

Implications of the Barings Collapse for Bank Supervisors

On 26 February 1995, administrators were appointed to manage the affairs of the Barings Group parent company and a number of other companies within the Barings Group. This followed the discovery of massive trading losses incurred by Barings Futures Singapore (BFS), an indirect subsidiary of the Barings bank, on Singaporean and Japanese exchanges.

On the following day an Inquiry by the Board of Banking Supervision was announced by the Chancellor of the Exchequer. Its main objective was to investigate the circumstances of the collapse, and to draw lessons from the experience for institutions, for the Bank of England's supervisory arrangements and for the structure of regulation within the UK financial system more generally.

The Board issued its Report on 18 July. It detailed the recent history of the Barings Group, the nature of the trading activities conducted within the Group, and how losses arose within BFS, were concealed and, ultimately, discovered. The Inquiry considered the question of how unauthorised trading activities continued for more than two years without detection by the Barings management, by the internal and external auditors, or by various supervisors and regulators.¹ Finally, the Inquiry drew some conclusions and lessons from the experience.

This article provides a short summary of the circumstances which led to the Barings collapse. It then outlines the main findings and conclusions of the Board of Banking Supervision, and makes some observations on the possible implications of those findings for banking supervisors. Finally, it makes some brief comments on the Barings collapse from the perspective of the Reserve Bank.

Overview of the Barings Collapse

Barings had a long history in London, with a presence in merchant banking of over 230 years. At the time of the collapse, the Barings Group comprised an authorised bank in the UK (Baring Bros & Co), a securities company (Barings Securities Limited – BSL) and various subsidiaries and branches operating in the UK and other countries. From the late 1980s, Barings had been involved in major structural changes, entering new areas of business and attempting to incorporate those new activities into the Group structure. The most challenging task was the incorporation of the securities business into a structure which, until then, had been dominated by banking activities and culture.

1. These included the Bank of England, the Securities and Futures Authority in the UK, the Ministry of Finance in Japan (as supervisor of Barings Securities, Japan) and the Singaporean and Osaka futures exchanges.

The collapse of the Barings Group was the product of losses incurred within one of its subsidiary companies, Barings Futures Singapore (BFS). Subsequent investigation by the Bank of England (BoE) revealed that at end December 1994, cumulative losses of over £200 million had not been recognised in Barings' accounts, with unrecognised losses in 1994 amounting to £185 million. This contrasted with the financial position indicated in the draft financial accounts for 1994, where pre-tax profit of £102 million was shown (this result was after allowing for transfers to a Group bonus pool of the same amount). The magnitude of the true loss as at December 1994, had the position been discovered at that time, might not have brought about the collapse of Barings. At that point, recorded Group capital was in the order of £350 million. Over the course of the next two months, however, cumulative unreported losses grew almost threefold, reaching £827 million by 27 February 1995. Adding in the costs of closing out all positions, cumulative losses incurred on BFS's unauthorised trading totalled £927 million.

The proximate cause of the losses, and the subsequent collapse, was the unauthorised trading activities of the head of BFS, Nick Leeson. Leeson was authorised to engage in active trading out of Singapore, but only as part of a 'switching' (or arbitrage) operation between the Singaporean and Osaka futures exchanges. These activities were viewed as low-risk operations by Barings management, given that they did not involve outright, open positions on the exchanges. It is now known, however, that Leeson had engaged, for a period of 2½ years, in unauthorised position – taking in Nikkei futures and Japanese Government Bond (JGB) futures on SIMEX and Osaka futures exchanges. In addition, Leeson had exposed the capital of the Group to unlimited potential loss by writing, again without authority, exchange-traded options against the Nikkei Index on those same exchanges.

By early 1995, Leeson had adopted a trading strategy which saw him taking:

- long (or bought) positions in Nikkei futures;
- short (or sold) positions in JGB futures; and
- a 'short volatility' position in Nikkei exchange traded options.

To be profitable, the respective positions would have required futures prices on the Nikkei Index to have increased, Japanese bond prices to have fallen and for volatility in the Nikkei Index to have remained low. In fact, from around mid January, the Nikkei fell, at times sharply. This led to a deterioration in both the Nikkei futures and options positions. Similarly, an easing in Japanese interest rates saw losses incurred from the short JGB futures positions.

