

## Lessons from Barings

By Ms. Nawaz and J. Leslie.\*

Why did it happen yet again? Another banking collapse leaving regulators and the regulated in disarray. Let us see if there are lessons to learn from the Barings fiasco. Lucky for the taxpayer this time round though, they did not have to pay through increased taxes for the follies, ignorance and highlife-styles of bankers, who in the case of Barings, seemed only interested in somehow getting their unpaid bonuses. One could go on about high living and simple thinking, but that is not the aim of this article. Let us try and learn something from the whole business.

### Fact and Fiction

Derivatives have become the favorite scapegoat for a host of financial disas-

ters. Question: If you give me a knife to cut an apple, and I cut my hand, is something wrong with the knife? Possibly, but there is a stronger probability that I do not know how to use the knife (discounting the possibility of an accident).

So, the first point presumably is that all good bankers should know what they are doing. But in Barings Bank is there a case if not for not a great deal more supervision, but just effective supervision.? But, there is also

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perhaps a need for a greater awareness of what derivatives are about and the risks as well as opportunities they offer bankers and their customers.

To illustrate the above point, in the case of Barings the London executives found themselves funding larger and larger amounts in collateral payments (margin calls) on Leeson's futures trading positions in Osaka and Singapore. Why did this situation arise? Either they were completely ignorant, or the more plausible explanation seems to be that they were literally forced to throw good money after bad in a blind belief that Leeson, the miracle worker, knew what he was doing and that the huge exposure would quickly resolve itself. (The sit-tight-and-everything-turns-out-all-right theory).

### **Chaos and confusion**

By 1993, Nick Leeson was elevated to the position of general manager of Barings Futures (Singapore). Officially he reported to the managing director James Bax; but in reality he seemed to have bypassed him and the Tokyo regional office and reported directly to head office in London. The London bosses were very happy with this set-up; Leeson had made increasing contributions to group profits/ and very few at the top might have wanted to burden this "bright star" placing the

onus of additional reporting lines on him.

Concerns over potential risks would seem to have been downplayed at top level board meetings. Needless to say, Leeson should have benefited from all this. This point was reinforced by Leeson being both in charge of trading and settlement procedures. In any bank or securities house, such a situation is guaranteed to provide a potential cocktail for inebriation and collapse. Peter Baring, the chairman, at the outset mentioned a "conspiracy" theory behind the whole debacle. Some form of conspiracy cannot be ruled out altogether. Account 88888 which has now become legendary in the financial circles - was used by Leeson to hide "a multitude of sins." Various transactions accumulated over a period of time in this account, for example, losses on bid-offer spreads, subsidies paid to customers to induce them to trade with Barings, false trading profits, gambling losses and subsidies paid to Tokyo dealers.

A senior Barings executive told Financial Times that he "still did not understand what had happened". He added further "I don't know the answer to it, and I don't think anybody does". Such statements re-enforce the belief that greed may have been one of the main factors behind the disaster. As long as profits flowed in from

Singapore, no questions were asked (ostrich theory prevailed!).

### Remember BCCI?

Whereas the two debacles may not exactly be comparable, it is quite interesting how some similarities are difficult to ignore:

➤ BCCI lost between US \$300 million and US\$500 million in commodities and futures trades between 1982 and 1985. This wiped out BCCI's capital base. It was later revealed that when losses started accumulating, the trader employed the classic gambler's instinct: bet more and hope to recoup the previous loss. Indeed in 1982, the bank's chief financial officer challenged the fact that the upper management in the bank has limited oversight role - his subsequent advice went unheeded. Similarly, Leeson also comfortably managed to bypass internal checks.

➤ Warning signals in the case of BCCI were ignored by regulators till it all became too obvious. BCCI's Treasury losses should have been more closely scrutinized; also subsequent Florida money-laundering allegations should have been looked into in greater detail. Unfortu-

nately, the Bank of England and other regulators slipped up. In the case of Barings, according to one Japanese derivatives specialist: "To say that you were unaware of it (Leeson's large positions in the market) was like living in the US in the 1960s and not knowing that the Vietnam war was on." No regulators made noise. Back in London, Barings management "believed" the positions to be fully hedged, thus risk-free. Yet a basic knowledge of arbitrage trading would have made them realize that such trading could not have generated the reported profits from their Singapore operation.

