# CHAPTER II :

## *THE COLLAPSE OF BARINGS PLC*

### *2.1 BARINGS PLC*

Barings Plç is one of Britain's oldest and most venerated merchant bank. The firm began as a merchant house founded by two brothers, John and Francis Baring, descendants of a Dutch wool trader, on Queen Street, London, close to New Year's Day of 1763.

The firm grew rapidly and a major change for Barings Plc came in 1986, when financial institutions in London were deregulated after the so called 'Big Bang'. Overnight the banking rules and traditions changed.

When this new culture, new way of investment banking was introduced, it started from Asia, where Barings had always been strong, following the growth of the British Empire in the East.

Japan became the bank's testing ground for the relatively high risk ventures in derivatives, focusing on emerging Asian markets.

*Note :It should be understood by users of derivatives that there are inherent risks associated with derivatives. This is simply because derivatives make assumptions about the future. It may be the movement in interest or currency rates. Or it could be a problem of valuation of the instrument e.g, option or over the counter derivatives which may be illiquid and there is no real market.*

## *2.2 NICK LEESON*

Nicholas W.Leeson, who joined Barings Bank in 1985 at the age of 18, was the son of a plasterer. He grew up in a council house in Watford, North London. He left school with 8 'O' levels and 2 'A' level subjects, but failed in Mathematics.

Between 1985 and 1991, he worked at menial tasks in the bank,Barings sent him to Singapore in 1992, at the age of 25, to deal in derivatives. In Singapore, Nick Leeson became totally transformed. He became an aggresive wheeler-dealer where nerves of steel and split-second decision-making brought rich rewards (or ruins).

It was reported that his basic salary was US$ 300,000 (RM 768,000) with bonus running up to US$ 2 million in a good year.

By 1994, Nick Leeson had become the general manager of Barings Securities (S) Pte Ltd. He was the chief futures trader for Asia & North America, and he reported directly to London.

His legitimate job was arbitrage trading of Nikkei Stock Average Futures on the Osaka futures markets and Singapore International Monetary Exchange (SIMEX). This arbitrage used large amounts of capital accelerated by quick computer software to buy and sell on the basis of small price disparities among markets. This is a classic application of modern trading techniques that, by bringing prices quickly in line from market to market, make it possible for traders to have similar pricing information whether they're in New York, London, Tokyo or Singapore.

His job was to exploit minute price differences between the same Japanese equity and interest rate instruments traded on the

Singapore and Osaka futures exchange. These price anomalies might last only minutes, so speed and decisiveness were essential.

It was, moreover, almost risk-free. Every purchase on one exchange was offset within seconds by an equal sale on the other. At the end of each day, all positions had to be closed out -- reduced to zero -- so that the whole process began again each morning. The profit on each trade was tiny, though in large enough volumes it could produce hefty revenues. But this was not all Leeson was doing.

## 2.3 THE EVENT

### 2.3.1 Trading Activities

Leeson's tradings were mostly in Nikkei futures and options and JGB futures. He was authorised to arbitrage between SIMEX and OSE in respect of Nikkei futures, and between SIMEX and TSE in respect of JGB futures. His job was to take advantage of price differences by buying at one Exchange at a lower price and selling at the other Exchange at a higher price. As both Nikkei and JGB futures are traded independently on OSE and TSE on the one hand and SIMEX on the other, price differences could emerge periodically due to different makrket conditions and other factors.

Leeson also took positions during the day in anticipation of favourable short term market movements and at the end of each day, he was required to ensure that there were no overnight open positions. Since Leeson assumed the trader role, the total monthly volumn of Nikkei futures bought and sold increased 46 times from a total of 2,051 in July 1992 to a peak of 96,121 in September 1994. In terms of unhedged position, 189 long Nikkei futures was booked at the end of August 1992 and this had increased to 26,032 by 31 January 1995 and 61,039 long contracts on 24 February 1995. The size of these unhedged positions would mean that the Baring Group was exposed to phenomenal risk relative to even small measures of market volatility.

### *2.3.2 The Wrong Bet*

In late November or December 1994, Leeson decided to bet that the Nikkei index would not drop below about 19,000 points on March 10, 1995. It seemed to be a safe bet since the Japanese economy was already rebounding after a 30-month recession. True until early January 1995, the Nikkei 225 still above 19,000 level.

