

## PROMOTING CONFIDENCE AND STABILITY IN FINANCIAL MARKETS: CAPITALIZING ON THE DOWNFALL OF BARINGS

### I. INTRODUCTION

Barings, P.L.C. (Barings) was the oldest investment firm in Britain and one of its most illustrious. It was a 223-year-old financial institution that financed the Louisiana Purchase and the Napoleonic Wars<sup>1</sup> long before it served as an investment adviser to Queen Elizabeth II.<sup>2</sup> Yet, despite a prominent history, this venerable institution collapsed on February 26, 1995, as the result of a single trader's derivative activities in Singapore.<sup>3</sup>

The story of the Barings collapse raises a host of issues in derivatives trading, risk management, systemic risk, and international securities and banking regulation. In the aftermath of the collapse, many questions and concerns have arisen. How could an old, prominent, and stable institution like Barings collapse so quickly? Do other financial institutions face similar risks? What lessons can be learned from Barings and steps implemented to prevent similar, if not more catastrophic, collapses from occurring in the future? More specifically, the collapse raises concerns about the regulation of derivative activities by banks,<sup>4</sup> involving both the proper scope and role of international regulation of derivative activities as well as the proper extent and effectiveness of external regulatory controls.

This Note explores these questions and proposes possible solu-

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1. See Barbara Sullivan & Ray Moseley, *Old Bank, Modern Scandal; Manhunt Under Way for 'Rogue Trader'*, CHI. TRIB., Feb. 28, 1995, at 1.

2. See Richard W. Stevenson, *Markets Shaken as a British Bank Takes a Big Loss*, N.Y. TIMES, Feb. 27, 1995, at A1.

3. Broadly defined, a derivative instrument is a contract whose value is derived from or is dependent upon one or more underlying assets or indexes. The primary economic function of derivatives is the transfer of market risk resulting from an adverse change in the price of an asset or portfolio of assets. Derivatives can include a wide variety of financial contracts such as forwards, futures, swaps, and options. See Jane C. Kang, *The Regulation of Global Futures Markets: Is Harmonization Possible or Even Desirable?*, 17 J. INTL. L. BUS. 242, 243 n.1 (1996).

4. See Paul A. Schott, *Derivatives: A Primer on Bank Agency Actions For Managing Risks*, 14 No. 7 BANKING POL'Y REP. 1 (Apr. 3, 1995).

tions to them. Part II presents facts and events surrounding the collapse of Barings. Part III explores several of the factors which contributed to the collapse by focusing on the findings presented and issues raised in reports by the Board of Banking Supervision of the Bank of England and by the Singapore Minister of Finance. Part IV examines the effects of the Barings collapse and considers those concerns which underlie the collapse of major financial institutions generally. Part V expands this analysis by examining lessons to be learned from the collapse of Barings while proposing mechanisms that may prevent a Barings-type situation from occurring in the future.

## II. THE COLLAPSE OF BARINGS

At the age of twenty-seven, Nicholas Leeson was Barings's head arbitrage trader in Singapore.<sup>5</sup> In late 1994, Leeson began to implement an options trading strategy premised on the assumption that the Nikkei 225, an index of leading Japanese stocks, would remain within a limited and narrow trading range.<sup>6</sup> Leeson's trading strategy was simple: He would buy futures contracts at a comparatively low price in one market, and then sell the same number of contracts at a slightly higher price in a second.

The underlying value of such futures contracts is dictated by the performance of the shares that constitute the index. If the shares rise in value, the futures contract is worth more; if the shares fall in value, the contract is worth less. The key to success in futures trading is leverage: Buying a futures contract only requires a small proportion of the value of the index to be paid up front. Leveraging, therefore, greatly magnifies any swings in the value of the index. A large increase in the index value may result in significant gains; a large decrease in the index value, on the other hand, may cause a complete loss.<sup>7</sup> Thus, perhaps unsurprisingly, Leeson's trading strategy failed when a catastrophic earthquake hit Kobe, Japan on January 17, 1995.<sup>8</sup> The quake's economic aftershocks caused the Nikkei to fall substantially, resulting in large losses on Leeson's positions.<sup>9</sup>

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5. See Richard W. Stevenson, *Big Gambles, Lost Bets Sank a Venerable Firm*, N.Y. TIMES, Mar. 3, 1995, at A1.

6. See *id.* at D15.

7. See generally *The Barings Crisis: The City's Lost Weekend*, FIN. TIMES, Mar. 3, 1995, at 3.

8. See Stevenson, *supra* note 5, at A1.

9. See *id.*

Rather than accepting his losses as the Japanese stock market fell, Leeson doubled his bets, hoping to break even once the market rose again. After abandoning the arbitrage strategy he normally employed, Leeson began to buy Nikkei 225 futures on both the Singapore International Monetary Exchange (SIMEX) and the Osaka Securities Exchange.<sup>10</sup> His gamble was that this position would turn a profit if Japanese stock prices rose. Leeson eventually built up futures positions on the two exchanges with a total notional value of over \$7 billion.<sup>11</sup> Leeson also began to sell futures on both long and short-term Japanese government debt instruments.<sup>12</sup> Because interest rates move inversely to the price of debt issues, Leeson believed that the positions would be profitable if Japanese interest rates rose.<sup>13</sup> These positions more than tripled, eventually growing to a notional value of \$22 billion.<sup>14</sup> Leeson was able to conceal these losses by locating them in a special account, numbered 88888 (five-eights), which he opened in July of 1992.<sup>15</sup> This account was established to record trading errors, which were typically small amounts cleared quickly as adjustments were made.<sup>16</sup>

Unfortunately for Leeson and for Barings, both the Japanese stock market and Japanese interest rates fell, resulting in huge losses on all of his positions.<sup>17</sup> Between late January and late February, in an attempt to cover Leeson's failing positions and stave off disaster, Barings met margin calls that totaled over \$400 million.<sup>18</sup> On February 23, Leeson left Singapore, and the next day Barings's CEO Peter Baring was informed of the situation.<sup>19</sup> By that time, Leeson's open positions had unrealized losses of nearly \$1 billion.<sup>20</sup> By day's end on Friday, February 24, Barings executives calculated that the losses on

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10. *See id.*

11. *See* Tony Shale, *Why Barings Was Doomed*, EUROMONEY, Mar. 1995, at 40.

