

**RETURN TO AN ORDER OF THE
HONOURABLE THE HOUSE OF COMMONS DATED
18 JULY 1995 FOR THE**

**REPORT OF THE
BOARD OF BANKING SUPERVISION
INQUIRY INTO THE CIRCUMSTANCES
OF THE COLLAPSE OF BARINGS**

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Ordered by The House of Commons to be printed 18 July 1995

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**BOARD OF BANKING SUPERVISION
INVESTIGATION INTO THE FAILURE OF BARINGS**

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13 July 1995

Bank of England
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Dear Sirs

We attach a copy of the Report of the Board into the collapse of Barings, with the intention that it is to be passed to the Chancellor of the Exchequer in accordance with our terms of reference.

Yours faithfully



E A J George
Chairman of the Board



Sir Alan Hardcastle
Convenor of the Independent Members

**REPORT OF THE
BOARD OF BANKING SUPERVISION
INQUIRY INTO THE CIRCUMSTANCES OF
THE COLLAPSE OF BARINGS**

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1. INTRODUCTION

The status of the inquiry

- 1.1 On Sunday 26 February 1995 joint administrators were appointed by the High Court in London to manage the affairs of Barings plc, the Barings Group parent company, and certain other companies within the Barings Group. This followed the discovery of massive losses incurred by Baring Futures (Singapore) Pte Limited (BFS), an indirect subsidiary of Barings plc, which had been trading in financial products on Singaporean and Japanese exchanges.
- 1.2 On 27 February 1995 the Chancellor of the Exchequer, the Rt Hon Kenneth Clarke QC MP, announced that we, the Board of Banking Supervision (BoBS) of the Bank of England (the Bank), should conduct an investigation into the events leading to the collapse of Barings plc. The formal terms of reference of the inquiry were later agreed to be: "To establish in detail the events that led to the collapse of Barings; to identify the lessons to be drawn, for institutions, for the Bank's own regulatory and supervisory arrangements, and for the UK system of regulation more generally; and to report to the Chancellor of the Exchequer".
- 1.3 BoBS consists of three ex-officio members, namely the Governor, Mr Eddie George, the Deputy Governor¹ and the Executive Director of the Bank responsible for Regulation, Supervision and Surveillance (S&S), Mr Brian Quinn, and six independent members appointed jointly by the Chancellor of the Exchequer and the Governor of the Bank. The six independent members of BoBS are Mr Jon Foulds, Mr Peter Gerrard CBE, Sir Alan Hardcastle, Lord Swaythling, Mr Harry Taylor and Sir Dennis Weatherstone. The Banking Act 1987 (the Act) imposes a statutory duty on the independent members of BoBS to advise the ex-officio members on the exercise by the Bank of its supervisory functions under the Act and any other matters relating to, or arising out of, the exercise of such functions.
- 1.4 The report is divided into two parts. The first, Sections 1 to 13, sets out and analyses the events that led to the collapse of Barings. The second, Section 14, sets out the lessons that we believe may be drawn from this episode.
- 1.5 The report represents the product of an investigation conducted by BoBS with the assistance of a team led by Mr Ian Watt CBE², Head of the Bank's Special Investigation Unit (SIU) and adviser to the Bank's Governors, assisted by: staff from SIU; Arthur Andersen, as accountants to the inquiry; Mr Nigel Davis QC and Norton Rose, as counsel and solicitors to the inquiry; and Mr Richard Evans of JP Morgan, as a derivatives and risk management adviser. Throughout the report references to 'the investigation team', 'the inquiry' or 'we' mean BoBS or members of the team assisting it. However, such conclusions on the facts as are expressed in the report are, of course, those of BoBS alone.

¹ Mr Rupert Pennant-Rea resigned as Deputy Governor on 22 March 1995. His place on BoBS was not filled during the remainder of the inquiry.

² Mr Watt was also appointed by the Bank on 28 March 1995 to conduct an investigation under Section 41 of the Act and to report to the Bank on certain aspects of the nature, conduct and state of the business of Baring Brothers Ltd (formerly Baring Brothers & Co., Ltd.).

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- 1.6 The members of BoBS wish to commend the entire inquiry team led by Mr Watt for the expeditious and thorough way in which they conducted the investigation and for the assistance and advice they provided to us throughout the inquiry, which was of a very high professional standard.
- 1.7 Insofar as the report is concerned with the supervision of Barings by the Bank, the Securities and Futures Authority (SFA) and other regulators, it is based upon an investigation conducted on behalf of the independent members of BoBS only, and the conclusions expressed are those of the independent members alone.

Course of the investigation

- 1.8 Members of the investigation team have held meetings and discussions with directors and employees of Barings plc and its subsidiaries (the Barings Group) and representatives of regulators, supervisors and other parties in the UK, Singapore, Japan, Hong Kong, the United States and other jurisdictions. At the same time copies of certain documents were obtained from: the Barings Group in London, Singapore, Japan and Hong Kong; Coopers & Lybrand (C&L) in London; the Bank; the SFA; and other sources. This evidence has been analysed and interviews have been conducted in London and Tokyo with Barings Group directors and employees past and present, C&L London, and employees of the Bank and the SFA. Some of the interviewees have been interviewed on more than one occasion. When transcripts were taken of interviews, the interviewees were provided with transcripts of their interviews and invited to correct or make comments on the transcripts. We wish to acknowledge the assistance of those who were interviewed and whose names appear as Appendix I. Appendix II lists the names of other people referred to in the report.
- 1.9 The inquiry has been prevented from having the same degree of access in Singapore. Moreover, the inquiry has not been able to speak to Mr Nick Leeson, formerly General Manager and Head Trader, BFS, who is currently held in custody in Frankfurt, pending resolution of an application for his extradition to Singapore.
- 1.10 We have concentrated our investigation on the affairs of Baring Investment Bank (BIB), the organisation of which is described in Section 2, and on the individuals most directly concerned in the events that led to the collapse. We have not, as a consequence, addressed broader issues relating to the governance of Barings plc and the Board of that company, except insofar as individual directors were involved in the business of BIB.
- 1.11 We invited those persons who we considered might be affected by our preliminary proposed conclusions to make representations and observations on them prior to the finalisation of the report. Careful consideration has been given to the representations and comments made, whether orally or in writing, by those persons who responded to such invitations and changes have been made when points were accepted. It should be made clear, however, that many of the conclusions are not accepted by the persons to whom they relate. In arriving at our conclusions in relation to individuals and institutions we have been mindful that our understanding of the events described in the report was derived following the collapse of Barings. We consider that these conclusions reflect the information which was, or reasonably should have been, known at the relevant time.

1. Introduction

Format of the report

- 1.12 A short description of the Barings Group, the regulatory environment in which it operated, its auditors and management, the nature of BFS's trading and the events immediately preceding the collapse is provided in this introductory section. We also describe the limitations on the access we have had to information relevant to the inquiry and the resulting implications. Appendix III provides a list of abbreviations used in the report and Appendix IV contains a glossary of some of the technical terms used. Appendices V and VI provide a description of the relevant instruments traded and the exchanges on which they are traded.
- 1.13 From the second half of 1992 until the collapse the Barings Group was engaged in a major restructuring, by which its banking and securities businesses were gradually being brought together under the umbrella of BIB. This represented a time of considerable change in the culture and organisation of those businesses and it is relevant to describe these changes in order to set into context the events concerning BFS during this same period. This description appears in Section 2.
- 1.14 Sections 3 and 4 cover the trading activity in BFS during the period July 1992 to 24 February 1995. This trading was executed on the Singapore International Monetary Exchange (SIMEX), the Osaka Securities Exchange (OSE), the Tokyo Stock Exchange (TSE) and the Tokyo International Financial Futures Exchange (TIFFE). Until the time of the collapse BIB's London management believed the trading activity conducted within BFS to be very profitable and that it made a major contribution to the overall profits of the Barings Group. However, the true nature and profitability of the trading were concealed. The methods of concealment are described in Section 5. The actual trading carried out by BFS required substantial funding from Barings in London and Japan. The provision of this funding is described in Section 6. Section 7 describes the failings in BIB's internal controls which were central to the failure to detect the unauthorised trading conducted by BFS. Our analysis of the actual trading activities carried on within BFS has revealed that during the financial years 1993 and 1994 there were significant unidentified and unreported losses in respect of BFS's activities: the effects of adjusting the reported results of Barings plc to take account of the concealed losses are analysed in Section 8.
- 1.15 The internal audit of BFS in 1994 and the role of the external auditors are described in Sections 9 and 10 respectively. The reporting to supervisors and regulators by Barings, and the supervision and regulation of Barings, are covered in Sections 11 and 12 respectively. Section 13 contains our conclusions as to the factors leading to the collapse.
- 1.16 Finally, Section 14 sets out the lessons which we believe arise from the collapse of Barings for authorised institutions, the Bank and for the UK system of regulation generally.
- 1.17 In referring to individuals we have adopted the convention throughout this report of introducing them by their full name and title on their first mention and thereafter referring to them by surname only, unless the full name is required to avoid confusion. This convention is intended to simplify the report and no discourtesy to anyone is intended.