The sequence of profits and losses from the various positions in the different markets was not even over January and February. At times, losses in one market were offset by gains in another. At one point in early February, Leeson had recovered losses made from the start of the year. In the final two weeks of February, however, all the markets in which he held open positions turned against him. It was over this two week period that the bulk of the net losses was recorded.

Report of the Board of Banking Supervision – Findings and Conclusions

In its investigation of the Barings collapse, the Board of Banking Supervision sought to establish how the massive losses were incurred and why the true position within BFS, and thus within the Barings Group, was not identified earlier.

The answer, in the Board's view, was virtual total failure of risk management systems and controls, and managerial confusion, within the Barings Group. In reaching this view, the Board noted that the true position of Barings had also eluded the external auditors, as well as the various supervisors or regulators, including the BoE, overseeing the activities of the Group from a prudential perspective.

Failures in risk management and control

The Board identified a number of failings associated with the measurement and management of risks within the global operations of Barings. In relation to the particular circumstances of BFS, where the losses were incurred, the Board found, amongst other things, that:

- there was a lack of separation between the front and back offices within BFS. As general manager of the company, Leeson effectively controlled both sides of the trading operation. From that position, he was able to conduct unauthorised trading and subsequently manipulate the number and details of the transactions in which he had engaged, concealing them from Barings management. Secret accounts were used to park losses arising from the unauthorised transactions;
- the operation of the matrix-based reporting system within the Barings Group, which had Leeson nominally reporting through different management lines, made responsibility for oversight of his activities ambiguous and ultimately ineffective in practice. With hindsight, it appeared that no-one carried ultimate responsibility for monitoring Leeson's activities in Singapore;
- Barings management did not question, until it was too late, the apparent high levels of profits being generated out of the authorised, but supposedly low risk, arbitrage activity conducted by Leeson. At one point, it was acknowledged within Barings management that over 60 per cent of the revenues of its worldwide derivatives operations was generated out of Leeson's arbitrage operations;
- Barings management did not question, nor did it control or place limits on, the high, ongoing levels of funding required by BFS from its parent and associated companies. These funding needs jumped sharply towards the end of February 1995. Immediately prior to the collapse, funding to BFS represented twice Barings Group capital; and

- the recommendations of an internal audit review, conducted on BFS in August 1994, were not acted upon quickly enough, or not at all, by Barings management. The internal audit, in fact, pointed to many of the weaknesses in both the risk management structure and the controls which were present within the BFS operation.

Lessons for management

The Board of Banking Supervision concluded that the failings at Barings could not be attributed to the complexity of the business carried out within BFS, but were primarily a failure on the part of a number of individuals within the Barings Group to do their jobs properly. While the use of futures and option contracts did enable Leeson to take much greater levels of risk (through their leverage) than might otherwise have been the case in some other markets, it was his ability to act without authority and without detection that brought Barings down.

Against that background, the Board outlined five main lessons for management flowing from the Barings failure:

- management teams have the duty to understand fully the businesses they manage;
- responsibility for each business activity has to be clearly established and communicated to all relevant parties;
- clear segregation of duties is fundamental to any effective control system;
- relevant internal controls, including independent risk management, have to be established for all business activities; and
- top management and the Audit Committee have to ensure that significant weaknesses, identified to them by internal audit or otherwise, are resolved quickly.

Lessons for the Bank of England

The Board of Banking Supervision did not hold the BoE, as supervisor of the consolidated Barings Group, 'responsible' for the collapse of Barings. That responsibility rested with the management and the board of Barings. It concluded, however, that there

had been failings associated with the on-going supervision of the Barings Group. One focus of the Report was to assess how, in the light of the Barings experience, the BoE's supervisory arrangements could be improved. Among the suggestions made were the following:

- The BoE should explore ways of increasing its understanding of the non-bank businesses (particularly financial services businesses) undertaken by those banking groups for which it is responsible, and how those businesses interrelate to one another and to such groups' banking businesses. It should obtain a more comprehensive understanding of how the risks in those businesses are controlled by group management.
- Liaison with other regulators and supervisors should be encouraged and enhanced.
- Greater use should be made of information which could be obtained from banks' internal audits. It was recommended that, as part of that process, the BoE meet regularly with the chairman of the major banks' audit committees to discuss internal audit, control and related issues and to ask whether there were matters which should be brought to the attention of the BoE.
- The BoE's 1994 decision to establish a traded markets team to examine banks' risk models was commended. The Board suggested that a review be conducted, in the light of the Barings episode, of the number and skills of the people available for on-site visits and for general internal consultation on derivatives and other trading activities and also banks' credit portfolios. On the broader issue of extending the use of on-site techniques, along the lines adopted by US supervisors, the Board was less enthusiastic. It argued that the benefits of more extensive examination approaches, over approaches with only limited usage of such techniques, had not been demonstrated.
- The Board concluded that there was no basis, arising out of the Barings experience, to suggest wholesale changes to the

Banking Act or to the broad structure of banking supervision in the UK.