12. *See* Sheila C. Bair, *Lessons From the Barings Collapse*, 64 FORDHAM L. REV. 1, 3 (1995).

13. *See id.*

14. *See* Stevenson, *supra* note 5, at 15.

15. *See Uncovering the Cover-Up: Singapore Issues a Damning Report on the Barings Collapse*, ASIA WEEK, Oct. 27, 1995, at 48.

16. *See id.* The Singapore Report, *infra*, reveals that the five-eights account was in deficit by \$1.5 million by May, 1993.

17. *See* Stevenson, *supra* note 5, at D15.

18. *See* Bair, *supra* note 12, at 3.

19. Leeson and his wife flew first to Kuala Lumpur and then on to Kota Kinabalu in Sabah. Leeson was eventually arrested in Frankfurt, Germany on March 1, while he and his wife were en route to London. *See Uncovering the Cover-Up*, *supra* note 15, at 48.

20. *See* Stevenson, *supra* note 5, at D15.

Leeson's positions exceeded the company's net worth.<sup>21</sup>

Barings's executives immediately informed the Bank of England, the primary regulator for both investment houses and commercial banks in Britain.<sup>22</sup> Over the following weekend, the Bank of England calculated the losses in excess of \$750 million and initiated an attempt to rescue Barings.<sup>23</sup> Because many of the contracts Leeson had accumulated on the Japanese markets were still open, Barings was exposed to unquantifiable further losses until those contracts expired or were otherwise closed. Rescuing Barings proved to be an impossible task, and on Sunday, February 25, administrative orders<sup>24</sup> were granted in respect to nine key Barings companies.<sup>25</sup> The next day, the Singapore exchange agreed to take over Barings's contracts and manage their orderly liquidation.<sup>26</sup> Soon thereafter, Barings's proprietary positions on SIMEX, the Osaka Securities Exchange, the Tokyo International Financial Futures Exchange, and the Tokyo Stock Exchange were all liquidated,<sup>27</sup> resulting in an aggregate loss of approximately \$1.4 billion.<sup>28</sup>

In early March, Internationale Nederlanden Group (ING), a Dutch bank and insurance firm, purchased Barings's entire business for one British pound.<sup>29</sup> ING subsequently dismissed twenty-one Barings executives who had direct or indirect responsibility for the Singapore operation.<sup>30</sup> Thus, a financial empire, constructed over two centuries, was undone.<sup>31</sup>

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21. See Stevenson, *supra* note 2, at D1.

22. See *id.*

23. See *id.*

24. "Administration" is the British equivalent of bankruptcy in the United States. See Bair, *supra* note 12, at 4.

25. See Andrew Wilkinson, *The Insolvency of Financial Institutions—The English Approach*, 721 PLI/COMM 493 (Sept. 1995).

26. See Stevenson, *supra* note 2, at D1.

27. See Bair, *supra* note 12, at 4.

28. See Shale, *supra* note 11, at 40.

29. See *id.*

30. See Richard W. Stevenson, *Germany Orders Leeson Extradited to Singapore*, N.Y. TIMES, Oct. 5, 1995, at D6.

31. On December 2, 1995 a court in Singapore sentenced Leeson to six and a half years in prison for illegally covering up trading losses that led to the Barings collapse. As part of a plea bargain, Leeson pled guilty to two charges of cheating, and the prosecution dropped the remaining nine criminal charges of fraud and forgery. See *Singapore Sentences Leeson to 6 ½ Years in Prison*, N.Y. TIMES, Dec. 2, 1995, at 35.

### III. UNDERLYING CAUSES OF THE BARINGS COLLAPSE

Sole responsibility for the Barings collapse was immediately attributed to Nicholas Leeson, dubbed by many the "rogue trader" of Barings.<sup>32</sup> That one person acting alone could topple an institution such as Barings suggested that even the strictest controls, either by a company's management or by its external regulators, would be ineffective in preventing similar types of fraud, and raised the specter of similar collapses in the future. Further inquiry, however, reveals that Leeson's activities could and should have been detected and that the Barings collapse ought, therefore, to have been prevented. The discussion which follows reveals how internal management controls, external auditors, and even some regulatory authorities, all share a measure of responsibility for the collapse of Barings.

Following the debacle, two main inquiries were launched. The first was made by the Board of Banking Supervision of the Bank of England, which published a 337-page report of its findings on July 18, 1995<sup>33</sup> (U.K. Report). The second was conducted by two partners at the accounting firm Price Waterhouse, appointed as Inspectors by the Singaporean Minister of Finance to investigate the affairs of Baring Futures Singapore (BFS)<sup>34</sup> (Singapore Report). The relevant findings of each report are discussed below.