1. Introduction

Summary history, structure and principal activities of Barings

- 1.18 At the time of the collapse Baring Brothers & Co., Ltd (BB&Co) was the longest established merchant banking business in the City of London. Since the foundation of the business as a partnership in 1762 it had been privately controlled and had remained independent. BB&Co was founded in 1890 to carry on the business of the bank in succession to the original partnership. In November 1985 Barings plc acquired the share capital of BB&Co and became the parent company of the Barings Group. In 1991 the Barings Group acquired a 40% equity interest in Dillon, Read & Co Inc (Dillon Read), a US investment bank based in New York.
- 1.19 The voting share capital of Barings plc was held by its executive management and the non-voting share capital was held by the Baring Foundation, a UK registered charity.
- 1.20 In addition to BB&Co, the other two principal operating companies of Barings plc were Baring Asset Management Limited (BAM), which provided a wide range of fund and asset management services, and Baring Securities Limited (BSL), itself a subsidiary of BB&Co, which generally operated through subsidiaries as a broker dealer in the Asia Pacific region, Japan, Latin America, London and New York. Appendix VII includes charts setting out the corporate structure of the Barings Group as at 31 December 1994. BAM and the corporate finance activities of BB&Co are not referred to in any detail in the report as they are not considered relevant to the inquiry. Hereafter, when we refer to Barings we mean BIB and its component companies and operating units, principally BB&Co and BSL.
- 1.21 BB&Co was an authorised bank, based in London, with branches in Singapore and Hong Kong. BAM also owned two banks: Banque Baring Brothers (Suisse) S.A. and Baring Brothers (Guernsey) Limited.
- 1.22 The business of what became BSL was acquired from Henderson Crosthwaite by BB&Co in 1984. BSL was incorporated in the Cayman Islands, although its head office, management and accounting records were all based in London. BSL had a large number of overseas operating subsidiaries including two which are of particular relevance to this inquiry, namely BFS and Baring Securities (Japan) Limited (BSJ).

Regulatory environment

- 1.23 The Barings Group's operations across the world were subject to the supervision of a variety of different supervisors. Of these, only supervision by certain UK, Singaporean and Japanese supervisors are relevant to the inquiry.
- 1.24 The Bank authorised BB&Co (which was therefore an authorised institution) under the Act to accept deposits. The Bank was therefore responsible for monitoring whether BB&Co continued to meet the criteria set by the Act for its continuing authorisation. The minimum criteria for authorisation are contained in Schedule 3 to the Act and the most relevant are summarised in Appendix XIV. The Bank was also responsible for the consolidated supervision of the Barings Group. This entailed the receipt and analysis of data on the consolidated (Group-wide) capital ratios and consolidated large exposures and the assessment of the risks to BB&Co emanating from the non-bank parts of Barings; it did not entail actual supervision of the non-bank parts of the Group. The limits on the Bank's responsibilities in respect of its role as the

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consolidated supervisor of the Barings Group are described in more detail in Section 12.

- 1.25 The SFA, as a self-regulating organisation under the Financial Services Act 1986 (FSA), authorised BB&Co, BSL and Baring Securities (London) Limited (BSLL) (from its establishment in 1993) to carry out certain types of investment business in the UK. The SFA has a duty to regulate the investment businesses of its member firms conducted in the UK in order to afford an adequate level of protection for investors. Accordingly, the SFA regulates its members in relation to: their financial resources; the security of investors' money and assets held by members; and the fair and proper conduct of investment business undertaken. The regulation of the financial resources of BB&Co was delegated by the SFA to the Bank under a Memorandum of Understanding (MoU) in April 1991, a copy of which is attached as Appendix VIII.
- 1.26 BFS was a corporate clearing member of SIMEX. SIMEX is a self regulatory organisation for the financial futures industry in Singapore. The approval for the establishment of SIMEX as a futures exchange was granted by the Monetary Authority of Singapore (MAS) under the Singapore Futures Trading Act. SIMEX is primarily concerned that its members are financially sound and are professional in their dealings with other members.
- 1.27 BSJ was licensed by the Japanese Ministry of Finance (MoF). It was also subject to the rules and regulations of the self-regulatory exchanges on which it traded.

The auditors

- 1.28 The Barings Group financial statements were the subject of an annual external audit pursuant to the Companies Act 1985. The purpose of the annual audit is to report to the shareholders on whether the financial statements give a true and fair view of the state of affairs and results of the group concerned and comply with applicable UK company legislation. The auditors of Barings plc, BB&Co and BSL at the relevant times were C&L London.
- 1.29 For the financial periods ended 30 September 1992 and 31 December 1993 the auditors of BFS were the Singapore firm of Deloitte & Touche (D&T), who were succeeded for the financial year ended 31 December 1994 by C&L Singapore. At the time of the collapse C&L Singapore had substantially completed its audit of BFS for internal group reporting purposes and had reported to the directors of Barings plc, but had not reported on BFS's statutory financial statements.
- 1.30 For the financial periods ended 31 December 1992 and 31 December 1993 C&L London had audited and reported on the Barings Group financial statements. At the time of the collapse C&L London's audit of the consolidated financial statements of Barings plc and the financial statements of BSL for the year ended 31 December 1994 was well advanced, but they had not yet issued their formal report on those financial statements.

Barings' management

- 1.31 The management structure of Barings at the time of the collapse is described in Section 2. The Board of Directors of Barings plc (the Board), under the chairmanship

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of Mr Peter Baring, met six times in 1994. The Executive Committee of the Board (EXCO), also under the chairmanship of Peter Baring, met weekly to consider the key business issues and decisions affecting the Barings Group. The Management Committees of BIB (under the chairmanship of Mr Andrew Tuckey, Deputy Chairman of Barings plc and Chairman of BIB) and BAM were given a high degree of autonomy to make decisions relating to their business units. Mr Peter Norris was the Chief Executive Officer of BIB (CEO designate from December 1993, CEO from November 1994) and a Director of Barings plc (from December 1993), having previously been CEO of BSL.

- 1.32 In February 1994 the Board appointed an Audit Committee comprising three non-executive directors. Previously, the whole Board had had an annual meeting with C&L London. By the time of the collapse the Audit Committee had met only once, in June 1994, to receive a presentation on the management letter by C&L London in respect of the year ended 31 December 1993 and a report from BB&Co's Internal Audit Department. No matters relating to BFS were discussed at that meeting.

Background to BFS's trading activities

- 1.33 BFS, a Singaporean registered company, was an indirect subsidiary of BSL. BFS was originally formed to allow Barings to trade on SIMEX. At the time of the collapse BFS employed 23 staff. BSL's other significant Singaporean subsidiary was Baring Securities (Singapore) Pte Limited (BSS) which employed some 115 staff. BSS's principal activity was securities trading.
- 1.34 BB&Co and BSL issued a number of comfort letters to the MAS and to commercial banks which lent funds or securities to BFS. The purpose of the letters was to assure the recipients that Barings would financially support BFS. For example, in a minute of a BSL board meeting on 16 April 1991 it is recorded that the directors resolved to issue such a letter to the MAS. Included within the proposed wording was the statement: "[BSL] accepts full responsibility for the operations of [BFS] ... In addition to our legal responsibility deriving from our shareholding in [BFS] ... [BSL] will ensure that [BFS] maintains a sound liquidity and financial position at all times, and we will, on demand, provide adequate funds to make up for any liquidity shortfall in [BFS]". The letter of comfort later issued to the MAS was the same as the proposed wording in all material respects.
- 1.35 From late 1992 to the time of the collapse BFS's General Manager and Head Trader was Leeson. Prior to his move to Singapore in March 1992, Leeson worked for Barings in London in a back office capacity for almost three years. A more comprehensive description of his career and background is included in paragraphs 2.55 to 2.60.
- 1.36 Barings sought to control and manage its operations by means of a 'matrix management' system, a not unusual method of management control for financial businesses which have global operations. Managers who are based overseas often have local reporting lines (typically of an administrative nature) as well as reporting lines to a product manager (who may be based at the business' head office or a regional office). Leeson reported to Barings' management in Singapore for BFS's office infrastructure, in particular to Mr James Bax, Regional Manager South Asia and Director of BFS, and to Mr Simon Jones, Regional Operations Manager South Asia, also Director of BFS and Chief Operating Officer of BSS. Jones and the heads of the support

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functions in Singapore also had reporting lines to the Group-wide support functions in London. Whilst there was some debate about Leeson's precise reporting lines (paragraph 2.27), from 1 January 1994, for product profitability, Leeson reported to Mr Ron Baker, Director of BB&Co and Head of the Financial Products Group (FPG) of BIB, via Ms Mary Walz, one of Ron Baker's London based managers and also Director of BB&Co and Global Head of Equity Financial Products, BIB. Section 2 of the report sets out the conflicting views which existed as to Leeson's precise reporting lines within Barings during his time in Singapore.

