

## **Barings bank (risk management disaster)**

The story of the Barings is one of a rogue trader that alone caused the bankruptcy of a supposed solid bank. This came at a big surprise and shock to everyone and especially to the finance industry as the phenomenal loss had been dissimulating for months fraudulently.

26th February 1995, the bank Barings Plc, one of the oldest banks of the United Kingdom was declared bankrupt. Nick Leeson, one of the bank's trader in Singapore had lost \$1.4 billions on derivatives trading while the bank reported capital was only about \$600 m. This hit came principally from a hit on a long position in the Nikkei 225 futures of notional value around \$7bn on the Osaka and Singapore Exchange.

Officially Nick Leeson was arbitraging the Nikkei 225 futures contracts on the different exchanges, the Singapore International Monetary Exchange (SIMEX) and the Osaka Stock Exchange (OSE), buying the same futures at a low price in one exchange and selling simultaneously at a higher price on the other exchange. For Barings London, Nick Leeson was presumably doing a trading strategy with little or no exposure to risk as he was allegedly hedged.

Leeson had been the star trader of the bank. Hired as a relatively young clerk, he went to BARINGS' Singapore office in 1992. Within a year, he had made alone 10 million pounds, which accounts for 10% of the bank profit for that year. For this trading exploit, Nick Leeson was granted 1 £130,000 bonus on

top of his £50,000 salary. Senior management had lots of trust in him and gave him progressively full firing power. Due to the rapid expansion of Barings Settlements, he quickly found himself in charge of both the front and back office. He would be trading on the futures market and at the same time, be in charge of booking and reporting the various trades. In a normal day, he would work in the Singapore Money Exchange (SIMEX) until trading closed at 2pm, and then would go to the office (or 'back room') where all the records of the day's trades were recorded. This meant in particular that Nick Leeson would be the only one to check and to know if the records matched the actual sales. Usually, a different person is doing the back office accounting, to detect any dodgy deals. However, this was not the case at Barings, giving Nick Leeson the dreadful power to cover his tracks in case of substantial loss.

In the end of 1994, this was way beyond the mind of the senior management of Barings, who cherishes their young trading prodigy. The huge Futures position of Nick Leeson was simply part of his trading mandate and no one would suspect any suspicious trading loss behind.

Leeson's position on the Osaka Stock Exchange was publicly known as the exchange report such positions each week. Barings London thought that this long position was matched by a short position of the same notional value. This 's implies being short twice as many contracts as the Simex contracts are with a notional twice as small as the one of Osaka's contracts. But, contrary to what the senior management was thinking, Nick Leeson was in fact long the same amount in the Symex exchange. Nick Leeson managed to hide his real position in a secret account known as an Error account and with the famous

number of **88888**. It was possible to dissimulate his position and to use the 88888 account because uncommonly for a trader, he was responsible both for front and back office. Nick bought a substantial number of contracts, 11,000 on the 20th of January 1995, just three days after the earthquake in Kobe. Probably, he thought that the market had overreacted and that the fall of the Nikkei 225 from 20,000 to 18,950 was only temporary. But the Nikkei 225 dropped even further and by Monday 23rd 1995, the Nikkei 225 was around 17,950. At the end of February 1995, Nick Leeson had leveraged his position to \$7bn, holding about 61,000 contracts (55,000 March contract and 6,000 June contracts). His position on the Simex was 8 times bigger than the next largest position. Although he could have hidden the position for quite a while because the margin called were only a small proportion of the notional value, his position was too big not to be discovered. The margin calls were enormous and Barings Tokyo London had to transfer urgently a massive \$835 m to Barings Singapore in January and February to cover the margin calls on Simex. These calls made finally Barings bankrupt as its reported capital was only of \$635m.

Nick Leeson who was one of the golden boys of the bank, as half of the profit from Barings came from Barings Singapore went from the heaven to hell overnight. The Bank of England had to close Barings, also known as the Queen's bank since it was used by Elizabeth II. Barings Shareholders lost \$1bn. Eventually Barings was sold to ABN-Amro for a symbolic £1.

Leeson was arrested in Frankfurt in a flew from Singapore. He was then extradited back to Singapore where he received a 6 and a half year sentence to jail. Barings creditors are still going though legal proceedings in 2002. They have tried to sue the Bank of England for its perceived negligence as the lead regulator in the whole affair without success. Many executives who were involved in the failure to control Leeson either resigned or were sacked.

In July 1999, Nick Leeson was released from jail on the ground of good behaviour. Ruined, abandoned by his wife and sick with a cancer (detected while in prison), Nick Leeson became quite popular as the symbol of the rogue trader. This was publicised by various conferences and appearance on television. He wrote the book "Rogue Trader" about his exploits, which later on have been adapted into a film starring Ewan Mc Gregor AND Anna Field. Nick is still currently heavily indebted and is studying psychology.

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<sup>1</sup> The views and opinions expressed herein are the ones of the author's and do not necessarily reflect those of Goldman Sachs

## Reference

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