

THE COLLAPSE OF BARINGS BANK



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OUTLINES

- Trailer of movie
- History of Barings Bank
- Summary of the collapse
- Key issues
- Causes of problems
- Critiques
- Recommendation



[HTTPS://WWW.YOUTUBE.COM/WATCH?V=7B8FGMKJNEM](https://www.youtube.com/watch?v=7B8FGMKJNEM)

THE BARINGS BANK



- One of the world's oldest merchant banks found in 1762
- The bank collapsed in 1995 after suffering losses 1.3 billion USD resulting from the speculative investment primary from future contracts on Nikei stocks.
- The collapse conducted by Nick Leeson working in office in Singapore
- After the collapse, Barings bank was sold to ING bank in the value of only 1 pound.

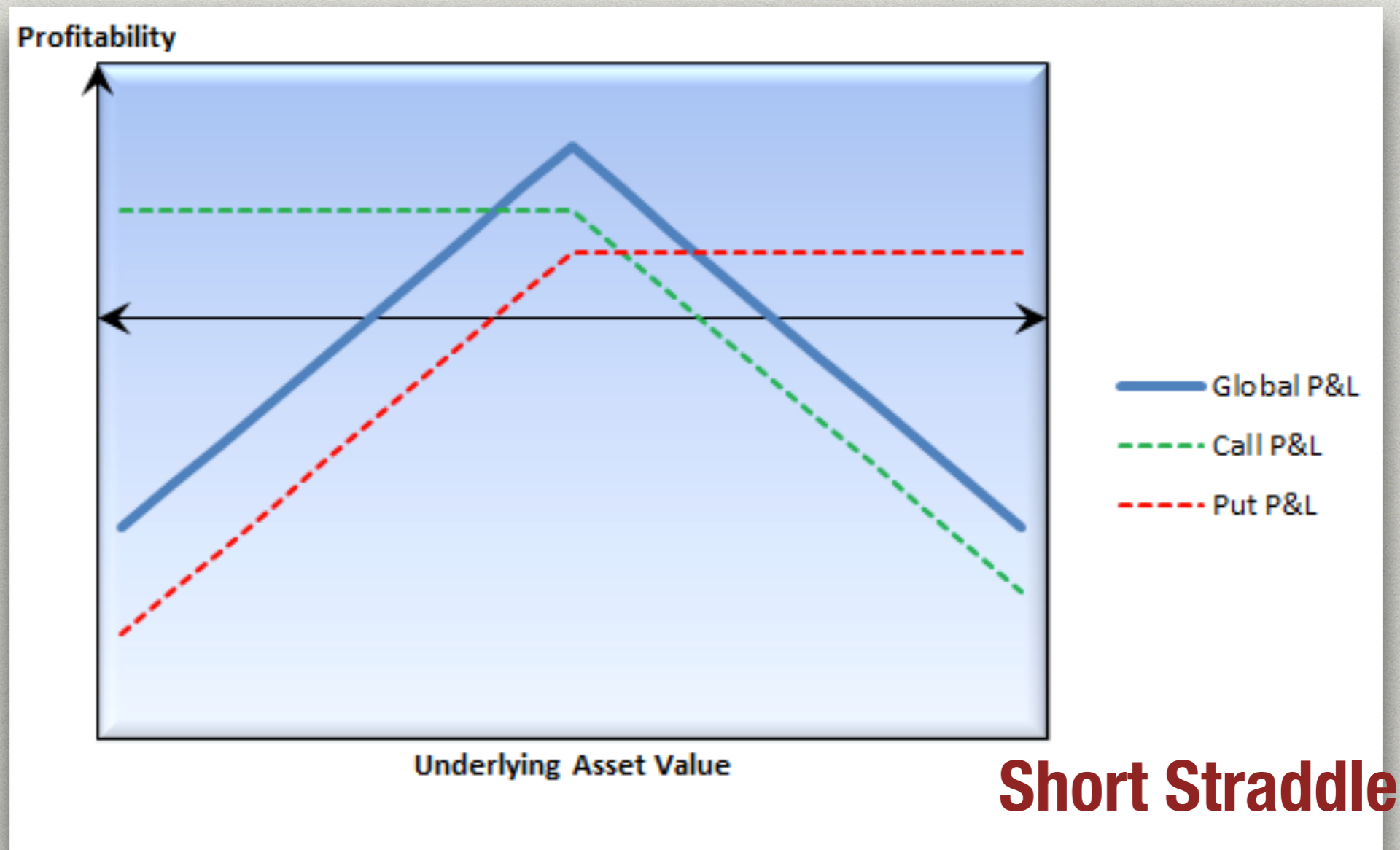


Summary of case study

- Leeson nor Barings disclosed this denial when Leeson applied for his licence in Singapore. (reckless because bank made huge profit, moral hazard for both parties)
 - Unauthorised speculative trading
 - Using bank's error account to hide mistakes and losses in the beginning but latter Lessen uses the account to hide bad trade. (this results in the downfall of Bearing Bank latter on)
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- Since Lessen was employed at trading office and bank office, this makes it easier for him to hide losses: bank's own deficient internal auditing and risk management practices.
 - Unauthorised speculative trading to make huge profit.
 - Bank's error account to hide losses and error made in trading and latter hide the bad trade as shown in the movie.
 - Working at trading office and back office should not be employ.
 - The movie is the reflection of arrogance and ignorance of traders in reality.