- 1.37 From mid-1992 BFS executed trades on SIMEX (in Singapore) and OSE, TSE and TIFFE (all in Japan). BFS primarily executed trades in three kinds of financial futures contracts (namely: the Nikkei 225 contract, the 10 year Japanese Government Bond (JGB) contract and the three month Euroyen contract), and some options on those same financial futures contracts. The market prices of these contracts were related to the price or value of the underlying Japanese securities. For example, the price of the Nikkei 225 contract was related to the value of the Nikkei 225 index of leading Japanese companies' share prices. The products are described in Appendix V. Since SIMEX was created in 1984 it has developed parallel markets for these products in direct competition to the Japanese exchanges on which they are traded. Thus, the three products in which BFS primarily traded could be traded on one of the Japanese exchanges or on SIMEX or both, and the different characteristics and rules of the exchanges (described in Section 3 of the report) gave rise to advantages for certain customers to deal on one exchange in preference to the other.
- 1.38 BFS's original function was to execute trades on behalf of Barings' clients. Most of these clients were clients of either BSL or BSJ, and the trades were booked by BFS in the name of BSL or BSJ. This is commonly known as 'agency' business, and was managed by Mr Mike Killian, Head of Global Equity Futures and Options Sales, BIB, from Tokyo and latterly the United States. BFS would generate revenue from the commission it charged clients for this type of trading. Barings' records show that in mid-1993 BFS began to generate profits from trading for Barings' own account ('house' or 'proprietary' trading) by purporting to take advantage of price differences between SIMEX contracts and the equivalent contracts on the Japanese markets. This is commonly recognised as a form of arbitrage trading, and was called 'switching' business by Barings.
- 1.39 The reported profits from this trading were significant. We describe in Sections 4 and 5 how the reported profits from this activity from January 1993 to the collapse were in fact offset by much greater losses which were actually being incurred and which were concealed.
- 1.40 The trading conducted by BFS on these exchanges required very substantial funding in the form of margin payments to the exchanges to support the positions held by BFS. At the time of the collapse BFS's unaudited balance sheet recorded that it had placed some £468 million with SIMEX as margin. Most of this funding was provided by BB&Co via BSL and BSLL or by BSJ. This funding is described in Section 6 of the report.
- 1.41 Until the collapse, Barings' management in London believed the trading conducted by BFS to be essentially risk free and very profitable. They believed that BFS entered into equal and opposite matched positions on a particular contract on SIMEX and one of

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the Japanese exchanges, and reasoned therefore that the net value of the two holdings would not be affected by price movements on the exchanges. However, as is set out in Sections 4 and 5, BFS did not in fact hold matched positions and the value of its positions was substantially affected by price movements on the exchanges.

Events leading up to the collapse

- 1.42 In March 1992 Leeson was transferred from London to Barings' operations in Singapore. After passing local examinations, he himself began trading on the floor of SIMEX. At about the same time, or in early 1993, he was appointed General Manager of BFS.
- 1.43 In July 1992 account '88888' was opened in BFS's records as a 'client' account. As we describe in Sections 4 and 5, this account was used to conceal the unauthorised trading activities of BFS through 1993, 1994 and up to 23 February 1995.
- 1.44 In July and August 1994, a BSL internal audit team of three visited Singapore to perform a review of the operations of Barings' offices in Singapore and other nearby countries. BFS's operations were reviewed by one member of the team, Mr James Baker, an Internal Audit staff member, BSL. The report of the visit was finalised in October 1994. It identified, among other items, that there was a lack of segregation of duties between BFS's front and back offices. The report, and the issues arising from it, are described in Section 9.
- 1.45 By January 1995 management of Barings in London became aware of market concerns and rumours regarding the scale of Barings' trading activities on OSE (Section 7) and the possibility that Barings had a customer who could not meet a margin call. Barings received a telephone call on 27 January 1995 from the Bank for International Settlements (BIS) who had heard rumours to the effect that Barings had margin losses in the Nikkei contract and could not meet its margin calls. These market concerns and rumours do not appear to have caused management undue alarm because management thought that, unbeknown to the rumour mongers, Barings' positions were matched with equal and opposite positions on SIMEX.
- 1.46 In January 1995 SIMEX noted from its financial surveillance programme that BFS appeared to be financing the positions of clients, in particular those in account '88888'. On 11 January 1995, SIMEX wrote to BFS, in Singapore, asking for an explanation for this.
- 1.47 From late January 1995 the size of the gross matched positions entered into by BFS on SIMEX and the Japanese exchanges increased, as reported to the Barings Asset and Liability Committee (ALCO) in London which discussed the associated funding issues and the market perception of Barings' positions. On 26 January 1995 ALCO instructed that Leeson be ordered not to increase and, where possible, to reduce the size of the positions, but these instructions were not complied with in the period up to the collapse.
- 1.48 On 27 January 1995 C&L Singapore faxed a note to C&L London which identified that there was an amount of ¥7.778 billion (some £50 million) in BFS's 31 December 1994 balance sheet apparently due from Spear, Leeds & Kellogg (SLK), a New York based specialist and securities trader. On or before 1 February 1995 C&L London informed

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Mr Geoffrey Broadhurst, Group Finance Director, BIB, of this supposed transaction. This supposed receivable was identified by us as one of the techniques used by Leeson to conceal the balance on account '88888' which recorded the unauthorised trading activities. We describe it in more detail in Section 7, and deal with its use in concealment in Section 5, with its relevance to external audit in Section 10 and with its relevance to large exposure reporting to the Bank in Section 11.

- 1.49 On 31 January 1995 ALCO in London discussed a letter dated 27 January 1995 from SIMEX to BFS, a copy of which had been sent to London. The letter presented a summary of BFS's positions at 30 December 1994, and reminded BFS of its responsibilities to ensure that it had sufficient funds to enable it to fulfill its financial obligations to SIMEX.
- 1.50 On 3 February 1995 Bax sent a memorandum to Norris, Broadhurst, Ron Baker, Mr Ian Hopkins (Director and Head of Group Treasury and Risk, BIB (from 23 August 1994) and Director of BB&Co) and Mr Tony Gamby (Settlements Director, BIB (from 1 January 1994), and Director of BB&Co) headed "SIMEX" and reading in part: "As you know recent incidents have highlighted the current operational weaknesses of our SIMEX business and an urgent need for a new approach ... The growing volumes traded on SIMEX have meant Leeson can no longer continue to run the trading and settlement roles effectively. In any case, it has long been acknowledged that there are control weaknesses in this arrangement". The incidents referred to were not explained in the memorandum but clearly included a reference to SLK.
- 1.51 In the week beginning 6 February 1995 Mr Tony Hawes, Group Treasurer, BIB, visited Singapore with Mr Tony Railton, Futures and Options Settlements Senior Clerk, BIB, in an attempt to resolve a number of issues. Tony Hawes told us his agenda was to:
- (a) understand the issue raised by Barings' auditors, C&L, in relation to the large purported debtor of some ¥7.778 billion (£50 million), (referred to in paragraph 1.48), in BFS's 31 December 1994 balance sheet;
 - (b) finalise a written response to the letter dated 27 January 1995 from SIMEX to BFS, in which SIMEX had sought reassurance from Barings as to its ability to fund large payments to SIMEX at short notice;
 - (c) brief his colleague, Railton, on: "improving the book-keeping and treasury in Singapore so that we would receive in London information that would allow us to identify what all the margin they were putting up there was for and to ensure that we were funding it correctly, we would know which clients we were lending money to and provide all the information which had been lacking up to that point"; and
 - (d) arrange larger daylight overdraft facilities with local banks.
- 1.52 Railton told us that he felt that he was sent out in order to understand how the BFS Settlements Department worked and to provide cover for Ms Norhaslinda Hassan, the BFS Senior Settlements Clerk, who was on maternity leave.
- 1.53 Tony Hawes spent the week of 6 February 1995 in Singapore. He was unable to resolve the first of his issues, but did not believe the matter was urgent as he was told

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that the apparent debtor (SLK) had since repaid the funds to BFS. He knew that he was coming back to Singapore two weeks later and was prepared to resolve it then, leaving a list of questions for Leeson to answer in the meanwhile. He finalised the reply to SIMEX and met their representatives. He left Railton with some work to complete in Singapore and returned to London.

- 1.54 Railton was asked by Tony Hawes to complete a spreadsheet the purpose of which was to analyse the timing of the different types of margin which had to be paid to SIMEX by BFS.
- 1.55 Over the course of the week beginning 13 February 1995 Railton realised: "If you close out all the positions there is absolutely no way on God's earth that you could actually return all the yen". He described to us his increasing concern at what he seemed to be discovering. He told us that towards the end of the week he informed Mrs Brenda Granger (Manager of the Futures and Options Settlements Department in London, BIB), Gamby and Tony Hawes of this problem. He recalled informing Granger and Gamby of his estimated shortfall, ¥14 billion (some US\$140 million). At this stage no misfeasance seems to have been suspected.
- 1.56 It was also during the week of 13 February 1995 that Railton discovered that the breakdown of the US Dollar margin funding requests which BFS had been submitting to London was meaningless. He had, in fact, had concerns about these requests since late 1994. Railton told us that BFS knew the total US Dollars that they wanted and that Ms Nisa Kader, BFS Settlements Clerk, Singapore: "was just changing the figures [in the breakdown analysis] to meet the total". On 17 February 1995, following this discovery, Railton introduced a new form of margin request. Railton told us that around this time it became clear that: "half the stuff I had been advised on as to how it [the spreadsheet] worked did not work ... The project was becoming more and more complicated the further one went along. I advised Brenda [Granger] of this, and I said, 'I really am stuck now because we are missing this 14 billion [Yen]'".
- 1.57 According to Granger, Railton reported to her on 17 February 1995 that his reconciliation, of what he thought ought to be on deposit with BFS's bank or as margin on SIMEX and what was actually there, did not reconcile, and that the funds at SIMEX and the bank were US\$190 million less than the amount recorded in the BFS accounting records as owing to BSL, Banque Nationale de Paris (BNP) and BSJ. Railton recalls the figure as ¥14 billion, Granger ¥19 billion (US\$190 million); we believe they are describing the same reconciliation problem and only differ in their precise recollection of the difference. Granger told us that Railton was now "really worried". Railton still believed at this stage that the difference may have been due to his lack of understanding of the relatively complex BFS margining system, although by this time he believed that only Leeson could answer his questions.
- 1.58 By the third week the reconciliation problem remained unresolved. Railton told us that he was relieved that Leeson (whom he had not been able to see before to discuss the position in any detail) had eventually agreed to see him on the Monday morning. However, Leeson was reported to be ill on Monday and Tuesday (20 and 21 February 1995) and did not appear at the BFS office.
- 1.59 During the evening of Wednesday 22 February 1995 Railton met Leeson at BFS's office and recalls telling him: "we were missing this amount of yen, and he said 'Yes, I agree

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with you', which took me back a bit". Leeson then identified more detailed information that would need to be produced, although the matter remained unresolved.

