Case 1
The Barings Bank Disaster

Course: FIN B 365
Dr. Bidisha Chakrabarty

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SOURCE: N. INSTEFJORD, P. JACKSON, W. PERRAUDIN: SECURITIES FRAUD AND IRREGULARITIES, IN: ARTHUR ANDERSEN: OPERATIONAL RISK AND FINANCIAL INSTITUTIONS, P. 148, 1998.

The Collapse of Barings Bank

In 1984, the merchant bank Barings & Co acquired a team from a UK broker, Henderson Crosthwaite, and began building a subsidiary, Barings Securities Limited (BSL), specializing in trading Far Eastern securities. Barings recruited Nick Leeson in July, 1989, to work in futures and options settlement in its London office. In March, 1992, Nick Leeson was transferred to Singapore to run the back office of Barings Future Singapore (BFS), a Barings subsidiary involved in futures dealing on the Singapore Monetary Exchange, SIMEX. He was promoted rapidly and by late 1992 he was BFS's general manager and head trader.

Much of BFS's business consisted of own-account trading aimed at exploiting small pricing differences between similar contracts on the Singapore and Japanese exchanges. It also acted as broker for clients wishing to trade on SIMEX. From late 1992 until early 1995, Leeson reported increasingly large profits on apparently risk free arbitrage trading in which positions on SIMEX were supposedly hedged by equal, offsetting positions on Japanese exchanges.

In fact, Leeson was conducting an elaborate deception. From the first, he made losses. To conceal the losses, Leeson employed a hidden SIMEX account numbered 88888, persuading a back office programmer to alter Barings accounting systems so that the information about 88888 would not be reported back to London. The fact that Leeson was in charge of both dealing and back office operations in BFS was crucial in facilitating the deception.

In August, 1994, an internal audit of BSL concluded that the lack of segregation between front and back offices should be reflected but Barings' management did not implement the recommendation. In January, 1995, SIMEX became concerned that Barings might be financing its clients' trading, in particular an account 88888, against the rules of the exchange. It wrote to BSL to query this. Also in January, the BFS auditors, Coopers & Lybrand Singapore, became concerned about a receivable of £ 50 million, apparently due from a New York-based trader. In fact, Leeson had forged the documentation on this receivable in his efforts to cover up his activities in raising funds for margin payments on his increasingly large losses.

In early February, Barings dispatched London staff to Singapore to establish what was happening. In the week beginning February 13 a settlement clerk sent from London found an apparent gap of $ 200 million in BFS’s positions. On the evening of February 23, Leeson and his wife fled to Kuala Lumpur, from where he faxed his resignation.

Strenuous efforts by the Bank of England to organize a rescue of Barings on the following three days failed largely because it was impossible to gauge Barings’ exposure accurately. On the night of February 26, Barings was therefore declared insolvent as of February 27, 1995, to the tune of £ 827 million. The cumulative loss after liquidation was £ 927 million. A week later, Barings was taken over by International Nederlands Group NV (ING), a large Dutch banking and insurance group. The SFA took disciplinary action against individual directors of Barings resulting in several being banned as directors or managers.

SOURCE: ECONOMIST: A FALLEN STAR, LONDON, SINGAPORE, 03-04-95.

A FALLEN STAR

“DERIVATIVES need to be well controlled and understood, but we believe we do that here". So said Peter Baring, chairman of Baring Brothers, in October 1993, at the launch of the bank's joint venture in derivatives with Britain's Abbey National. His belief proved mistaken.....

Barings' collapse shocked the financial world not because of its size - with #5.9 billion of assets at the end of 1993, it is an international toddler - but because of the strong position it built in emerging markets even before they became fashionable, and because of the bank's illustrious 233-year-old history. Barings was steeped in tradition (in 1818 a Frenchman dubbed it Europe's sixth great power), and still largely run by family members - though most of the shares have for the past 25 years been vested in a charitable foundation. Barings had a reputation for caution and conservatism, even though it was famously rescued in 1890 by a consortium led by the Bank of England after it had lost millions in Argentine loans.