Unluckily, on the morning of 17 Jan 1995, however, an earthquake measuring 7.2 on the Richter Scale devastated the city of Kobe and Nikkei index plummeted from 19,331.17 (on 13 Jan 1995) to 18,840.22 (on 20 Jan 1995), a loss of 490.95 points (or 2.5%) within one week. To add salt to wound, the boom in construction spending that Leeson had expected after the disaster did not materialise. When market reopened on Monday (23 Jan 1995), the index loss 1,054.73 points in a single day.

All in all, between 13 Jan 1995 to 23 Jan 1995, a total of 1,545.68 points (or 8% of Nikkei index) had thrown to the drain and by then, Leeson's losses had amounted to US$630 million - more than the entire capital reserves of Barings Plc.

Despite that, over the next three weeks, Leeson bought thousand more contracts betting that the Nikkei index would stabilise at 19,000. To raise money to pay for 'margin calls' from SIMEX and Osaka, he set up a series of 'short straddlers' positions (please refer to 'short straddlers' explanation on page 11) by selling large numbers of put options (besides the initial call options that had bought) at specific strike price (around 19,000 points). All these huge exposures were unhedged, or no bets the other way to protect Baring should market turn otherwise.

During the period of 17 Jan 1995 to 24 February 1995, Leeson also actively traded in JGB futures. Huge intra-day open positions were maintained, ranging from 1,400 contracts on 17 January 1995 to 5,600 contracts on 19 January 1995, and as at 24 February 1995, a huge number of 26,079 short JGB were exposed.

Lady Luck seemed pulling Leeson's leg. Whereas the price of Nikkei futures fell, the price of JGB futures had increased by approximately 2% during this period, and the large short JGB positions resulted in large losses. These build up positions with respect to both Nikkei and JGB contracts (large unhedged long positions maintained on Nikkei futures and large unhedged short position maintained on JGB futures) between 17 January 1995 and 24 February 1995 resulted in significant losses to the Baring Group and eventually caused its collapse. During this period, the cumulative losses increased from S$392 million on 31 December 1994 to S$1.4 billion as at 24 February 1995. Eventually, total losses amounted to S$2.2 billion.

On the 24th February 1995 (Friday evening), Leeson sent a fax to the Management from the Regent Hotel, Kuala Lumpur offering his resignation and apologised for having fled.

Two days later on the 26th February (Sunday), Barings Plc in London were declared insolvent and went into administration. It was subsequently sold to International Nederland Group (ING) for a nominal *f*1 with inherited liabilities of open positions.

On the other hand, Leeson was detained in Frankfurt, Germany on 2nd March 1995 when he was on his runaway back to London. After fighting nine months against extradition, he finally gave in and pleaded guilty in Singapore and being sentenced to six and a half years jail term for two cheating charges i.e cheating SIMEX by underdeclaring BFS final long open osition for March (6

SIMEX by underdeclaring BFS final long open osition for March (6 years jail) and cheating BFS auditors into believing that some of the deficit in the book was the result of a legitimate and genuine transaction (half year jail term).

## 2.4 FACTORS LEADING TO THE COLLAPSE

### 2.4.1 Barings Internal Problems

#### Differences Between Directors

According to the official British report, relations between directors in London and Singapore were riven by personalities differences. Simon Jones, regional operations manager for South Asia and Geoffrey Broadhurst, Baring Investment Bank group finance director, were barely on speaking terms. Broadhurst, who described his relationship with the Singapore office as 'very, very poor' and communication with Singapore had been carried out via James Bax, regional managing director.

On the key question of overseeing Leeson's activities, neither Bax nor Jones considered this their responsibility.

#### Internal Reorganisation

In an attempt to drag itself into the modern world, Baring was trying to reorganise and integrate its two cultures,. the banking and the securities.

Like many reorganisation, it created confusion. People were given responsibilities they did not fulfil. Management structure became tangled -- and Leeson fell through the middle. He reported to three different bosses for his three activities -- futures, sales and settlements -- all oft them in London. He was, in effect, answerable to no one. For example, he regularly overshot the dealing limits imposed on him by Barings, but no one in the bank ever questioned and objected.

### *Conflict Of Role*

Leeson was not only chief dealer but in charge of the back-office as well. Since the back-office is where deals are settled and processed, it is the first point checking on dealers. A watertight barrier between dealing and back-office is essential, yet Leeson was able to subvert it.