- 1.60 The next morning, Thursday 23 February 1995, Railton went to SIMEX to see Leeson. Leeson gave him some explanations, but due to the noise of the exchange and because Leeson carried on trading, Railton did not feel that it was worth carrying on the discussion and returned to BFS's office. That afternoon Leeson came back to the BFS office, sat down with Railton and Jones and started to discuss the situation. After 20 to 30 minutes Leeson left the office. Railton thinks this was at about 4pm to 4.30pm. Railton recalls continuing to discuss the matter with Jones and Miss Rachel Yong, Financial Controller, BSS. Railton recalls Jones saying: "I do not blame you for wanting to speak to Nick [Leeson]. This does not make any sense to me". In the event Leeson did not return to the office.
- 1.61 On the evening of Thursday 23 February 1995 Leeson and his wife are believed to have travelled to Kuala Lumpur from where he faxed, on Friday 24 February 1995, a letter to Bax and Jones in which, according to Bax, he wrote that: "he was sorry, his health was deteriorating and therefore he wished to resign". From there Leeson and his wife flew to Kota Kinabalu. On Wednesday 1 March 1995 they flew to Frankfurt, where Leeson was detained by the German authorities on Thursday 2 March 1995. Leeson has been charged with offences under the Criminal Procedure Code of Singapore and the Singaporean authorities are seeking his extradition from Germany.
- 1.62 In London, on Thursday 23 February 1995 Gamby, to whom Granger reported, was told by her that: "Nick [Leeson] was coming back to the office later on in the evening to ensure that the reconciliation was done". Around midday (London time) on that day Gamby recalls hearing that Leeson could not be tracked down. Later that afternoon Gamby told Norris that they had: "a US\$170 million reconciliation problem, but, more to the point, we could not find the trader".
- 1.63 On Thursday 23 February 1995 Tony Hawes flew from Tokyo on his planned return visit to BFS, arriving in Singapore at 2am Friday (Thursday night in London). He told us that, on arrival at his hotel in Singapore: "The phone rang almost immediately. It was Peter Norris from London asking me 'what on earth was happening in Singapore and where was Leeson?'" . Tony Hawes met Railton, who had also been called by Norris, and went to the offices of BFS. They started trying to reconcile the cash position, and Tony Hawes concluded that the apparent settlement of the SLK year end receivable (paragraph 1.48): "had been manufactured". They were joined by Bax and Jones. Tony Hawes started looking at a computer printout and noticed an: "account called an error account with goodness knows how many transactions on it, all of them seemingly standing at enormous losses". This was the account '88888' which was used to conceal losses from Barings London. It is described in more detail in Sections 4 and 5.
- 1.64 Norris contacted Walz in an attempt to locate Leeson. Walz eventually spoke to Leeson's mother-in-law who told her that Leeson and his wife had called a couple of hours earlier to say that they were going to Bangkok for the weekend. As Gamby said: "That was really when the alarm bells started flashing". In London that Thursday evening a group including Broadhurst, Granger, Gamby, Mr George Maclean (Head of the Bank Group, BIB, and Director of BB&Co), Norris and Walz continued discussing

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the reconciliation. Mr David Hughes, Treasury Department Manager, BIB, who worked for Tony Hawes, told us that on the Thursday evening: "I got called into Peter Norris' office. News was then breaking that there was a significant problem ... As you can imagine, all kinds of speculation was occurring at that time". The team in London worked through the night: "looking at the positions". Early the next morning Norris instructed Gamby to travel to Singapore to verify the situation reported by Tony Hawes and, according to Gamby: "to see, hope against hope, if there was some client sitting behind the '88888' account that we were not aware of". Gamby travelled to Singapore with Granger and Mr Mike Finlay, who also worked in the Futures and Options Settlements Department in London. His team worked through Saturday night, and confirmed what Tony Hawes had uncovered, namely that BFS was apparently insolvent.

1.65 At some stage over that weekend the Barings team working in the office of BFS forced open a drawer in Leeson's desk. Railton told us: "There was a stack of paper. There were holes in some. You could see how he had produced [the] confirmation of the SLK deal, I believe, and also I think a bank statement as well". Granger told us she was there and: "He [Bax] opened the folder and there was this fraudulent document". Gamby also said that in Leeson's drawer: "We found some cut and paste material for the SLK transaction. There was this SLK letter with a scissor cut around the signature ... we also found a cut and paste of a Citibank statement". The significance of these documents is described in Section 5.

1.66 Meantime, on the morning of Friday 24 February 1995 certain Barings plc directors met in London and, having taken legal advice, decided that the Barings Group could continue to trade through that day. At noon on Friday Peter Baring met the Bank's then Deputy Governor and informed him that he considered that Barings had been the victim of massive fraud. The Governor returned immediately from holiday and vigorous attempts were made to save Barings over the weekend, but, owing in part to the uncertain cost of closing the open positions when the markets reopened on Monday morning and the related difficulty in establishing the facts about Barings' financial state, these efforts were unsuccessful. As a result, three partners of Ernst & Young (E&Y) were appointed as administrators of Barings plc and certain of its subsidiaries in the late evening of Sunday 26 February 1995. In Singapore, on Monday 27 February 1995, partners of Price Waterhouse were appointed by the Singapore High Court (the Court) as Judicial Managers of BFS, when BFS failed to pay a margin call.

1.67 Just over a week later the majority of the assets and liabilities of the Barings Group were purchased by Internationale Nederlanden Groep N.V. (ING), the large Dutch banking and insurance group, although BFS remains under the control of the Judicial Managers.

Indicators

1.68 This report identifies a number of warning signs which were available to Barings' management concerning the nature of the activities undertaken by BFS. The most significant indicators are set out in paragraph 1.70. The indicators vary in their weight and an individual item taken on its own may not have raised alarm. Taken together, however, we consider that they provided Barings in Singapore and London (some of them during 1993 and 1994, and all of them by January/February 1995) with significant warning signals of the danger to which it was exposed.

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1.69 Careful analysis of these indicators is important. There were substantial realised and unrealised losses resulting from BFS's unauthorised activities in 1993 and 1994. The information provided to the inquiry indicates that, at 31 December 1994, the cumulative concealed losses were £208 million. The majority of the trading losses incurred by BFS's activities occurred in 1995 (Section 4); the loss at 27 February 1995 being £827 million. If management had identified and realised the significance of the unauthorised activities in Singapore, depending on the date of discovery, Barings might have been saved from insolvency (although it would still have incurred a very substantial loss).

1.70 The indicators as identified by the inquiry are:

- (a) The identification of the lack of segregation of duties in BFS between front and back offices, which was subsequently reflected in the internal audit report following the review of BFS's operations which was conducted in July and August 1994;
- (b) The high level of funding required to finance BFS's trading activities;
- (c) The unreconciled balance of funds (the 'top up' account) transferred from Barings in London to BFS for margins;
- (d) The apparent high profitability of BFS's trading activities relative to the low level of risk as perceived and authorised by Barings' management in London;
- (e) The discovery of the purported transaction relating to an apparent receivable of ¥7.778 billion (approximately £50 million) from one customer (SLK) of BFS as at 31 December 1994;
- (f) The letter sent by SIMEX to BFS on 11 January 1995 (which was not communicated to London at that time), which included specific reference to account '88888' and its large funding requirements; and the letter sent by SIMEX to BFS on 27 January 1995 (which was communicated to London) in which SIMEX sought assurance regarding BFS's ability to fund its margin calls should there be adverse market movements;
- (g) Issues and questions arising out of Barings' reporting of large exposures and client money to supervisors and regulators;
- (h) The high level of inter-exchange arbitrage (or 'switching') positions without any application of gross limits; and
- (i) Market concerns circulating in January and February 1995.

Limitations on access to documents and individuals

1.71 The inquiry has not had unfettered access to all relevant directors and employees of the Barings Group and its records, or to third parties who hold, or may hold, relevant information. Indeed, we have not been able to perform some important investigation work. The position is summarised in the following paragraphs.