How did one fresh-faced trader do to Britain's oldest bank what Argentina failed to do 105 years ago? Mr. Baring has suggested that there could have been a conspiracy by Mr. Leeson and outside associates that was designed to force the bank under. That would be thrilling; but the truth is likely to be more prosaic. Most of Mr. Leeson's losses came from trading two ordinary derivative instruments based on the Nikkei: futures contracts (agreements to buy or sell an asset at a fixed price at a defined date) and options contracts (which give the right, but not the obligation, to buy or sell the asset). He was also trading contracts on Japanese bonds and interest rates.

…. Mr. Leeson was supposed to be "arbitraging", seeking to profit from differences in the prices of Nikkei-225 futures contracts listed on the Osaka Securities Exchange (OSE) in Japan and the Singapore Monetary Exchange (SIMEX). Such arbitrage involves buying futures contracts on one market and simultaneously selling them on another. Since the margins on this are small, the volumes traded by arbitrageurs tend to be large. However, the strategy is not very risky: a long position in one market (i.e., one betting on a rise) is offset by a short position (i.e., one betting on a fall) in the other. Arbitrage should not have broken Barings. Mr. Leeson's trading strategy seems, however, to have evolved well beyond arbitrage.

Instead of hedging his positions, he gambled on the future direction of the Japanese markets. According to Eddie George, the governor of the Bank of England, Mr. Leeson began doing this at the end of January. His unhedged positions escalated rapidly. By February 23rd, when his superiors belatedly twigged what he was up to, Mr. Leeson had bought $7 billion-worth of stock-index futures and sold $20 billion-worth of bond and interest-rate futures contracts. Most of Barings' losses came from the stock-index futures.

Barings is not commenting officially on Mr. Leeson's transactions. But sources within the bank suggest a slightly different story from Mr. George's. In this version, Mr. Leeson's gambling started last September (or even earlier), when he decided simultaneously to sell put options (conferring a right to sell) and call options (a right to buy) on Nikkei-225 futures. These deals, known as "straddles", make profits for the seller of the options provided that the market proves less volatile than the option prices predict. Mr. Leeson sold up to 40,000 such option contracts. Traders at other banks reckon that, in doing so, he earned Barings $150m by the end of 1994.

Profits like this are never earned without risk, as Mr. Leeson discovered when the Kobe earthquake struck on January 17th. The Nikkei wobbled - and Mr. Leeson's strategy crumbled. For it to pay off, the Nikkei had to stay in the 18,500-19,500 range. Worried that the market would fall below 18,500, Mr. Leeson seems to have bought Nikkei futures on a huge scale in an attempt to push it up. This was not easy: the Tokyo stock market is the world's second largest. And on January 23rd disaster struck: the Tokyo stock market plunged 1,000 points to under 17,800. Mr. Leeson threw caution to the wind. There were bonuses, due to be fixed on Friday, February 24th, to consider. Hence his increasingly desperate attempts in February to buy enough Nikkei futures to force the market up. And hence, when he failed, the huge losses that sank the bank.

Failure on the bridge

Why did Barings not tumble to Mr. Leeson's activities before it was too late? One answer is that nobody was watching him closely: in effect, **he** was Baring Futures Singapore. He was sent out in 1992 as head of settlements, before moving on to become head of trading. He seemed successful; last year, Barings' profits from futures trading rose from Sdollars 2m ($1.2m) to SDollars 20m.

The risk that this success disguised was the all-encompassing nature of Mr. Leeson's job. Astonishingly, the bank did not require him to give up his job as head of settlements when he became head of trading. At most other banks the two functions are segregated. Allowing a trader to settle his own deals makes it simpler for him to hide the risks he is taking, or the amounts of money he is losing. The bank also lacked an independent risk management unit to provide another check on Mr. Leeson. "There was no control system," says a former colleague; "Nick was the system." Barings itself recognized these deficiencies. It was planning to break up Mr. Leeson's dual role and to create a new derivatives department. And it had hired a risk manager from Bankers Trust, an American bank.

