

## Baring Brothers & Co. Ltd

### Summary

In February 1995, Baring Brothers & Co. Ltd (Barings) London, collapsed after losses of £827 million following unauthorised trading in derivatives by Nick Leeson in its Singapore subsidiary (Barings Futures (Singapore) Pte. Ltd, that completely wiped out the bank's capital of £200 million, leaving it unable to meet its obligations.

The disaster could have been greatly mitigated, if not entirely avoided, had earlier internal audit reports drawing attention to potential risks had been given the importance they deserved and acted upon immediately. For example, Leeson, the trader, was responsible for managing the back-office; suspense accounts were not being properly reconciled; because of internal office jealousies in London nobody was asking to see evidence of the "customers" for whom positions were purportedly taken and on which margin had to be paid, etc.

In addition, the small Singapore office was producing profits out of all proportion to its size, something that should have raised questions in London. The Barings collapse must surely be considered as a classic example of the perils of not acting upon, or simply ignoring, critical audit reports.

### How did Barings collapse so quickly?

In mid-February 1995 a senior settlements clerk was seconded from London to Singapore to cover a local colleague's maternity leave and quickly identified some major problems, not least of which appeared to be a US\$190 million black hole in the accounts. On 23<sup>rd</sup> February there was a meeting between Leeson and the senior settlements clerk to sort out the problem, but after some 30 minutes Leeson made excuses and left the meeting never to return.

Subsequent investigations revealed that by the end of 1992 Leeson had built up hidden cumulative losses of £2 million, a figure that remained largely unchanged until the end of October 1993. During November and December 1993, losses grew sharply to £23 million.

In 1994 the cumulative loss was £208 million, slightly more than the reported Barings Bank Group profit of £205 million, and more than double the £102 million in bonuses which Barings had paid out that year.

Remarkably in 1994, Leeson was recorded as having produced for Barings some £28.5 million in revenue, equivalent to 77% of the total net profit of the Barings Bank Group.

From January 1994 onwards Leeson used options on the Nikkei 225 index, the main Japanese share price indicator, to go "short volatility" in the Japanese equity market, i.e. he was betting that the markets would trade within a narrower range than was generally expected.

The Kobe earthquake of January 17<sup>th</sup> 1995 ushered in a period of market turbulence and Leeson started to buy Nikkei futures. By 6<sup>th</sup> February, he had more or less recouped the additional losses incurred immediately after the earthquake and had a cumulative loss of £253 million, "only" 22% higher than that of the £208 million at the beginning of the year. Unfortunately, from this date onwards there was a persistent downward trend in the market and as the market began to slide, Leeson greatly increased his exposure, resulting in the £827 million loss of just three weeks later.

Previously, in January 1995 The Singapore Futures Exchange (SIMEX) had written two letters to Barings' Singapore office. The first, on 11<sup>th</sup> January, referred to the account '88888', queried the accuracy of information provided by Barings Singapore relating to certain margin requirements,

complained of the lack of information and explanations in the absence of Leeson, and referred to a possible violation of SIMEX rules by Barings' financing the margin requirements of client. Leeson's manager left it to Leeson to draft a response. The letter of 27<sup>th</sup> January sought an assurance of BFS's ability to fund its margin calls.

It is therefore easy to conclude that:

- the losses were incurred by reason of unauthorised and concealed trading activities;
- the true position was not noticed earlier by reason of a serious failure of controls and managerial confusion within Barings; and that
- the true position had not been detected prior to the collapse by the external auditors, supervisors, or regulators of Barings.

But one of the many intriguing aspects of this case is where did Leeson get the "margin cash" from, which futures and options exchanges require traders to deposit to ensure they have enough funds to cover any open positions with the exchange? The SIMEX has particularly stringent margin requirements and Leeson clearly needed funds from somewhere in the Barings Group to support his ever-increasing positions on the exchange.

Barings Singapore appears to have told London that the funds were required to support client business, and not for proprietary trading activities. Accountants in London were reported as being suspicious, as well they might have been, as funding from Singapore from the rest of the Group had exploded from around £200 million on 19<sup>th</sup> January to around £750 million on 23<sup>rd</sup> February, just one month later.

But despite this increase of £550 million, which must have taxed Barings' overall corporate liquidity resources to the limit, nobody appeared to have questioned the transfer, no doubt bearing in mind Leeson's reputation in the bank as being "almost a miracle worker" and "turbo-arbitrageur".

### Timeline of events

#### 1992 July

Suspense Account 88888 opened up shortly after Leeson was posted to Singapore, to accommodate his early losses of £2 million

#### 1993

Barings reported Group profits of £100 million, while Leeson had cumulative losses of £23 million

#### 1994

Barings reported Group profits of £205 million, while Leeson had cumulative losses of £208 million.

Meanwhile, Barings' external audits, Coopers & Lybrand expressed the view that the controls in place in Singapore were satisfactory.