#### A. U.K. Report

The U.K. Report made three relevant findings: (1) Barings's losses were caused by unauthorized and concealed trading activities within BFS; (2) the company's true position was not noticed earlier because of serious control failures and managerial confusion within the Barings Group; and (3) this position had not been detected prior to the collapse by the external auditors, supervisors, or regulators of Barings.<sup>35</sup> Thus, according to the U.K. Report, the collapse was caused by a breakdown of responsibilities in three areas: internal management and controls, external auditors, and regulatory authori-

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32. See, e.g., the Chicago Tribune's headline "Old Bank, Modern Scandal; Manhunt Under Way for 'Rogue Trader,'" *supra* note 1.

33. See BOARD OF BANKING SUPERVISION, BANK OF ENGLAND, INVESTIGATION INTO THE FAILURE OF BARINGS (1995).

34. See Report by Singapore Inspectors on Barings Futures (Singapore), FIN. REG. REP., Oct. 1995, available in LEXIS, Nexis Library. The 183-page Singapore Report was published on October 17, 1995.

35. See *HM Treasury—Barings—Statement by the Chancellor*, HERMES—U.K. GOVT. PRESS RELEASE, July 18, 1995, available in LEXIS, Nexis Library, Reuter Textline.

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Leeson had complete power to oversee both the trading activities of BFS and its "back office systems," those systems that provide for the settlement of accounting transactions.<sup>36</sup> No independent Barings official reviewed and verified Leeson's transactions and ensured that his trading activity stayed within acceptable risk levels. Thus, Leeson was not properly supervised, due in part to confusion concerning the internal chain of command.

The U.K. Report concluded that such a massive unauthorized position could not have been established had Barings maintained an effective system of management and operational controls. Barings's banking operation in London, Barings Brothers & Co. (BB&Co.), funded BFS through Barings Securities Ltd. (BSL), on a no-questions-asked basis. BB&Co. did not assess counterparty risks, verify funding requests or reconcile records, nor did it establish whether the funds requested were for client or proprietary trading. BB&Co. advanced the money ultimately lost in Singapore to BSF without an independent check on the request's validity or an attempt to reconcile losses with any known trading position. If the management at BB&Co. had examined the information from Singapore, they likely would have discovered that the information given to them was meaningless.<sup>37</sup> Senior management thus failed to inquire into how a supposedly risk-free arbitrage operation could generate such extraordinarily high levels of profit.<sup>38</sup> The U.K. Report concluded that these profits should have been regarded as abnormal and questionable, and that the extraordinary profitability reported in 1994 should have attracted management's attention long before the February 1995 collapse.<sup>39</sup>

The U.K. Report also criticized Coopers & Lybrand Singapore (C&L Singapore), the auditors for BFS. C&L Singapore completed an assessment of BFS's internal controls in November 1994, which concluded that the company's safeguards were satisfactory. The U.K. Report observed that "this conclusion was . . . not readily compatible with the fact that there was a lack of segregation between front and back office."<sup>40</sup> Similarly, Coopers & Lybrand London (C&L Lon-

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36. See Bair, *supra* note 12, at 4.

37. See *Statement by the Chancellor*, *supra* note 35.

38. See *The Wider Lessons of Barings*, FIN. TIMES LTD. FIN. REG. REP., July 1995, available in LEXIS, Nexis Library.

39. See *Statement by the Chancellor*, *supra* note 35.

40. *The Wider Lessons of Barings*, *supra* note 38.

don) audited BB&Co.'s operations for both 1993 and 1994. The U.K. Report challenges the effectiveness of C&L London's testing of Barings's internal controls and proposes that more thorough tests would likely have revealed the inadequate support for Singapore's funding requests.<sup>41</sup>

The U.K. Report did not suggest that events leading up to the Barings collapse called for any fundamental change in the U.K.'s regulatory framework. However, the U.K. Report does contain two major criticisms of the Bank of England's supervisory performance with regard to Barings. First, the Bank of England erred in 1993 in giving BB&Co. an "informal concession" with respect to a bank's normal obligation to notify it, in advance, of margin exposures which represent more than twenty-five percent of its capital base. This error in judgment resulted in almost two years of confusion about whether or not Barings's margin exposure should be subject to the standard 25 percent limit. This ambiguity permitted the open-ended build-up of Barings's exposure on the SIMEX.<sup>42</sup> Second, the Bank of England did not rigorously consider the effects of permitting BSL and BB&Co to be supervised on a joint or "solo consolidated" basis.<sup>43</sup> This supervisory agreement consolidated Barings's banking and securities businesses, leaving no limit on the intra-group funding of Barings's securities operations by its banking arm. This was the first time that a major securities company had been solo consolidated with a bank.<sup>44</sup> In effect, this meant that BB&Co. was able to use its bank deposits to remit large advances to BFS via BSL.<sup>45</sup> Although ostensibly to finance client trading, this funding was actually used to "subsidize" unauthorized speculative activity.<sup>46</sup>

In addition, the U.K. Report examined closely whether any executives in London acted in collusion with Nicholas Leeson, and whether there was an attempt to "cover-up" evidence that should have alerted executives earlier. The Board was unable to determine Leeson's motives or whether he was acting alone.<sup>47</sup>

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41. See *Statement by the Chancellor*, *supra* note 35.

42. See *id.*

43. See *id.*

44. Illustrative of the problematic nature of this arrangement is the fact that in the first three weeks of February alone, Barings remitted nearly \$1 billion to BFS. See *Uncovering the Cover-Up*, *supra* note 15, at 48.