None of this explains why Barings' managers failed to spot the huge amount of cash that Baring Futures had to pay out to both SIMEX and the OSE to support its futures positions. Firms that deal on a futures exchange must first deposit a lump sum (called "initial margin") with the clearing-house that backs the exchange. If the value of their contracts falls, they are required to top that sum up daily with additional margin calls. A rogue trader should thus be quickly spotted on a futures exchange.

Yet Mr. Leeson's deals apparently raised no suspicions, even though traders at rival firms were astonished at the growth of Barings' positions. When the crisis broke, the bank's exposure on the OSE was eight times as big as it’s nearest rival; its position on SIMEX was even bigger. Why did nobody within Barings (or at the exchanges) investigate? The answer, according to one Barings executive, is that the cash for margin payments flowing out of Baring Futures did not exceed the bank's set limits until February 23rd, the day Mr. Leeson fled Singapore.

Given that the losses were by then big enough to sink the bank, it seems surprising that Mr. Leeson could explain irregularities to his bosses and to internal auditors, who looked at Baring Futures three times in the past 12 months. Because initial margin calls are the same for a long position as for a short one, he seems to have persuaded his bosses that the cash outflow was consistent with his arbitrage strategy - although had this been the case, Barings would have received later margin payments, not paid them. To meet these later calls, Mr. Leeson may have employed a fictitious client account at Barings that he had set up as long ago as 1992.

Into this account went some of Barings' cash, including all the proceeds of Mr. Leeson's options sales. He may then have used the fictitious account to pay the further margin calls on his futures positions. When the account was exhausted, he turned to Barings in London. They were happy to fork out because the "client" had earlier given them so much commission (this suggests a cavalier attitude to customers as well as to internal controls). Only on February 22nd did the bank uncover the awful truth.

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Yet this strategy had a big flaw that may help to explain Barings' collapse. By giving its individual businesses plenty of autonomy, it failed to foster a common culture. The old style bankers who dominate Barings' senior management have long looked down their aristocratic noses at the traders who run the bank's securities operations. Management became too thinly spread across the banks' activities. This flaw caused the bank grief long before Mr. Leeson.

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Derivative despair

The Barings disaster raises fresh questions about the financial markets' policemen. The British government has already ordered an inquiry. It will want to establish if the exchanges or their regulators could have done more to stop the bank from its own folly. It will also look again at the vexed questions of whether the globalization of financial markets and the spread of derivatives trading require tough new regulations.

The exchanges probably could have done better. Neither the Osaka nor the Singapore markets emerge from this affair covered in glory. They failed to ferret out why Baring Futures was racking up unusually large positions. They asked for information; but the firm seems to have responded with a few fictitious client names. Nor are the exchanges good at sharing information. This is because the OSE is cross that SIMEX stole its business after the Japanese authorities forced it to raise its margin rates to the highest in the world. Yet neither exchange can hope to prevent firms going bust - and thus putting their members' capital at risk - if they do not pool information.

International regulators also need to work together more closely. British regulators have received only the scantiest of information from the Monetary Authority of Singapore, the country's bank regulator, even after the Barings collapse. Yet domestic lead regulators - whose task it is to oversee the entire position of their charges - cannot do their job unless they keep in touch with banks' activities in other jurisdictions. In this respect, regulators seem to have gone global less rapidly than their charges.

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There are clearly risks for anyone who deals in derivatives; the ease with which they can be used to assume risk creates hazard. Barings now knows that better than most. Yet the firm also seems to have learnt little in the 100-odd years since it last went bust. Reams of reports have been written advising companies how they should manage derivatives risks. The Group of Thirty, a think-tank, came out with a list of specific recommendations in 1993. By one estimate, Barings ignored half of them. Its collapse should teach other banks a useful lesson.

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