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- 1.72 In London, we have been able to interview all relevant directors and employees of the Barings Group. Although we have not had direct access to the offices of the Barings Group, we have been provided with copies of all the significant documents that we requested, with the exception of certain electronic mail messages which apparently have not been retained. We had requested access to Barings' electronic mail messages (either stored in hard copy or electronic form) sent and received by certain members of management and staff at Barings in London and BFS. We are informed that not all of these messages were routinely stored. In the case of messages sent from BSL's offices in America Square in November 1994 and January 1995, the computer tape archive is either missing or is corrupted. We have not had any access to electronic messages archived by BFS. Accordingly, we have not had full access to this source of information. During our investigation, we also requested access to telephone records and recordings for certain members of staff and management of the Barings' offices in London, Singapore and Tokyo. Barings' policy, generally, was to record the telephone lines of dealers, settlements staff and selected other personnel. In the course of our work we reviewed the telephone recordings available for Walz, Mr Fernando Gueler (Head Proprietary Equity Derivatives Trader, BSJ) and Mr Adrian Brindle (FPG Trader, Tokyo) for the period 23 January 1995 to 27 February 1995. Additionally we obtained transcripts of calls made by Ron Baker in New York during the period from 26 January 1995 to 27 January 1995. We were not, however, granted access to any telephone recordings made in Singapore which might have included lines for Leeson, Bax and Jones. Individuals who had taped lines may have chosen to take calls on or transfer calls to other extensions which were not taped.
- 1.73 In Tokyo, we have had free access to all the relevant documents, directors and employees of BSJ. BNP, whose Tokyo office was the only external client of BFS, has not permitted the inquiry access to its employees or documents.
- 1.74 In Singapore, we have been provided with copies of a limited number of documents by BFS and SIMEX. There remain a number of very significant categories of documents which we have not been permitted to examine, including BFS's bank statements. Similarly, while we have spoken to some BFS directors and employees on a brief and informal basis, we have not been permitted by the Judicial Managers (see below) to interview any of these important witnesses, while they remain in Singapore, nor to review any tape recordings of BFS telephone calls. Almost all the figures, analysis and conclusions in Sections 4 and 5 are derived from the inquiry's analysis of a photocopy of the '88888' account statement originally found by Tony Hawes. We were also given a copy of the same document by Jones. To verify this information we would need access to further SIMEX statements, BFS's records and selected BFS directors and employees. Since the collapse, a number of individuals and entities based in Singapore have had control of access to relevant documentation and individuals. The current situation in relation to each is as follows:

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- (a) **Judicial Managers** - The Judicial Managers retain custody of the majority of BFS's records. They initially provided some documents, but thereafter did not permit the inquiry team access to any further documents requested, nor have they permitted interviews of BFS's employees without directions from the Court. An application for directions to be given access to information held by the Judicial Managers was therefore made on behalf of BoBS to the Court on 27 April 1995. The Court declined to give the directions requested principally because insufficient commercial benefit could be shown to accrue to BFS as a consequence of the proposed exchange of information between the inquiry and the Judicial Managers. The Judicial Managers did not support this application nor did they oppose it. However they did permit Bax and Jones to make representations to us in response to our notification of our provisional conclusions;
- (b) **Singapore Inspectors (the Inspectors)** - The Inspectors, who are partners of Price Waterhouse, were appointed on 10 March 1995 by the Singapore Minister of Finance to investigate the collapse of Barings under their Companies Act. The Inspectors have not given the inquiry team access to the documents and information they control because they maintain that there is no 'gateway' for them to disclose information to any party other than their Minister of Finance. The Singapore Minister of Finance, in turn, has not permitted the inquiry access due, we understand, to legal constraints in Singapore. The joint administrators of Barings plc have given the Inspectors access to documents and members of staff in London. As a person appointed under Section 41 of the Act, Mr Watt has been able to obtain copies of transcripts of those interviews the Inspectors conducted in London. The investigation team has met the Inspectors and their representatives to discuss particular aspects of the investigation. While they did not provide the inquiry with any documents, apart from the transcripts, this has gone some way to assist the inquiry in overcoming the difficulties caused by the lack of access to documents and individuals in Singapore. However, there remain significant areas in which we lack information;
- (c) **Commercial Affairs Department (CAD)** - CAD is responsible for conducting the criminal inquiry into BFS's and Leeson's activities in Singapore. They have a number of relevant documents under their control. CAD did not permit the inquiry access to these documents without approval from the Judicial Managers of BFS, which was not forthcoming;
- (d) **C&L Singapore** - We have not been permitted access to C&L Singapore's workpapers relating to the 1994 audit of BFS or had the opportunity to interview their personnel. C&L Singapore has declined our request for access, stating that its obligations to respect its client's confidentiality prevent it assisting us;
- (e) **D&T** - We have not been permitted access to the D&T workpapers relating to the 1992 and 1993 audits of BFS or had the opportunity to interview their personnel;

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- (f) SIMEX and Citibank (Singapore) - We have approached both institutions in an attempt to verify the authenticity, accuracy and completeness of the transactions recorded in the '88888' account statement we have obtained. SIMEX would be able to provide an independent record of BFS's dealing, and Citibank copies of BFS's banking records. Initially SIMEX provided some statements of daily transactions by BFS, but, apart from that, both institutions informed us that the Judicial Managers, to whom obligations of confidentiality are owed, would not consent to the release of further information to the inquiry; and
- (g) SIMEX - We have not been permitted to see the detailed supervisory working papers relating to SIMEX's supervision of BFS, nor to interview SIMEX's staff responsible for that supervision (paragraph 12.161).

1.75 In Appendix IX we describe the steps we have taken in attempting to gain access to the information held in Singapore.

1.76 The inquiry has identified a number of third parties with whom BFS and Leeson in particular had a trading relationship. The investigation team has had limited discussions with some of these parties, but has not been able to examine their detailed trading records freely or conduct interviews with them.

1.77 Leeson has been invited to cooperate with the inquiry, but has declined to do so as long as he remains liable to be extradited to Singapore. There are no available means of compelling him to assist. Through his solicitors, he has been informed of the conclusions we have reached about his part in the collapse. His solicitors in a letter dated 22 June 1995 have replied to us: "We note the preliminary conclusions reached by your enquiry relating to Mr Leeson. These conclusions are inaccurate in various respects. Indeed, in relation to certain of the matters they betray a fundamental misunderstanding of the actual events. Unfortunately, given the uncertainty regarding Mr Leeson's position we are not able to provide you with a detailed response to your letter". Since receipt of this letter we understand that information has been provided by Leeson through his solicitors to the Serious Fraud Office (SFO) pursuant to undertakings of confidentiality which does not enable the SFO to pass this information to us. We have received no communication from Leeson since his solicitor's letter of 22 June 1995 that his unwillingness to respond to our requests for information or our invitations to comment upon our conclusions has altered.

Implications of limited access

1.78 The implications of not having had access to the information described above are as follows:

- (a) we have not been able to verify with Leeson the strategy which lay behind the unauthorised trading conducted by BFS or to understand his motivation;
- (b) we have not been able to verify the entries (and therefore the losses) on account '88888' against records held by SIMEX;
- (c) we have not been able to exclude the possibility that anyone else at Barings (Singapore, London, Tokyo or elsewhere) was involved in this unauthorised trading;

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- (d) we have not been able to exclude the possibility that third parties were involved in unlawful activities with any employees of Barings;
- (e) we have not been able to exclude the possibility that any of the funds sent by BSL, BSLL and BSJ to BFS have been misappropriated;
- (f) we have not been able thoroughly to investigate the management roles of Bax and Jones;
- (g) we have not been able to review and conclude on the adequacy of the work performed by BFS's auditors; and
- (h) we have not been able to review and conclude on the adequacy of SIMEX's supervision of BFS's activities.

1.79 The contents of this report are based on information to which we have been able to obtain access, including that provided to us in interviews. In view of the limitations on access to information which we have described, it is possible that material new facts may subsequently come to light. Despite these limitations, we consider that we have been able to ascertain the causes of the collapse of Barings, and to identify some important lessons for the future.

2. CREATION AND MANAGEMENT OF BARING INVESTMENT BANK (1992 - 1995)

Introduction

- 2.1 The activities of BFS which are the subject of this inquiry were conducted during the period July 1992 to February 1995 when a major internal reconstruction was being tackled by the Barings Group. Hitherto autonomous businesses with very different cultures were being combined and a major management reorganisation was being put in place.
- 2.2 This section describes the evolution of BIB with particular reference to the major organisational and management changes that had taken place since 1992.
- 2.3 To set the evolution of BIB into context, we describe the background to BB&Co and BSL and their differing cultures. We then explain the reorganisation of BSL in 1992/93 and the establishment of BIB during the course of the following eighteen months, indicating some of the management issues and problems faced during this period. The management control of FPG and within it the equity derivatives business and BFS are central to this inquiry and hence we also describe how these businesses were organised and how they fitted into Barings' organisational structure. We go on to describe the responsibilities for risk management and financial control in BIB and, in the final part of this section, we comment on Barings' remuneration policy.

Background to BB&Co and BSL

- 2.4 BB&Co was previously a merchant bank specialising in corporate finance and debt trading. In 1984 BB&Co acquired the stockbroking business of Henderson Crosthwaite, a UK based stockbroker which had strong connections in the Asian equity markets and which was headed by Mr Christopher Heath. This led to the formation of BSL of which Heath became Chairman. It was Barings' first significant involvement in the equity securities business.
- 2.5 Barings ran its banking and securities activities as separately managed business units, occupying different offices in the City of London. Only Tuckey was a member of the Board of Directors of both BB&Co and BSL. The banking side, under the umbrella of BB&Co, continued to focus on its traditional core activities, which were mostly based in the United Kingdom, although there were offices in Asia.
- 2.6 The management control of BB&Co was exercised through four committees: Management, Credit, Underwriting and Treasury and Trading. Decisions on strategy and operational matters, credit risk, underwriting risk and market risk were taken by the relevant committee. The committees comprised the senior executives of the merchant banking business together with individual managers relevant to the particular area of activity. The presence, importance and effective operation of the committees resulted in the merchant banking business having a relatively strong culture of management and internal control, which permeated through the BB&Co organisation. BB&Co also had an established internal audit function which maintained appropriate lines of communication with Barings plc management and the external auditors.