45. See *The Wider Lessons of Barings*, *supra* note 38.

46. See *id.*

47. See *Statement by the Chancellor*, *supra* note 35.

## B. Singapore Report<sup>48</sup>

The Singapore Report was more critical than the U.K. Report, concluding that Barings officials knew much of what was going on and sought to hide Leeson's losses and even thwart investigations into Leeson's activities. The differences in the two reports, however, do not alter this Note's analysis of the implications and lessons of the Barings collapse.

The Singapore Report blamed the Barings collapse on the losses incurred as a result of Leeson's allegedly unauthorized and concealed trades in Singapore.<sup>49</sup> It noted that management failings, a lack of internal controls, weaknesses in internal and external audits, and poor external supervision allowed the situation to develop. Specifically, three problems were cited: (1) management's failure to segregate the trading and settlement functions of BFS; (2) the absence of effective controls over Leeson's activities; and (3) the lack of coordination among the Barings Group's different departments, each of which dealt with matters arising from Leeson's trading activities. The Singapore Report also criticized the supervisory performance of the Bank of England, the performance of external auditors, and the regulatory performance of the SIMEX.<sup>50</sup>

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48. The Singapore report highlighted ten issues identified as significantly impacting the Barings collapse:

Whether there was any weakness in organizational structure and controls which resulted in Leeson's activities not being effectively monitored or controlled (chap. 4);

To what extent the internal audit had identified warning signals that ought to have alerted the Barings Group to the need to monitor and control Leeson more closely (chap. 5);

To what extent the Compliance Department was responsible for checking Leeson and his activities (chap. 6);

To what extent a proper system was in place for monitoring the Barings Group's risk exposure and the role of ALCO [the Asset and Liability Committee] (chap. 7);

How BSL Settlements identified and resolved concerns stemming from Leeson's activities (chap. 8);

How Group Treasury dealt with funds requested by Leeson to maintain his trading positions (chap. 9);

The role of Financial Controls and Credit Control in relation to Leeson's activities (chaps. 10 and 11);

To what extent FPG [the Financial Products Group] and its senior managers contributed to Leeson's ability to function as he did (chap. 12);

How this state of affairs escaped the regulatory reporting regime that the Barings Group was subject to (chap. 13); and

To what extent external controls may have been negated (chaps. 14 and 15).

See generally *Report by Singapore Inspectors on Baring Futures (Singapore)*, *supra* note 34.

49. See generally *id.*

50. See *id.*

#### IV. EFFECTS OF THE BARINGS COLLAPSE

After Leeson had been found, ING purchased Barings, and the fatal contracts were satisfied, some may have questioned whether the Barings affair was worthy of much thought or concern. Indeed, in some respects the repercussions of the entire affair may seem relatively minor. Immediately following the collapse, for example, there was no acute sense of crisis in Singapore even though the ill-fated bets had been made there.<sup>51</sup> SIMEX, which traded the futures and options that made up Leeson's positions, limited the effects of the crisis by taking over Barings's contracts and managing their liquidation, thereby keeping losses at a minimum.<sup>52</sup> In addition, other effects of the collapse such as the damage done to London's reputation for safe financial dealing and personal losses incurred by a number of Barings's investors, may be regarded as the price paid for taking part in risky financial games. Some may view the Barings affair as a just ending for a financial institution which played the high-stakes derivatives game. Finally, history reveals that February 26, 1995 was not the first time Barings had "gone bust"; the first "Barings Crisis" occurred in London in 1890.<sup>53</sup> Barings recovered from that loss, as have other financial institutions in similar situations. Consequently, one may legitimately ask whether there is a need to be concerned about the effects of this or similar collapses of financial institutions.<sup>54</sup>

A look at some of the collapse's global effects, however, illustrates the serious impact of Barings and of these types of downfalls. In Tokyo, nervousness caused by the Barings collapse sent stock prices rapidly downward.<sup>55</sup> The Nikkei index closed down 660.33

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51. See Stevenson, *supra* note 2, at D1.

52. See *id.*

53. For a brief history of the first "Barings Crisis," see Andrew St. George, *Second Crisis Hits Bankers to the Great and the Good; Barings Served Kings and Emperors, It Has Had a Hand in the Creation of the US and Financed Russia, But Its Luck May Have Run Out*, THE INDEPENDENT, Feb. 27, 1995, at 25.

54. Any lingering doubt about the potential recurrence of such rogue activities by individual traders should have been dispelled in June 1996, when Sumitomo Corporation announced that it had lost an estimated \$1.8 billion due to unauthorized copper trading by former chief copper trader, Yasuo Hamanaka. See *Japan Traders Wary of Copper Market After Sumitomo*, REUTERS FINANCIAL SERVICE, Oct. 22, 1996. In a remarkable parallel to the Barings collapse, the events surrounding Sumitomo spanned three jurisdictions: the United Kingdom, where Sumitomo was trading on the London Metal Exchange (LME), the United States, where the LME recently had established a warehouse for delivery of copper and where copper is traded on the New York Mercantile Exchange, and Japan where Sumitomo is legally domiciled. See Kang, *supra* note 3, at 242.

55. See Stevenson, *supra* note 2, at A1.

points,<sup>56</sup> or 3.8 percent, the largest one-day fall since the financial aftershock of the Kobe earthquake itself.<sup>57</sup> The Barings collapse pushed stocks down in over a dozen countries in Asia and Europe as investors tried to recover their assets without getting caught in the eddies of the collapse.<sup>58</sup> Additionally, the British pound fell to an historic low against the German mark.<sup>59</sup> These results illustrate the ease with which a single financial institution located in one country (England) was able to establish trading practices in a second nation halfway around the globe (Singapore), and thereby affect financial markets worldwide (Hong Kong, Japan, England) through its mis-managed operations.