### *Star Performer*

After leaving sixth form at Parmiters Comprehensive (he left school after taking three A levels, including Maths in which he got the bottom grade of F), he worked as a clerk in a bank for two years. He then joined Morgan Stanley and then Baring Securities as a settlements clerk.

In 1992, at the age of 25, he was made head derivatives trader in Singapore and then general manager of the office, in charge of dealing and back-office settlements.

He made an immediate impact with his height and bold dealing technique. The profits of the Singapore office leapt nearly 10-fold from £1.18 million to £8.83 milliom in his first 18 months. Leeson personally generated nearly 20% of Barings' entire group profit of £68 million for 1993.

Like any successful trader, he enjoyed the fruit of his success with a salary thought to be £450,000.

What the Barings management back in London saw, however, was a star. The profits came tumbling in and their biggest profit earner had to be kept sweet. In early Feb 1995, Mr Norris, the chief executive, flew to Singapore to congratulate Leeson on his profits and to promise him a £0.9 million bonus, to be paid in February.

Leeson was simply making too much money to be questioned. In any case, the Singapore office was small, with few employees, so the rigid controls that might have been imposed on larger offices may have seemed unnecessary. Barings did not show it to the Bank of England, which is responsible for making sure banks have adequate controls.

### 2.4.2 FRAUD

Mr Leeson arrived in Singapore in April 1992 as the head of BFS's settlement operations and at the same time to be BFS's floor manager at SIMEX.

Two days after BFS commenced trading on SIMEX on 1 July 1992, Leeson opened account 88888 as an error account. Thereafter, fictitious transactions were booked regularly into this account. Through account 88888, transactions were funded by various means. For options sold by BFS, SIMEX would credit the premium received into BFS's bank account, and at the same time debited a similar amount from that account as margin for the options. On the other hand, Leeson's funding request to BSL were inflated to include option margins and BSL remitted such funds.

Meanwhile, with his dual role, Leeson often instructed BFS's settlement staff to record fictitious trades in the accounting system. (this conflicting role had helped Leeson mask his problems from both his bosses in London and from Singapore regulators). These fictitious trades were reversed out at the start of the following day and if need be, the same process would be repeated at the end of that day. All these entering of fictitious trades were intended to reduce in BFS's accounting records and consequently in the SIMEX computer system all BFS's open positions in Nikkei and JGB futures at the end of each day.

In addition, investigations also revealed that there were two sets of books kept, one for the house and one for the customer, this meant a trader could have gone undetected because he would have been able to hide between books.

## *2.5 COULD COLLAPSE BE AVOIDED ?*

Why can a derivative be so lethal and damaging as it proved to be in Barings' case ?

In retrospect, the Baring Group / Leeson could have averted collapse by timely actions. These include : -

### 2.5.1 Use Protective Stops

Any disciplined trader, whether in the stocks or futures markets, will tell you that stop loss orders must be placed each and every time the market is entered.

### 2.5.2 Averaging A loss

If prices drop further after having bought stocks or futures contracts, a buyer's typical strategy is to buy further because the lower price makes the latter a better buy. The justification is that by averaging down, he will have a lower average entry price and hence would require a smaller upmove to breakeven.

Unfortunately, that's not true; you stand to lose twice as much if the market continues to go against you --- and it almost does.

And due to the leverage nature of the contract, exchange rules require additional margins to cover the 'floating' losses suffered thus far. Because funds will be exhausted at one or another (and in Barings' case, it was reported that about US$ 850 million was borrowed and much of it siphoned to satisfy margin calls), the inability to satisfy fresh margin calls will cause a default, resulting in forced-selling of positions by the exchange.

### 2.5.3 Do not Overtrading The Account

Trading too many contracts to the extent of committing all your trading capital is a violation of investment rules. At the time of default, Leeson was reported to be holding in excess of 40,000 contracts of Nikkei Futures contracts!

The answer as to why a company like Barings Plc can lose its total net worth is because it has placed too many bets on its subsidiary in Singapore which had not used the Nikkei Futures contracts strictly for hedging its clients portfolio of Japanese stocks, but instead went further by taking 'open' positions.

It was its inability to satisfy further margin calls from SIMEX that led to the fall of the subsidiary and, through the colossal loans from its parent company, the whole Barings group.