Some Observations on the Barings Report

The Report contains a comprehensive description and analysis of the events that led to the collapse of the Barings Group. The conclusions that neither the products traded nor Barings business was particularly complex, and that the problem was one of inadequate systems to measure, monitor and manage risk, follow directly from the facts as revealed. It was essentially a problem of the management and staff of an institution not adhering to practices that many would regard as quite basic to any global trading operation.

That said, it is puzzling that Barings management, for the most part comprised of experienced bankers, should have failed so dramatically in their duties. A second issue is why the risk management and detection structures, which in theory at least existed within the Barings Group of companies, proved to be so inadequate.

That Barings Group management were looking to improve control systems is acknowledged in the Report. Indeed, one of the central aims of the organisational restructure which was under way within the Group was to improve risk management systems, especially in the securities side of the business. One hurdle which Barings management faced in pursuing that objective was that the two broad businesses – the bank and the securities house – possessed greatly different management styles, cultures and, perhaps, appetites for risk. In those circumstances, long lead times can be involved in establishing integrated systems and giving practical effect to them. While those improved systems are being put in place, there are risks that controls could be subverted and a particularly heavy responsibility tends to fall on the line management and staff.

Such was the case at Barings. This does not excuse the gross failings of systems and

individuals. Rather, the lesson to be drawn is that appropriate high-level systems need not only to be adopted and identified as a bank policy, but also be *made to work* in a measurable time-frame.

A further point is that, while the contracts traded by Leeson were not intrinsically complex, the *authorised* business environment had features which provided camouflage for the *unauthorised* activities. The authorised activities involved exceptionally large (though theoretically riskless) positions spanning exchanges in two countries, four subsidiaries (viewed as clients on some occasions and 'in house' counterparties at other times) and involved margining requirements which did not appear to be appreciated by senior management in London. This helps to explain why Barings management was not surprised or alerted by the large trading volumes, the large 'profits' and the large requirements to fund margins at the exchanges.

Another lesson of the Barings experience is the speed with which problems in a trading area can manifest themselves. Although Leeson was involved in unauthorised activities for between two and three years, losses even up to early February were not sufficient to 'break the bank'. It is also worth recalling that one-quarter of the eventual gross losses of the Barings Group were incurred on a single day. For supervisors, a lesson is that emphasis on statistical reporting will not generally provide effective early warnings where market risk is concerned; instead the focus must be on the methodologies employed by banks to identify and measure risk, and on their systems to achieve good risk management practice.

Conclusions

The Barings collapse is another reminder of the serious problems which can arise within

banks. In this instance, the difficulties led to the failure of a banking group with a history spanning over 230 years. Contrary to initial and popular reactions to the collapse, however, the Barings experience says less about the 'problems' with banks' use of derivatives than about the problems that arise when risk management systems and practices and accounting procedures are ineffective. The experience also demonstrates the particular problems that can arise where there is deceptive activity and fraud on the part of senior bank staff.

For its part, the Reserve Bank has been acutely aware of the problems posed by the lack of appropriate risk management controls within banks. Many of the banking difficulties of the late 1980s/early 1990s in Australia (and elsewhere) were the product of less than adequate credit risk management systems. As part of its ongoing response to such issues, the Bank has been developing its supervisory capabilities, particularly in relation to the assessment and analysis of risk management methodologies and practices within banks. Associated with this has been greater input from, and review of, banks' internal audit functions. For over two years asset quality teams from the Bank have been visiting banks to help assess the effectiveness of banks' systems for monitoring and controlling credit risk, and their consistency with good industry practice. More recently, similar groups have been involved in the analysis of methodologies and practices used by banks in relation to the identification and measurement of market risk. These visit programs will be a continuing feature of bank supervision in Australia and will help to minimise the possibility of problems occurring at banks. In the final analysis, however, no amount of supervision can absolutely guarantee against serious problems.