To this point, the United States has not been mentioned as being significantly affected by the Barings collapse. Nevertheless, American investors ought to be concerned by international market disruptions such as those caused by the Barings collapse. For example, there has been a trend in recent years for U.S. investors to purchase mutual funds and closed-end funds which invest in foreign securities markets as well as acquiring the debt and equity securities of foreign issuers. Purchases and sales by U.S. investors of foreign debt and equity securities, which in 1980 amounted to \$35.2 billion and \$17.9 billion, respectively, grew to \$815 billion and \$1,829.4 billion, respectively, in 1994.<sup>60</sup> In 1994 approximately 5.5 percent of U.S. investors' equity holdings was represented by foreign equities.<sup>61</sup> Additionally, foreign purchases and sales of debt and equity securities of U.S. companies, which were \$9 billion and \$75 billion, respectively, in 1980, grew to \$222 billion and \$708 billion, respectively, in 1994.<sup>62</sup> Since 1984, foreign trading on the New York Stock Exchange has risen at a compound rate of 18.5 percent, a rate which outstrips annual volume on the NYSE which has grown at 12.34 percent.<sup>63</sup>

Should a Barings-type scenario repeat itself, even if losses are confined to the London or the Hong Kong exchanges, American in-

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56. *See id.* at D1.

57. *See Sullivan & Moseley, supra* note 1.

58. *See id.*

59. *See id.*

60. *See* STATISTICAL ABSTRACT OF THE UNITED STATES 1995: THE NATIONAL DATA BOOK, tbl. 826; SIA, 18 FOREIGN ACTIVITY: AN ANALYSIS OF FOREIGN PARTICIPATION IN THE U.S. SECURITIES MARKETS No. 2 (Apr. 1995).

61. *See* Cochrane, Shapiro, & Tobin, *Foreign Equities and U.S. Investors: Breaking Down the Barriers Separating Supply and Demand 4* (NYSE Working Paper No. 95-04, 1995).

62. *See* Statistical Abstract, *supra* note 60, at 817; SIA, *supra* note 60.

63. *See* NYSE Fact Book 1994.

vestors with interests in mutual funds comprised mostly of stocks trading on those exchanges would feel the effects of the collapse. In the same vein, it is easy to imagine “emerging markets funds” suffering large losses due to the collapse of an institution with a dominant presence in the developing market in which the fund has invested.

Thus, the primary concern for bank regulators to address in the aftermath of Barings is systemic risk. Systemic risk is described as the risk that illiquidity or failure of one institution, and its resulting inability to meet its obligations when due, will lead to the illiquidity or failure of other institutions.<sup>64</sup> Banks that engage in derivative activities in an imprudent manner are exposed to great risk and, consequently, face significant potential losses that could jeopardize major firms or even the financial system as a whole.<sup>65</sup> The inability of one bank to meet its contractual obligations has the potential to create a domino effect, toppling one financial institution after another. In another scenario, the widespread reliance of investors on dynamic hedging strategies during a market disturbance could turn an otherwise containable market downturn into an illiquidity-driven crash.<sup>66</sup> Although systemic risk concerns are more prevalent today because of the increased interdependence of the world’s economies, Barings did not cause a domino effect, nor did the effects of Barings rise to the level of an illiquidity-driven crash. Nevertheless, the ever-increasing development and use of derivatives and other innovative financial instruments, combined with the ever-increasing interdependence of financial markets, suggest that any lessons from past failures should be heeded. Any sort of financial debacle carries with it a risk that threatens the stability of financial markets and investor confidence in those markets. Ironically, the Barings collapse may have been of just the right magnitude to force regulators, managers, and traders to re-evaluate current practices and improve risk management and trading activities before a greater financial crisis occurs.

#### V. LESSONS FROM BARINGS: PREVENTING FUTURE FINANCIAL CRISES

In a report to Parliament, Chancellor of the Exchequer Kenneth Clarke stated, “In cases such as [Barings] it is important that lessons

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64. See Adam R. Waldman, *Comment: OTC Derivatives & Systemic Risk: Innovative Finance or the Dance Into the Abyss?*, 43 AM. U.L. REV. 1023, 1053-54 (Spring 1994).

65. See Schott, *supra* note 4.

66. See Waldman, *supra* note 64, at 1054.

are learnt quickly and promulgated widely, so that all parties, including the management of other financial institutions, can learn from the unfortunate example."<sup>67</sup> The Barings collapse offers important lessons for financial managers, traders, and regulators, and provides them the opportunity to evaluate and improve their current practices where necessary. The U.K. Report noted three levels of protection that might have prevented the build-up of such concealed losses: internal management controls, the external auditing process, and supervision by relevant regulatory authorities.<sup>68</sup> Lessons from Barings may be organized first around internal management control, and second around external regulatory control and cooperation.<sup>69</sup>

### A. Internal Lessons

Internal lessons refer to those steps a financial institution can implement to improve itself in order to prevent a Barings-type collapse. Four interrelated steps include the following: (1) managerial incentives; (2) independent risk-management systems; (3) appropriate oversight; and (4) risk management processes. Each of these will be discussed in turn.