### 2.5.4 Experience

Although substantial losses had been incurred by the end of January 1995, these were only one quarter the eventual losses. He could then close out his positions to stop any further loss and tell Barings he had drop £100 million or £200 million of their money -- in which case he would have kissed goodbye to his job and bonus.

As cocky and arrogant as usual (his colleagues put it), he decided to double up his bet by buying more and more futures. Had he been more experienced, he might have decided to end the pain earlier.

### 2.5.5 Dual Role

If Leeson's dual role in his command of the front and back offices had been put to stop. Wearing two hats at the same time, this had given Leeson opportunity to manipulate tradings as and when he liked.

### 2.5.6 ALCO

ALCO had taken Leeson to task for increasing his positions and exceeding his trading limits in numerious occasions but not forceful enough.

### 2.5.7 Analysis

The reasons underlying the requests for very large amounts of funds by Leeson in January 1995 and February 1995 had been analysed and understood and immediate investigations were carried out. This would serve as an alarm to the Management.

### 2.5.8 SIMEX

SIMEX should have been more concerned when hugh positions were built-up by BFS and taken necessary steps to check irregularities.

### 2.5.9 Cooperation Between International Monetary Authorities

An increased cordination between regulatory authorities in various countries would help to identify and exchange company information on large exposures and risky transactions among the various bodies.

information on large exposures and risky transactions among the various bodies.

Early signal on any irregularities could also be detected should the present wide variation in the standards of regulations on prudential requirements between various jurisdictions could be standardised.

## 2.6 *CHRONOLOGICAL OF EVENTS*

| DATE | EVENT |
|---|---|
| 17 Sept 1986 | BFS was incorporated. |
| July 1989 | Leeson joined BSL as settlement clerk. |
| 3 July 1992 | Leeson opened account 88888 as an error account. |
| 28 June 1993 | Leeson was appointed as Assistant Director and Genaral Manager of BFS. |
| 11 Jan 1995 | SIMEX queried BFS on margin requirements for account 88888. |
| 16 Jan 1995 | SIMEX auditors noted BFS that they had violated SIMEX Rules and the Futures Trading Act and Regulations. |
| **17 Jan 1995** | **Kobe earthquake.** |
| 27 Jan 1995 | SIMEX questioned BFS on the adequacy of funds to meet potential losses or margin calls. |
| 10 Feb 1995 | BFS replied SIMEX by reassuring that Baring Group assets were available to meet the obligations of BFS. This reply was approved by ALCO. |
| 17 Feb 1995 | A discrepancy of Y14 billion for funds remitted to BFS from other Barings companies could not be reconciled and ever since,Leeson was seen trying to push away |

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|---|---|
| | on many occasions. |
| 23 Feb 1995 | Leeson & wife crossed over causeway and began his runaway, checked into Regent Hotel, Kuala Lumpur. |
| 24 Feb 1995 | Leeson faxed to Mr Jones (BFS director) and Mr Bax (BFS Managing Director) from Regent Hotel apologising for having fled and tendering his resignation. |
| **24 Feb 1995 (Friday)** | The Chairman of Barings was told that the bank was on the verge of collapse. A week end attempt to formulate a financial rescue failed. **Barings was declared insolvent.** |
| 26 Feb 1995 | Barings (London) went into administration. |
| **27 Feb 1995 (Monday)** | **Global stock markets were shocked and shakened.** |
| 27 Feb 1995 | Leeson & wife stayed at Beach Resort, Kota Kinabalu. |
| 28 Feb 1995 | Paid RM4,000 cash for two air tickets to Frankfurt. |
| 1 Mar 1995 | Left Kota Kinabalu on Brunei Airlines. |
| 2 Mar 1995 | On the way back to Britain, Leeson was detained in Frankfurt, Germany; Singapore government seek his extradition. |
| 23 Nov 1995 | Leeson arrived in Singapore after |

abandoned his fight against extradition from Germany.

2 Dec 1995 — Leeson pleaded guilty and sentenced to six and a half years jail for 2 charges i.e first charge which carries a jail term of six years for cheating SIMEX by under-declaring BFS final long open futures position for March and another six months on second charge for cheating BFS auditors by deceiving them into believing that the 7.778 billion yen (RM 1.9 billion) deficit was the result of a legitimate and genuine transaction.