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- 2.7 Other than in respect of its corporate finance advisory work, BB&Co was essentially in a risk business, taking its own credit and market risk positions. It was vital to the overall control of the business that a regime and culture of control were in place. Tuckey told us that Barings had always been run in a: "risk averse way".
- 2.8 The securities side, under the umbrella of BSL, had a major presence in the distribution of Japanese equities to foreign investors. It also made markets and held house positions in Japanese equities. During the late 1980s, BSL was a significant force in the Japanese warrant market, making substantial profits from the distribution and trading of equity warrants and providing highly publicised levels of profit related remuneration to its directors and employees. Also, during this period BSL opened a number of new offices in emerging market countries which significantly increased its cost base. This growth placed some strain on the regulatory capital of BSL and further capital was provided, which was funded by short term bank borrowings. Management was concerned that this short term bank funding of long term capital in BSL could be withdrawn by the banks. This concern was a significant factor leading to the idea of solo consolidation of BB&Co with BSL for Bank reporting purposes which was implemented in November 1993 (paragraphs 11.21 to 11.29).
- 2.9 Until the second half of 1992 BSL was run by Heath. Although there was a Management Committee, there was no formal management structure. The Management Committee was, we were told, not effective and, according to Norris, became "redundant". Key decisions were taken by Heath and/or Mr Andrew Bayliss, the then Deputy Chairman of BSL.
- 2.10 BSL was a business led by its front office with poor lines of communication between the front and back offices. From our discussions with Barings' management in place in 1994, we understand that little respect seems to have been held by the traders for senior back office management. The Risk Committee, which was formed in October 1993, was of diminishing effectiveness according to Mr Sajeed Sacranie (who at the time of the collapse was Personal Assistant to the Chief Executive Officer of BIB and who was Risk Manager of BSL for a period during 1993 and 1994). Although BSL was a broking business, it also conducted business for the 'house' (i.e. for its own account) and it was the 'house' Japanese warrant arbitrage business, developed on the back of its distribution capability, that provided substantial profits in the late 1980s.
- 2.11 Through the late 1980s and early 1990s BSL rapidly increased its number of personnel and offices and expanded into new markets, but did not develop formal systems of control commensurate with its fast growing and diversifying business.
- 2.12 The systems of management and internal controls in BSL were known to have been weak, as implied by the extensive management letter submitted to management by the external auditors, C&L, in 1992 and the problems in SFA reporting in the same year. Broadhurst told us: "Gareth Davies, who was the C&L partner, thought the control environment in Baring Securities needed significant bolstering". In interview, Davies told us: "In 1992, we had quite a few problems with our SFA return and some of the controls ... Significant effort had been put into London the last two years ... A lot of effort had been put into control". C&L's planning documents for 1992 state: "There is a good attitude towards controls and in general the control environment can be relied upon, although the depth of this attitude is in some doubt". At that time there was no internal audit function in BSL.

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- 2.13 By the middle of 1992 BSL's business had suffered a significant downturn and Barings Group executives became concerned at the size of the losses that were emerging and the still increasing cost base. Maclean told us: "I was aware of the difficulties with Baring Securities. In 1992 they had a bad year and something had to be done. That was fairly clear. They were losing money or in danger of losing money for the whole year, and were indeed losing money month by month during the summer of '92".

Reorganisation of BSL

- 2.14 Norris, who had recently returned from a senior position in BB&Co in Asia, was asked by Peter Baring and Tuckey to review BSL and to recommend a strategy for the future. This strategy included curtailing or closing some business activities, delegating more management authority to four regional centres (Tokyo, Hong Kong, Singapore and New York) and imposing stronger systems of management control throughout the business. Norris told us that: "By 1992 it [BSL] had become a deeply troubled and divided group, missing many of the management disciplines that you would expect to find in a multinational trading and broking operation. So the theme really was almost to start again from scratch and instal a coherent structure which contained those disciplines".
- 2.15 In September 1992, Norris was made Chief Operating Officer of BSL and Heath made Chairman, formally relinquishing his post as Chief Executive Officer. This post was left vacant until March 1993 when Heath left Barings together with a number of other senior executives and Norris was made Chief Executive Officer. The period from September 1992 to March 1993 also saw many of the changes recommended by Norris following his review of BSL. In addition, the entire management team of the derivatives business departed. Mr Richard Katz, Head of Equity Trading, BSL, and Director of BSL, told us that Norris introduced a: "much more efficient management and financial control structure than we had ever had before".
- 2.16 In discussing the impact of the change to a new management team in BSL, Mr Diarmid Kelly, Deputy Head of Equity Broking and Trading, BIB, and Director of BSL, said: "Peter Norris did an enormous amount of work in cleaning up the operation side, bringing in proper reporting for instance and also preparing management accounts which, on occasion, even I could understand. He did it very clearly. He also managed to bring a structure to the firm that had been lacking before. Prior to that we worked for Christopher Heath and that was about as complicated as the management got". The organisational structure chart at 31 December 1992, prepared by Norris following the collapse in order to assist the inquiry, is shown in Appendix X.
- 2.17 In terms of the future thrust of the securities business Peter Baring told us that when Heath left there was: "an abandonment of any ideas of major proprietary trading activities". The term 'proprietary trading' is generally used to describe the taking of risk positions for an institution's own account as principal and distinct from client business. It may be that when talking to us Peter Baring had in mind a narrower definition of 'proprietary trading' as directional or outright position taking.

Establishing Baring Investment Bank

- 2.18 By the end of 1992, Peter Baring and Tuckey had the idea of combining all of the investment banking businesses of Barings into a single business unit located in one

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central office. Tuckey told us: "This concept was developed because of a difficult relationship with the wholly owned subsidiary BSL in 1992 when we had basically a management disagreement between the centre of Barings and the people who were running Baring Securities". Norris said in relation to 1992 and the role of the management committee: "The ethos was, really, that the last thing you need in a stockbroking outfit is management in a formal bureaucratic sense".

- 2.19 Of major concern to Peter Baring and Tuckey were the very different cultures of BB&Co and BSL. Tuckey told us: "I knew that their [BSL] culture was different, as indeed brokers are generally different from corporate financiers anywhere you find them in any organisation. I saw that difference ... in time-scale. Everything in the broker's world is today and tomorrow ... whereas when you talk to a corporate finance person he is interested in what his clients are going to be doing next year ... It was the reason why we all felt it was right to allow this process of combination to take place over a long period". Peter Baring agreed that there was a difference in approach or culture between the securities side and BB&Co reflecting the different genesis.
- 2.20 During the second half of 1993 the Board decided to begin the process of bringing BB&Co and BSL closer together as a first step towards the combination of the two business units to form BIB. Tuckey issued a memorandum in December 1993 explaining the establishment of BIB and its structure. He concluded: "I am convinced that, by combining our merchant banking and securities businesses ... we shall be in a position to make the most of all the talents employed in the two businesses and of the opportunities which are now in front of us". A new umbrella organisation called the Investment Banking Group (IBG), later known as BIB, was established. The IBG had four groups: Equity Broking and Trading, Banking, Corporate Finance and Emerging Markets Corporate Finance. The two groups relevant to the inquiry are the Equity Broking and Trading Group, headed by Norris, and the Bank Group, headed by Maclean.
- 2.21 The months following the establishment of the IBG were a very difficult period for Barings as the securities people struggled to come to terms with the greater formality of BB&Co. Maclean told us: "I believe the seeds of this [the collapse] were sown when we went into BSL to bring the two companies together and made the assumption that the quality controls that we [BB&Co] had could quickly get installed there [BSL]. As it turned out, that appears not to be true".
- 2.22 One of the management concepts inherent in the restructuring of BSL in late 1992 and early 1993, and also in the formation of BIB from May to November 1994, was to develop a matrix reporting structure whereby profit responsibility was on a product basis but with local office management having an important role in holding together the office infrastructure (systems, controls, accounting, settlements and administration). Indeed it was considered essential to have a matrix structure in view of the strength of personality of key personnel and the desire to co-ordinate product activities on a global basis combined with decentralised authority. In Norris' view: "Each of our business lines [was described] as global products which were the columns in the management structure, and each of our offices and regional centres as the floors in the structure. Anybody who ran a business in any location related both to the person who managed that location and to the product manager who might be in the vicinity or who might be 10,000 miles away. It was only in that way that you could

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really ensure the integrity of the management process". He also said the role of the local manager and the role of the product manager were "equally important".