1. *Managerial Incentives.* Banks should structure employee compensation schemes to avoid potential incentives for excessive risk-taking.<sup>70</sup> Barings's executive management held Barings's voting share capital, and the non-voting share capital was held by the Barings Foundation, a U.K. registered entity. The executive management voted themselves a remuneration policy under which approximately fifty percent of pre-tax profits went directly into a bonus pool. This policy created a ratio of bonus to basic salary of 75:25, or more, at the director level.<sup>71</sup> Within this general scheme, Leeson's bonus for 1994 was a large multiple of his basic salary, reflecting the false level of profitability reported by him. In other words, Barings resembled a partnership so far as profit distribution was concerned, but management was protected by limited liability with respect to losses. This structure created an incentive for top

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67. *Statement by the Chancellor, supra* note 35.

68. *See The Wider Lessons of Barings, supra* note 38.

69. This Note does not attempt to outline every possible internal and external control device needed to assure safety in derivatives trading. Rather, it merely discusses certain areas in which control devices suggested by the Barings experience may be improved and implemented.

70. *See Schott, supra* note 4.

71. *See The Wider Lessons of Barings, supra* note 38.

managers to avoid scrutinizing the source of Leeson's trading profits, which would contribute significantly to the bonus pool. A large portion of the profits from Leeson's unauthorized risk-taking would go to management, while catastrophic losses would be borne by others, including non-voting shareholders—the Barings Foundation, for example.<sup>72</sup> Accordingly, the challenge for banks and bank managers is to structure their institutional compensation programs so as to discourage excessive risk-taking. This step can and should be buttressed by implementation of the next three steps.

2. *Independent Risk Management Systems.* Firms engaged in significant derivatives trading should separate risk management systems from trading functions and develop independent lines of reporting authority reaching to the highest levels of senior management.<sup>73</sup> An important element of risk management is the independence of individuals in charge of measuring, monitoring, and controlling risks on behalf of the bank.<sup>74</sup> These individuals should be managed independently of those conducting trading activities, all the way through senior levels of management.<sup>75</sup> As noted, Leeson was in charge of both the front and back offices at BFS. Had this responsibility been divided between two people, a system of checks and balances would have ensured that Leeson's trading was legitimate and within appropriate risk levels.

3. *Appropriate Oversight.* Management needs to understand the business in which they are engaged and establish tight internal controls. Former Barings employees claim that senior executives in London frequently demonstrated a fundamental ignorance about derivatives.<sup>76</sup> If a manager does not understand a product, it is easy for a trader to convince the manager that extraordinary profits or losses are unique to that product and are, therefore, appropriate. Had Barings's management understood derivatives more fully, they would perhaps have been more skeptical about the size of the profits Leeson's trading generated.

Similarly, senior management should institute adequate policies and procedures for conducting derivative activities on both long-term

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72. *See id.*

73. *See Bair, supra* note 12, at 5.

74. *See Schott, supra* note 4.

75. *See id.*

76. *See Shale, supra* note 11.

and day-to-day bases. Such a policy would include obtaining necessary approval and ensuring clear lines of responsibility for managing risk, adequate systems for measuring risk, limits on risk-taking, and a comprehensive risk reporting system.<sup>77</sup> Additionally, a bank's board of directors should approve all significant policies relating to risk management throughout the bank. Policies regarding risks of derivative activities should be consistent with the bank's overall business strategy, capital adequacy, management expertise, and general willingness to accept risk. The board should regularly receive information on risk exposure and reevaluate risk management policies, procedures, and tolerances.<sup>78</sup>

The role of appropriate oversight mechanisms illustrates the inter-relatedness of improving internal controls. If an institution is structured similarly to Barings, where management had incentives *not* to be prudent in the trading activities of its BFS subsidiary, management will be unlikely to implement the policies and procedures necessary to regulate those activities.

4. *Risk Management Processes.* Derivative risk management components are fundamental to all risk-taking by banks and should be integrated with their overall risk management systems.<sup>79</sup> A bank's system for measuring the various risks inherent in derivative activities should be comprehensive and accurate. Risks should be measured and aggregated across trading and non-trading activities on a bank-wide basis, and the systems implemented should accurately reflect the multiple types of risks involved. This emphasis on creating "bank-wide" strategies is applicable precisely where an institution's subsidiary, such as BFS, might be used to swiftly deplete an institution's entire capital. Had Barings incorporated the risks taken in its Singapore subsidiary (presuming, of course, that managers were aware of the risks) into a bank-wide risk assessment plan, perhaps it would have succeeded in restricting some of its subsidiary's activities.

Banks should also analyze situations in advance, including combinations of market conditions, which may place their operations under stress. These analyses should include not only the probability of adverse events, but also plausible "worst case" scenarios. They should also consider qualitative analyses of the actions management

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77. See Schott, *supra* note 4.

78. See *id.*

79. See *id.*

might take under particular contingencies.<sup>80</sup> It is unlikely that Leeson or anyone at Barings ever contemplated the Kobe earthquake, and few would argue that trading should be done on so conservative a basis that plans for such catastrophic events are in place. Nevertheless, the notion that banks should analyze possible “worst case” scenarios, including the ramifications and probabilities of natural disasters, represents a prudent strategy following the collapse of Barings.

Banks should also have an information system that monitors and reports their risk management measures, passing the data gleaned on to appropriate senior management and to the board of directors.<sup>81</sup> One commentator suggests that for dealer operations, exposures and profit loss statements should be reported at least daily to managers who supervise but do not conduct trading activities.<sup>82</sup> More frequent reports should be made as market conditions dictate. Reports to other levels of senior management and to the board may occur less frequently, but they must include adequate information for them to evaluate the changing nature of the bank’s risk profile.<sup>83</sup>

Furthermore, a bank should set boundaries for organizational risk-taking and ensure that positions exceeding certain predetermined levels receive prompt attention from management.<sup>84</sup> Had this type of system been in place within Barings, its management would have been alerted to Leeson’s positions. These guidelines illustrate once again the comprehensive approach required when improving internal controls because any such guidelines would prove useless if internal corporate structures encourage management to turn a blind eye to these warning signs.