#### 1995

By the end of January there were factors which should have alerted London management to the existence of potential problems within Barings Singapore. There were rumours in the market concerning Barings' very large position on the Osaka Stock Exchange and SIMEX, and possible client problems.

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Indeed, queries were raised at a high level from reputable sources, and even included a query on 27<sup>th</sup> January 1995 from the Bank for International Settlements in Basle. These rumours persisted in February.

Also on 27<sup>th</sup> January, the head of Barings settlements and back-office received a letter from SIMEX warning of a £74 million shortfall

Between 19<sup>th</sup> January and 23<sup>rd</sup> February, the Barings Group apparently unquestioningly had transferred £550 million to Singapore to support Leeson's unauthorised SIMEX positions.

In mid-February the seconded senior settlements clerk from London discovered a £190 million black hole in the Singapore accounts.

On 23<sup>rd</sup> February, in Singapore, Leeson is confronted with the problem and walks out of a meeting.

On the Monday after the crisis broke the Chairman of Barings, Peter Barings, said in London that "Barings' derivative arbitrage operations had been very profitable and that in terms of its financial exposures it was in principal a low risk business until the fraud took place".

By the end of February, Barings had collapsed

### Operational Risk Lessons to be learnt (so many!!)

1. The problem arose, not because of the complex nature of the risks being taken in any new-fangled instruments, but from **a straightforward failure of old-fashioned internal controls**. The fact that Leeson was permitted throughout to remain in charge of both front office and back office was a most serious failing.
2. **Management failed to give due priority to their own internal auditors**, who generally performed well but whose comments were ignored. The Barings' Group Treasurer had, in February 1994, identified the dual role of Leeson (working in the front and back offices) as unsatisfactory. Although the internal audits did not unearth the existence of the unauthorised activities, the internal audit report did make specific recommendations as to the separation of roles. These recommendations were never implemented; and at the local operational level there seems to have taken no significant steps to give effect to the recommended segregation of duties; even though in his management response to the report the local manager had stated that with immediate effect (1994) Leeson would cease to perform certain functions and that he would ensure the adequate supervision of all settlement and recording processes. The subsequent Bank of England report considered that this failure to put into effect his management response to these recommendations in the internal audit reports was reprehensible.
3. In addition, Coppers & Lybrand, the external auditors, came in for severe criticism in the official report, especially over their 1994 conclusion that the internal controls were satisfactory. This observation is not easy to reconcile with **the transparent lack of segregation of duties as well as other glaring shortcomings within the Singapore subsidiary**. (As an aside, it transpired that a fax, supposedly confirming a vital transaction but later found to be a forgery, was found in the Coopers & Lybrand audit files in Singapore. It contained the header "From Nick and Lisa"!!)

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4. The unauthorised trading was concealed by a number of devices. These included the suppression of account '88888' from Barings in London (which account was mentioned only in the margin files and did not attract the attention of Barings in London); the submission of falsified reports to London; the misrepresentation of the profitability of BFS's trading; and a number of false trading transactions and accounting entries. The internal account No. 88888 had been opened up as long ago as 1992, which raises the question of **who was responsible for reconciling suspense accounts, and why did neither the internal nor external auditors pick up on this during their regular audits.**
  
5. **Management in the head-office fell into the trap of hesitating to restrain a trader who appeared to be generating a disproportionate amount of profits (25% of the total) from essentially a low-risk, supposedly no-to-low income generating area of the bank.** The bank's Chairman did acknowledge that the bank was aware of the risks because "...it was possible to hedge its contracts simultaneously, leaving the bank with minimum exposure to market movements", but claimed no knowledge of how Leeson operated!
  
6. **Management in London failed to ensure that remuneration of one of their "star traders" did not encourage risk taking** (i.e. the bonus portion of his remuneration was too closely tied to his performance). Leeson's salary was reportedly only £50,000 but his anticipated annual bonus for 1994 was £450,000 – nine times his salary, and an increase from £130,000 the previous year!
  
7. **Management in London placed Leeson under considerable pressure to produce profits (without, it must be said, of asking too many questions)** so that their own bonuses could be paid in London).
  
8. **Barings in London sent £550 million to Singapore in little over a month to fund margin calls but although the accountants were "suspicious"** about the transfers (notwithstanding the 8 hour time difference between London and Singapore, but acknowledging the existence of an email system) **nobody appears to have asked for precise details of the positions and the "clients" which gave rise to such large margin calls.**
  
9. **Management failed to ensure that client trading and proprietary trading were separately controlled and accounted for and properly monitored,** and that there was a proper segregation of duties between the front and back offices in Singapore.
  
10. **There appears to have been confusion over the distinction between risk control and risk monitoring.**

Extracted from the Bank of England "Report of the Board of Banking Supervision Inquiry into the Circumstances of the Collapse of Barings" published 18 July 1995; and from "Great Financial Disasters of our Time" by Alan N. Peachey, ISBN 3-8305-1162-0.