- 2.23 Reporting lines were perceived by a number of people within Barings' management as not being clear, although some, including Peter Baring, Norris and Katz regarded them as entirely clear. Maclean, however, told us: "It [Barings] is a place where there are a lot of ambiguities". Hopkins said: "I think, generally, Barings has tended to be unstructured about reporting lines in any case over the years".
- 2.24 Sir William Ryrie, Executive Director of Barings plc and member of EXCO, told us there was a matrix reporting system and that: "People had to report to more than one boss and I just felt generally that there was not quite enough clarity as to who your boss was in certain places". He explained that he was not referring in particular to Singapore. However, he spoke to Norris about the reporting system. Ryrie told us: "I thought it was too complicated and that the lines of reporting were not simple enough". Norris disagreed with him. Ryrie noted, however, that: "There was not a detailed organisational chart of a kind that I would rather have expected to see when coming to Barings".
- 2.25 It seems that no clear or complete organisation chart of IBG/BIB was prepared and disseminated at the time the organisational structure was being formulated. Nor had one been prepared by the time of the collapse. A further organisation chart, this time at 31 December 1993, was prepared by Norris following the collapse in order to assist the inquiry. This chart, shown in Appendix X, identifies a number of matrix reporting lines both between BB&Co and BSL and also within BSL. It appears from our interviews that reporting lines and responsibilities were not fully understood by a number of individuals, especially concerning FPG, headed by Ron Baker, and BFS, of which Leeson was General Manager.
- 2.26 Maclean, who reported to Norris in the BIB structure, stated: "As far as I am concerned, Ron [Baker] reported to me on the debt businesses which were across Baring Brothers' books, but to Peter Norris as far as the equity financial products business which went across BSL's books. That is the way it is today". This was not the view of Norris, who stated that Ron Baker reported through Hopkins to Maclean, as Head of the Bank Group, and claimed that: "There is absolutely no ambiguity about where this business sat [in the Bank Group], how it was accounted for and who was responsible for it [Maclean]; absolutely none". Walz stated: "[Ron] Baker reported to George Maclean, who sat on the BIB Management Committee, and was Head of the Bank Group which housed, in addition to other groups, FPG". Ron Baker himself told us that from the time the BIB Management Committee (MANCO) was formed in May 1994: "My business was described as being part of the Bank Group so, as far as I was concerned, George [Maclean] was my direct report in that organisational context". He continued: "Over time the relationship with Peter Norris just grew stronger and stronger ... I would not say [Maclean] was cut out of it, but more and more I talked to [Norris] about the equity parts of the business and [Maclean] got involved in the debt side of things".
- 2.27 There is also some disagreement as to whom Leeson reported to on a product basis during 1994. Norris, Maclean, Walz, Tony Hawes and Gueler, each told us that at various times during 1994 Leeson reported through the management chain (Gueler and Walz) to Ron Baker, as Head of FPG. Ron Baker told the inquiry: "It was Mike

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Killian that he [Leeson] was reporting to. In an organisational sense it was Bax and Jones, but in a product sense it was Killian". He added: "In a product sense, I [Ron Baker] take [the] responsibility for the risk and the income strength from 1 January 1994, but I do not think, organisationally, it is correct to say that he reported to me until 1 January 1995". Ron Baker continued: "There was a lot of ambiguity about where Nick [Leeson] sat during 1994 ... De facto without knowing it, I inherited the income stream and the trading strategy that Nick [Leeson] was pursuing from 1 January 1994 ... I did not feel that Nick [Leeson] reported to me or that I had any real organisational control over him until the second half of 1994". Ron Baker agrees that he proposed Leeson's bonus for both 1993 and 1994. Killian told the inquiry: "We were informed by London that he [Ron Baker] had now taken on all the responsibility for arbitrage for Nick Leeson and for the proprietary people in Tokyo ... This would have been in 1993 ... third/fourth quarterish". Norris told us that Ron Baker took full management responsibility for the equity derivatives business from October 1993, including the 'switching' business managed by BFS. As Walz said to us in respect of reporting lines, it is not possible to: "put everybody into absolutely clear boxes". She clarified Leeson's reporting lines in 1994 as follows: "For his [Leeson's] intra-day trading activities he reported to Fernando [Gueler, who reported to Walz], but for his agency execution business he reported to Killian".

2.28 One of the consequences of the ambiguities in the IBG/BIB organisational structure was that some members of management believed that responsibility for certain activities (e.g. equity derivatives, BFS) rested with other managers, who deny they had such responsibility. This resulted in confusion and a pervasive lack of management control over these activities.

2.29 As the Board met infrequently, EXCO was the principal forum for the exchange of information across the Barings Group. EXCO had seven members at the date of the collapse. They were Peter Baring (Chairman), Mr John Bolsover, (Chairman and Chief Executive of BAM and Director of Barings plc) Mr John Dare (Director, Barings plc), Mr Michael Miles OBE (Director, Barings plc), Norris, Ryrie and Tuckey. All of the members of EXCO were also members of the Board. EXCO met weekly and its meetings were minuted by its secretary, Mr Jim Peers, Company Secretary, Barings plc. Any member could propose items for the agenda. EXCO had no formal terms of reference, although a memo from Peter Baring dated 2 January 1992 set out the routine matters that should come before it:

- “• Group management accounts and budget will be tabled and reviewed;
- Management Committee minutes (or the equivalent report, written or verbal) for BB&Co, BSL and BAM will be tabled;
- Proposed personnel changes at senior levels will be reported;
- Proposed opening or closing of new businesses or offices will be reported;
- Any problem area will be reported as soon as it has been identified;
- Anything else of importance to the Group (whether affecting operating subsidiaries or otherwise) will be tabled and discussed; including remuneration policy, occupancy and IT [information technology] development”.

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- 2.30 The memo continued: “[EXCO’s] greatest value would be ad hoc (and brief) discussions of issues affecting broad strategy. It is emphatically not the purpose of the Committee to second guess the way in which operating subsidiaries are run”.
- 2.31 It was confirmed to us by the members of EXCO that it operated in practice very much in the way set out in Peter Baring’s note. To the extent that discussions related to a particular area of the Group’s business, on which it was agreed required steps to be taken, it would usually be left to the member or members of EXCO who had specific responsibility for that area to see that the necessary steps were taken. Ryrie, when asked who would undertake steps agreed by EXCO with regard to BIB, said: “the person with executive responsibility would be Peter Norris”. Dare told us that he considered that it was Tuckey and Norris who were the people responsible for BIB for this purpose. Miles told us that, when questions were raised about the profitability of the ‘switching’ business, the individual who would explain the position would be Norris. He considered that, for the purposes of discussion at EXCO, the ‘switching’ business was: “very much in Peter Norris’ portfolio”.
- 2.32 Dare has described the function of EXCO to us: “The Executive Committee of the top company in the Group [Barings plc] had an overall responsibility at the top of the Barings Group and therefore its views crossed the entire Group. We considered issues coming up from the asset management side, the banking side and the securities side. It was executive in the sense that from time to time really vital decisions of the Group came to that body for ultimate decision, but a lot of its work was reviewing what was going on in the Group, and exchanging information and ideas, and monitoring major activities of the Group”.
- 2.33 In May 1994 the IBG/BIB MANCO was formed. This was the first committee of executive management from both the banking and securities side of Barings. It was an important symbolic and practical step towards the combination of the two businesses. The MANCO was chaired by Tuckey and was the primary decision taking body in BIB. From May 1994 to February 1995, the committee met weekly and was attended by an average of 10 members. The minutes were taken by Peers. In November 1994 ALCO was formed, superseding the BB&Co Treasury Committee and the BSL Risk Committee. ALCO met daily and was attended by all available members. Its members were Ron Baker, Mr Geoffrey Barnett (Chief Operating Officer, BIB, and Director of BB&Co), Broadhurst, Tony Hawes, Hopkins, Katz, Maclean and Norris. Norris chaired the meeting once a week when the performance of the previous week was discussed; on all other days Maclean took the chair. Meetings were minuted by Miss Helen Smith, Head of Market Risk, BIB.
- 2.34 It was always intended that BIB would be launched to coincide with the move to a single office. However, the move had to be delayed into 1995 and so Barings decided to launch BIB formally in November 1994, notwithstanding the fact that the two businesses would continue to occupy separate offices for a number of months.
- 2.35 During 1994 there were several organisational changes as Barings developed the BIB management structure. These changes included:
- (a) Hopkins became Head of a new department (Group Treasury and Risk) in August 1994 which included: treasury under Tony Hawes; market risk under Smith and operational credit under Mr Iain Blyth, Credit Manager, BIB and

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Assistant Director, BSL. Transaction credit remained with the Bank Group and Blyth also reported to Mr Johnnie Russell, Director Credit Exposure Management, BIB (formally from 1 January 1995), and Director of BB&Co. The risk controllers in Tokyo, Hong Kong and New York reported to Hopkins. We consider risk management in BIB later in this section;

- (b) Broadhurst became responsible for finance and accounting within BIB (having previously been Group Finance Director BSL) with responsibility for Group reporting, regulatory reporting and revenue reporting. We consider Group Financial Reporting later in this section;
- (c) Gamby, Settlements Director BIB, became responsible on 1 January 1994 for both Futures and Options Settlements and Equities Settlements. Gamby had the heads of three settlement units in London reporting to him. The Head of Derivatives Settlements was Bill Hawes. There appears to be some confusion over Granger's reporting lines in the derivatives settlements area. Bill Hawes told us that although there was an organisation chart showing Granger reporting to him: "I would say that Brenda Granger reported more in to Tony Gamby than myself, directly". Bill Hawes also told us that from September 1994 he was given additional responsibility for Granger's area but still thought Gamby was continuing to monitor it. Gamby told us that the reporting line was clearly through Bill Hawes. There was also a reporting line to Gamby from the heads of settlements offices in the four regional centres: New York, Hong Kong, Tokyo and Singapore. But Gamby told us that BFS was the only settlements entity which did not report into him. His explanation was: "I think historically that is the way that it had been organised in Singapore. That was the structure". He regarded Leeson as being responsible for BFS's settlements, although he told us in a letter that he was concerned with BFS to the extent that it impacted on the efficiency of London Settlements. We consider funding in Section 6;
- (d) Mr Nick Farley, Head of Information Technology, BSL, became head of a combined information technology department. Farley told us he reported to Norris prior to the formation of BIB and to Barnett thereafter, although he said: "I was not closely supervised by Geoffrey Barnett ... [he] was more involved with the London operation and tended to spend less of his time focusing on operations overseas";
- (e) Ron Baker reported directly to Maclean in respect of FPG having previously reported to Hopkins (paragraph 2.26), although there was some lack of clarity according to Maclean;
- (f) Miss Ash Lewis, Head of Internal Audit, Barings plc, and Assistant Director of BB&Co, became BIB Group Internal Auditor. Internal audit is considered in Section 9.