Finally, regular review and evaluation of banks’ risk management processes are necessary components of a prudent risk management system. This review should assess the methodologies, models, and assumptions used to measure risk and limit exposure.<sup>85</sup> The extent to which banks should reevaluate, and the frequency of those reevaluations, depend, in part, on the specific risk exposures created by trading activities, the pace and nature of market changes, and the pace of innovation with respect to measuring and managing risks. At a minimum, banks with significant trading and derivative activities

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80. *See id.*

81. *See id.*

82. *See id.*

83. *See id.*

84. *See id.*

85. *See id.*

should review the underlying methodologies or their models at least annually, and more often as market conditions dictate.<sup>86</sup>

5. *A Note on Capital Adequacy.* No problems associated with capital adequacy requirements were mentioned by either the U.K. or Singapore report; neither report found such requirements to be contributing factors in the Barings collapse. Although Barings was highly capitalized, the losses incurred by Leeson exceeded anyone's expectations. Furthermore, it is recognized that capital adequacy requirements alone do not provide adequate safeguards against the risks associated with derivative activities.<sup>87</sup> Nevertheless, derivative activities should be fully supported by an adequate capital position and capital adequacy requirements should be modified to recognize the complexities inherent in derivative activities.<sup>88</sup>

#### B. External Lessons

Following the collapse of Barings, the Basle Committee on Banking Supervision<sup>89</sup> (the Committee) issued guidance to bank supervisors worldwide. The Committee recognized the fact that derivatives are a global issue, not merely a national one, and realized the need for a single supervisory framework. The Committee's guidance was issued simultaneously through a joint press release with the Technical Committee of the International Organization of Securities Commissions that expressed similar guidance.<sup>90</sup> The joint release emphasized that the derivative activities of banks and securities firms give rise to similar risks, and that both industries should use similar risk management practices. The global nature of financial markets makes it clear that international trading in derivatives could benefit from international guidelines. The United States already has in place guidelines and safeguards which, if implemented internationally, could help reduce the risk of a Barings-type collapse and its effects in

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86. *See id.*

87. *See id.*

88. For discussion of the evolution of capital adequacy requirements for banks' derivative activities, see Barbara C. Matthews, *Capital Adequacy, Netting, and Derivatives*, 2 STAN. J.L. BUS. & FIN. 167 (1995).

89. Established in 1975, the Basle Committee is a committee of banking supervisory authorities comprised of banking regulators from twelve industrialized nations. The Committee's primary aim is to promote gradual transnational convergence of supervisory practices governing financial institutions. *See* J.J. NORTON, ET AL., INTERNATIONAL BANKING REGULATION AND SUPERVISION: CHANGE AND TRANSFORMATION IN THE 1990'S at 265 (1994).

90. *See* Schott, *supra* note 4.

other markets.

1. *The United States as a Model.* Some observers believe that the Barings collapse could not have happened in U.S. markets.<sup>91</sup> The United States operates a sophisticated set of safeguards designed to give the Commodities Futures Trading Commission (CFTC) and its self-regulatory organizations (SROs) advance warning when an individual firm's futures trading may be approaching dangerous levels.<sup>92</sup> In a situation like Barings, which involved unusually large positions, the CFTC's first line of defense would be its market surveillance system.<sup>93</sup> The CFTC and all U.S. futures exchanges maintain large trader reporting systems so that if a trader's positions exceeds a "reportable level," it must file certain information about itself with the CFTC.<sup>94</sup> When a trader's position crosses the threshold and becomes reportable, the trader must provide the CFTC with the name and phone number of the person who controls trading in the account and the identity of any other accounts controlled by that individual.<sup>95</sup> Futures commission merchants are also required to file daily reports concerning all accounts they carry which exceed reportable levels.<sup>96</sup> These reports can then be cross-checked with other reports filed by the individual traders. Accounts under common ownership or control are aggregated for reporting purposes so that a trader cannot avoid the CFTC's reporting requirements by controlling a number of small accounts below the reporting threshold.<sup>97</sup>

Information on large traders is filed electronically.<sup>98</sup> Information reflecting positions of traders as of the market close on Monday is available by Tuesday morning to the CFTC surveillance economist responsible for monitoring a given contract. Large, unusual, or concentrated positions are carefully scrutinized, and the CFTC surveillance staff briefs the Commission weekly on any unusual market conditions.

In addition to looking at unusual positions or market conditions, U.S. market surveillance systems also monitor compliance with limits

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91. See generally Bair, *supra* note 12.

92. See *id.* at 5.

93. See *id.*

94. 17 C.F.R. § 18.04 (1995).

