All of which is exactly what people like the OWS protesters are complaining about when they talk about greed and excess on Wall Street. Nobody is begrudging a bank's desire to make money, and nobody is saying a bank shouldn't be allowed to make money, even a lot of money, performing legitimate services for the state and the taxpayer.

But when you put a thumb on the scale in a financial services contract, the costs start to get outrageous very quickly. The banks would still do a very crisp, almost effortlessly lucrative business if they just stuck to submitting competitive bids for legitimate work - but instead of that, they for some reason have to game the system, grease politicians, rig bids, and stick the taxpayer with overpriced products. Which sucks, of course. Hopefully politicians will catch on and go the Massachusetts route more often.