### Lessons for Regulators

Well, here come some hometruths!

The regulators - like Pontius Pilate - appear to have escaped unscathed in this particular scandal, unlike the BCCI's. The question is, who would really be the watchdogs? With a financial organization having operations in different countries, it becomes very difficult to lay the blame at the door of any one regulator or even a group of regulators.

Supervising multinational financial institutions is a complicated affair.

The watchdogs, in our opinion, should not only be external watchdogs but also internal ones. It is cooperation towards this end which should be aimed at. For example:

☛ Co-operation between internal audit departments and external auditors on the one hand to be re-enforced by a triangular nexus of cooperation between internal auditors, external auditors and the appointed chief regulatory authority.

☛ In the case of institutions having operations in more than one country, international supervisory cooperation between regulators and exchanges becomes all the more important. It is vital that proper standards are in place for true international supervisory cooperation. Confusion in this area was very apparent in Barings case. In January and February 1995, SIMEX (Singapore International Monetary Exchange) was uneasy about the very large positions taken on the market by Barings Futures Singapore. Rival traders were astonished at the growth of Barings' positions. Its exposure on the Osaka Stock Exchange was eight times its nearest rival, and it was even greater on SIMEX.

☛ In January 1995, Leeson accounted for 13% of SIMEX's turnover. When concerns were expressed, Barings group treasurer flew out to Singapore to assure SIMEX that they were aware of these positions, and even confirmed this in writing. Yet, one cannot help but wonder, if the group treasurer was telling "the whole truth and nothing but the truth" at that time.

☛ After the collapse, the Singapore authorities were very unhappy at the way they were misled by Barings. Firstly, by posting Nick Leeson to Singapore, knowing that he had been refused a licence to operate as a futures trader in London. Secondly, by written statements that the Barings were aware of what was happening with Barings Singapore. Were they so taken up by the prestige of Barings as one of the "blue-bloods" of the British merchant banks, that they didn't question any of the statements made by the bank's officials.?

☛ What we do not require is extra regulation; with all its associated costs, which will kill off innovation and initiative. What we do require is more co-ordinated and focussed regulation together with greater transparency. For example, an internal/external

system of responding quickly to warning signals in an organization. When large sums of money were transferred by Barings management in London to satisfy margin calls in Singapore, alarm bells should have started ringing both in the bank and at the Bank of England.

Financial institutions should invest a little more in their people, before giving them responsibility and authority of the kind Leeson had. Its basically playing on human greed, putting impressionable people right out of school and college very quickly into such positions. The high living must have been like a fairy tale come true to Leeson, who came from a very humble background. He has indeed not been given proper time to develop a respect for conventions, traditions and probity demanded of the profession. It appears Leeson was rewarded and motivated by a payment system which depended to an unhealthy extent, on his profit performance.

The most powerful form of regulation may be a form of self-regulation whereby the institution's self interest in avoiding losses comes to the fore. Shareholders - especially

institutional ones holding large portfolios, could have a bigger role to play in this. They should concentrate more on how the institution is run than the amount of dividends being received each year. In the long run, it would certainly pay off. Perhaps shareholders need to be weaned off the 'dividend drug' so pervasive in British companies.

Hopefully, the collapse of Barings should lead to a re-examination by banks of the effectiveness of their own internal controls. A recent analysis by Touche Ross of 100 financial institutions in the UK found that the majority appear to have totally inadequate risk management systems. This is a worrying aspect, especially in view of the more sophisticated instruments being employed by the banks not only for hedging purposes, but for speculating as well.

Critical core risk management systems are required, and internal management reporting would benefit considerably from investment in Information Technology Systems.

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