95. See *id.* § 18.04.

96. See *id.* § 17.00.

97. See *id.* § 18.01.

98. See *id.* § 17.02.

on speculative positions.<sup>99</sup> For example, the Chicago Mercantile Exchange's speculative limit for the Nikkei 225 is 5,000 contracts.<sup>100</sup> Any exemptions from the limits, such as hedge positions, must be thoroughly documented.<sup>101</sup> In the United States, Leeson's positions would have triggered a review by exceeding preset speculative limits. Similarly, a review of the evidence submitted to obtain a hedge exemption would have occurred, including a review of any related cash market position. Thus, the extensive information sharing agreements among the CFTC, U.S. futures markets, and the CFTC's securities counterparts would enable the CFTC to independently verify whether a trader, such as Leeson, was holding positions that might offset large stock index futures positions.<sup>102</sup> Moreover, both the CFTC and the exchanges closely monitor compliance with financial integrity rules.<sup>103</sup> Financial surveillance systems on the exchanges routinely produce "exception reports" which provide information about firms which carry large positions, sustain a series of losses over time, or have the potential to generate large losses relative to the amount the firm has on deposit or the amount of the firm's capital. The exchanges are also required to do stress testing to monitor the vulnerability of their members during times of market volatility.<sup>104</sup> Finally, U.S. exchanges have affirmative duties to supervise their markets as a matter of law.<sup>105</sup> The CFTC also conducts regular reviews of the exchanges' self-regulatory and enforcement programs, and issues public "report cards" grading the exchanges' performance.<sup>106</sup>

Many of the above-described safeguards could be implemented globally to alert markets to abnormal situations before they escalate. For example, the Singapore Report, *supra*, criticized the SIMEX for being too liberal in raising Barings's position limits. Global limits could be set for each major type of risk involved and could provide

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99. See Bair, *supra* note 12, at 6.

100. Chicago Mercantile Exchange Rule 4402(D) (1994).

101. 17 C.F.R. § 19.00(b)(1) (1995).

102. See Bair, *supra* note 12, at 6.

103. See *id.* at 7.

104. See *id.*

105. Under CFTC regulations, every contract market is required to use "due diligence" to maintain a "continuing affirmative action program" to secure compliance with the Commodity Exchange Act, 7 U.S.C. §§ 1-25 (1994), the CFTC's regulations, and the exchange's rules. 17 C.F.R. § 1.51 (1995). See also *id.*

106. See 7 U.S.C. § 12e (1994).

the capability to allocate limits for individual business units.<sup>107</sup>

2. *International Regulatory Cooperation.* The U.K. Report failed to address an issue that cannot escape discussion, namely, weaknesses in international regulatory coordination.<sup>108</sup> In accounting for risks posed by subsidiaries of securities firms, regulators have to rely, to a large extent, on foreign supervisory authorities to ensure that overseas subsidiaries are prudently managed.<sup>109</sup> In the months preceding the Barings collapse, regulatory authorities representing the U.K., Japan, and Singapore failed to communicate sufficiently with one another. This failure underscores the urgency for a clear multilateral agreement designed to coordinate international securities market regulation, perhaps along the lines of the existing Basle agreement on the coordination of international banking regulation.<sup>110</sup>

A related issue requires consideration of the different approaches taken by bank and securities regulators. Under the Basle Concordat,<sup>111</sup> bank regulators are obliged to include foreign subsidiaries in their consolidated supervision of banking groups;<sup>112</sup> securities regulators, on the other hand, are not subject to such obligations.<sup>113</sup> The SFA stated in relation to Barings that it made no attempt to assess the risks posed by BSL's foreign securities operations, including BFS. For a business which mixes banking and securities operations, as Barings did with large intra-group financial flows and complex cross-guarantees and comfort letters, this dual approach to regulation makes little sense since the parent bank is exposed to the risks incurred by all its affiliated units, including overseas securities operations.<sup>114</sup>

A final issue concerns the dangers that accompany a solo consolidation of a bank and a securities firm. Under solo consolidation,

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107. See Schott, *supra* note 4.

108. See *The Wider Lessons of Barings*, *supra* note 38.

109. See *id.*

110. See *id.*; see also Norton, *supra* note 89.

111. The Concordat seeks to identify basic principles governing the responsibilities of host and home country regulators in the event of the failure or threatened failure of a bank operating across borders. See COMMITTEE ON BANKING REGULATIONS AND SUPERVISORY PRACTICES: REVISED BASLE CONCORDAT ON PRINCIPLES FOR THE SUPERVISION OF BANKS' FOREIGN ESTABLISHMENTS, *reprinted in* 22 I.L.M. 900 (1983).

112. See *id.* at 907.

113. See *The Wider Lessons of Barings*, *supra* note 38.

114. See *id.*

a securities firm may be able to expand risky business through “soft” funding from its affiliated bank, just as Barings did. The fundamental question to be asked is how appropriate is it for banks, and bank deposits, to be used as a funding source for an affiliated securities firm, particularly given the fact that bank deposits represent “subsidized” funding to the extent that depositors are protected by the official insurance safety net. Arguably, bank deposits should be withheld from high-risk, aggressively managed securities businesses unless they reflect the manifest risks involved.<sup>115</sup>

## VI. CONCLUSION

Regardless of where fault lay—whether with Nicholas Leeson, senior management, Barings’s external auditors, the Bank of England, or with the SIMEX—a 223-year-old financial institution came crashing to its knees in a matter of months. The Barings collapse did not result in worldwide financial crisis, nor did it topple institution after institution when it failed to meet its own obligations on SIMEX futures contracts. However, it is precisely the interplay of these observations that makes the Barings story not only interesting but important in the context of global financial institutions. The collapse may have been of precisely the magnitude necessary to alert the world to the fact that derivatives are risky, that losses can spiral out of control virtually overnight, and that the effects of a failed financial institution are not merely local but can reverberate around the globe. If, as a result of the Barings collapse, financial institutions evaluate and improve internal controls on risk management and regulators undertake a more cooperative global approach, perhaps devastating Barings-style collapses may be prevented in the future. At a minimum, steps taken to increase the level of confidence investors have in the long-term stability of financial markets can only serve to benefit all those associated with them.

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115. *See id.*