Key Issues

- The collapse of Baring bank in only one day
- Mismanagement of operation
- Danger of doing arbitrage



The cause on Baring bank's collapse

Separation of front and back office

- Nick Leeson had control of the back office as well as the front office.
- It has been already identified since August 1994 that the control of both positions of Nick Leeson is the weakness and recommend that the general manager should not responsible for the back office in order to avoid the conflict of interest.
- Consequently, Baring Bank has sent the part time separate financial manager to watch on the back office activities. Unfortunately, the new manager can sufficiently monitor Leeson's activities according to the incompetency of management.

Discrepancy between the management

- Although the top level management of the bank in England had received about the recommendation from internal audit report.
- Nothing had been taken as they said it is the responsibility of the management in Singapore.
- Therefore, it allows Nick Leeson to freely perform his unauthorised trading.

The creation of 88888 account

- Nick Leeson was asked by the London office of Baring to create another error in order to handle normal items occurred in Singapore.
- Unfortunately, he used this opportunity to hidden the lost and report the gain to Baring in London after he start to make gamble activities in derivative market

Lack of understanding in the derivative markets

- The Bank of England has summarized that the senior management did not deeply understand the risk that can occur from the activities Leeson could potentially make.
- Moreover, if they understood the derivative trading business, they would realize that it is impossible for Leeson to make that profit as he reported without taking any risk.

Unanticipated event

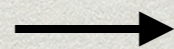
- The Kobe earthquake in Japan occurs on January 17, 1995 in which it has ruined the economy
- Nick Leeson initially took his action to do put and call option with a massive volume in the expectation that the economy will rapidly recover to cover the loss he had made.
- Unfortunately, the Nikkei market keeps dropping to cause enormous loss to the bank.

What have been done so far

- In 1993, the Basle Committee issued a proposal on a capital standard based on market risk
- The result is too complex along with strict, uniform, quantitative limit on activities of the bank.

After the collapse of Barings Bank

In 1995, the Basel set the new regulation by banks allow to use their own internal risk management model. To determine the capital requirement. This model can called as 'Value At Risk' model



Design to assess and monitor market risk (risk from the emergence of the derivatives market)



To calculate their own capital charges



To estimate the maximum possible loss in value of portfolio or financial position with a certain level of confidence over a given period of time.

The end of Barings Bank

- The loss was too much to recover about \$500million
- Baring bank failed, unlike the bankruptcy.
- ING Bank in the Netherlands bought Barings for £1.

Critique on the courses of actions

Combine of front and back office

- Leeson was responsible for both the trading and the settlement sides of the Singapore operations. This action is **wrong** since this made it easier for him to conceal his contracts from his superiors.

Lack of internal control and check

- Leeson made false declarations to regulation authorities and it did not attract the attention of Bearing's control authorities in Singapore.
- Leeson had hidden certain losses and had forged documents but nothing was detected by statutory auditors and control interns.

Such scenarios **should not** be happened. It showed that those Internal controls at Barings were **insufficient** to detect what was taking place with Leeson's derivatives trades and therefore, it cause the risk of possible disaster for Bearing.

Lack of understanding in the derivative markets

- The profits brought in by Leeson brought confidence to senior management and it found that the senior executives at Barings did not really understand the esoteric business of derivatives. They did not seem to be aware of the risks incurred by the bank.
- This action of those executives is **inappropriate**. They should have knowledge in trading techniques and financial markets. They needed to pay attention and set control to that impossible performance rather than be greedy by high profit.

What could have been done better to revert the situation?

1. There should never have allowed the back office and the front office to be the same person.
 - Otherwise, there will always be temptation to fix the books to enhance performance. Leeson was able to manipulate things to suit his own ends.
 - This should have raised alarm bells with management, but somehow he was able to get away with it without questions being asked.
 - The proper separation of front and back office could have avoided the Barings Collapse.
2. Barings management committee should have set up reporting systems to ensure that important information on operational risks reached them, and the board of directors should have put the management committee under constant pressure to formulate these risk reporting systems.
 - Because there was a lack of management control and the knowledge of what Leeson was doing, they did not investigate the unusual amount of huge profit being generated for what was essentially quite a safe business.
 - However they were happy to turn a blind eyes as long as the money came in and no one posted the hard questions that should have been asked.
 - Leeson's supervisors should have had direct and immediate knowledge of his activities.

3. There should be an internal audit report, as something strange happens.
- Leeson call for funds from Barings London, when trading losses as Barings management thought Leeson was arbitraging, and therefore, it funded his margin calls without demanding full explanations.
 - Also, controls in place were inadequate. Accounts were not captured completely which allowed Leeson to mask the risk he was running. The internal audit should have picked this up and flagged it up as a problem, this again would have avoided the Barings collapse.



Q&A