These changes happened over a period of months, not at once. Not surprisingly they created some management and personality issues compounded by there continuing to be two office locations.

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- 2.36 Barnett, as Chief Operating Officer, BIB, told us he had: "vicarious oversight of the Heads of the operating functions, London based, who had a worldwide view of their particular function". Functions heads outside London had a line of reporting to these heads. Barnett stated in a letter to us that the "secondary" reporting lines enabled him: "to act as the coordinator of the Investment Banking Group's policy in relation to operations of the Investment Banking Group Management Committee". He also stated that local chief operating officers [such as Jones] had three reporting lines: one into the local head of the office [Bax in Singapore], one into the global chief operations officer [Barnett] and one into Group Treasury and Risk [Hopkins].
- 2.37 One management issue raised by the reorganisation was the allocation of profits for bonus purposes, in particular concerning the transfer of the equity derivatives business from BSL to BB&Co. The bonus arrangements are considered in paragraphs 2.81 to 2.93.
- 2.38 Norris prepared a chart for the inquiry showing the organisational structure at 24 February 1995. This chart is shown in Appendix X.
- 2.39 The matrix structure introduced on the reorganisation of BSL is, as we have already noted, a form of management control that is not unusual in international banking and securities businesses; but a cornerstone of its effectiveness is the integrity and reliability of internal controls at the local office level. In this regard, Norris told us that he found Jones difficult to manage within the matrix, that he was hostile to people outside Singapore, was too stridently independent and that he wanted to get rid of him in 1993 but did not since Bax relied heavily on him. Peter Baring told the inquiry that in his view it would be a: "gross misconception to believe that the sort of matrix management system we were attempting to apply to Singapore was itself a mistake ... I think one can observe that if everybody in that system, as it existed, was doing what they should have done, we would not be where we are now". In a letter to us Broadhurst stated: "With the exception of Singapore, significant progress had been made in implementing matrix management throughout the overseas offices".
- 2.40 The fact that one individual (Leeson) was permitted to have first line responsibility for both trading and settlements meant that a crucial ingredient in the matrix organisation of local integrity was absent in BFS. Therefore, management control was ineffective, in that management believed and relied upon the risk and performance information generated by transactions processed in BFS, apparently without independent investigation (other than might be carried out during the annual external audit), until the internal audit of August 1994. Although this internal audit failed to identify the unauthorised activities of Leeson, it did highlight the lack of division of responsibilities between trading and settlements; but this fundamental weakness in internal controls was not rectified.

Management control of the equity derivatives business

- 2.41 By the middle of 1993, Norris realised that the equity derivatives business of BSL was not working effectively. He said that there was no culture and no sympathy for the business in BSL and it either needed a management sponsor or consideration would have to be given to closing it. Norris spoke to Tuckey and Maclean, to explore the idea of the Treasury and Trading Group within BB&Co taking on responsibility for the

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equity derivatives business. During the second half of 1993 Ron Baker, who reported at that time to Hopkins, was asked to take a look at the equity derivatives business.

- 2.42 Ron Baker had joined BB&Co in April 1992 having previously worked at Bankers Trust for six years, leaving in January 1992. After he left Bankers Trust he prepared a business plan for introducing debt trading activities into one of the smaller UK merchant banking houses. His proposition was one which BB&Co found attractive, particularly Michael Baring who was at the time Head of Treasury and Trading, and Ron Baker joined as a Director of BB&Co and a member of the Treasury and Trading Committee. We were told that it was relatively unusual for Barings to recruit outside at director level. As he set about implementing his plan, he was also given responsibility for the Product Placement Group. Soon after joining Barings he recruited Walz and two other people from Bankers Trust, Miss Heather Nicol (Senior FPG employee, New York, and Director of BB&Co) and Mr Mark Fisher (Senior FPG employee and Director of BB&Co).
- 2.43 The equity derivatives business comprised the over-the-counter (OTC) proprietary derivatives trading activity in London and the proprietary exchange traded derivatives businesses in Tokyo and Hong Kong. During what he described as "due diligence" of this business Ron Baker established that within the proprietary volatility book managed by the Tokyo traders was a "switching activity" conducted on behalf of BSJ by BFS which apparently produced, in his estimate, some 65% of the revenues generated by the volatility book. The 'switching' activity is described in Section 3. Ron Baker told us that: "It is my belief that nobody at that point in time knew that that was the way things worked outside that small group of people [who worked for BSJ in Tokyo]". In referring to the 'switching' book, Maclean told us: "It consisted of Leeson. Nobody talked about anybody else. It was called 'Leeson's business'. That is what people thought of it as".
- 2.44 The decision to place the proprietary equity derivatives trading business under the management of Ron Baker was taken for three reasons. First, it did not fit easily within the culture of the securities broking business and there was no client overlap. Secondly, the Debt Financial Products Group (which had been run by Ron Baker since he joined Barings) had experience of using derivatives on a proprietary basis, as part of their asset swap activity, although these tended to be OTC derivatives rather than exchange traded derivatives, and were debt rather than equity derivatives. Thirdly, Ron Baker's man management skills were thought to be what were needed to motivate the proprietary traders. The futures and options agency sales business, under the management of Killian in Tokyo, remained outside Ron Baker's responsibility at that time, with Killian continuing to report directly to Norris. Norris described the existing business to us: "Quite a lot of it [the Ron Baker derivatives business] was OTC, but they were also active users of exchanges. There was a LIFFE membership in London and obviously a large part of their hedging and trading activities were put through [exchange] floors". He noted that the existing business was mainly interest rate products.
- 2.45 As to the circumstances at the time he took over the proprietary equity derivatives business, Ron Baker told us: "It may well be that I agreed to bite off more than I could chew in taking on the job that was proposed to me. Perhaps I was far too cavalier about the way in which it was defined. I was willing to let other people define this thing. I would just take it on and fix it. 'Get out my way', sort of thing. I should have

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paid much more care and attention to how the job specification was defined, to what it included and did not include. I feel I was remiss in not doing that”.

- 2.46 By June 1994, the equity derivatives trading business was incorporated into FPG. FPG was organised into four smaller units: Debt Financial Products, Emerging Market Debt Trading, Eurobond Trading and Sales and Structured Products. The equity derivatives trading fell within Structured Products, the activities of which included, according to a paper prepared by Hopkins in June 1994, “equity index arbitrage in Tokyo and Hong Kong, dealing in Osaka Exchange traded equity index options and writing OTC equity swaps and options for clients”.
- 2.47 Although Ron Baker had had some involvement in the derivatives markets, he had not previously been involved in exchange traded futures and options of the kind conducted by the Structured Products Group (later renamed Equity Financial Products Group) in Japan, including the ‘switching’ business booked in Japan and London, but managed in Singapore. In interview, Ron Baker told us: “There is no doubt in my mind, that my lack of experience in the area was a contributing factor to what has happened here [the collapse]. All I can say in defence of that is that lack of experience is something that I have overcome before in my life when I have taken things on, but if you ally lack of experience to the lack of information I got and to the other failures in the organisation, in the failure to give me accurate information so I was learning off absolute crap information, then I think that meant getting up a learning curve which was impossible. There is no doubt in my mind that if I had had ten years experience in exchange traded equity derivatives, this would not have happened. The fact is I did not”. Subsequently, Ron Baker qualified his remarks by adding that he did not believe his lack of experience necessarily made him the wrong person for the job or caused the catastrophe. He said that it made him much more dependent on the control systems and information systems and organisation structure than he would otherwise have been and that it also made him more dependent on: “honest and forthright discussions with people like Gueler, Killian, Leeson, Broadhurst, Gamby, [Tony] Hawes to let me benefit from their experience and insight”. Norris said he thought Ron Baker did understand derivatives and trading.
- 2.48 As the senior manager ultimately responsible for the significant profitability of the equity derivatives business, Ron Baker provided explanations which he believed to be cogent to other senior managers about the equity derivatives business. However, these explanations were sometimes not based on a sound understanding of the business or of the facts. He told us: “I was an eloquent defender of the strategy as the year [1994] went on and as I became more confident. In the light of the audit report [into BFS issued in October 1994] about what had happened, I was somebody who came up with some explanations for people about what was happening that were fairly cogent ... I think I was somebody who told a good story about that because they believed in it. As it has turned out, that was not what was happening. I think I contributed [to the collapse] in a unknowing way there”.
- 2.49 Walz was responsible for equity financial products and had day-to-day contact with Gueler, who she saw as being responsible for Leeson’s intra-day activities as Leeson’s proprietary trading was mostly booked in Japan. However, according to Gueler, Ron Baker told him in October 1994 that: “Nick [Leeson] does not report to you. Your job is to focus on Japan and Nick [Leeson] will report to London”. Gueler’s understanding of this was that Walz would be responsible for Singapore and he recalled that: “She

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was not happy that one of her chief lieutenants in Tokyo was going to become less involved on the risk side". Responding to the question, "Did Leeson report to you?", Walz said: "No, I have to say the answer is 'no' to that". It appears that from October 1994 the level of direct contact between Walz and Leeson grew significantly and Gueler told us: "Mary would talk to Nick [Leeson] three times a day and only with us in Tokyo once a day". This high degree of contact is not accepted by Walz who, when asked if in the weeks leading up to the collapse she spoke to Leeson daily or weekly, said: "I do not think it was daily".

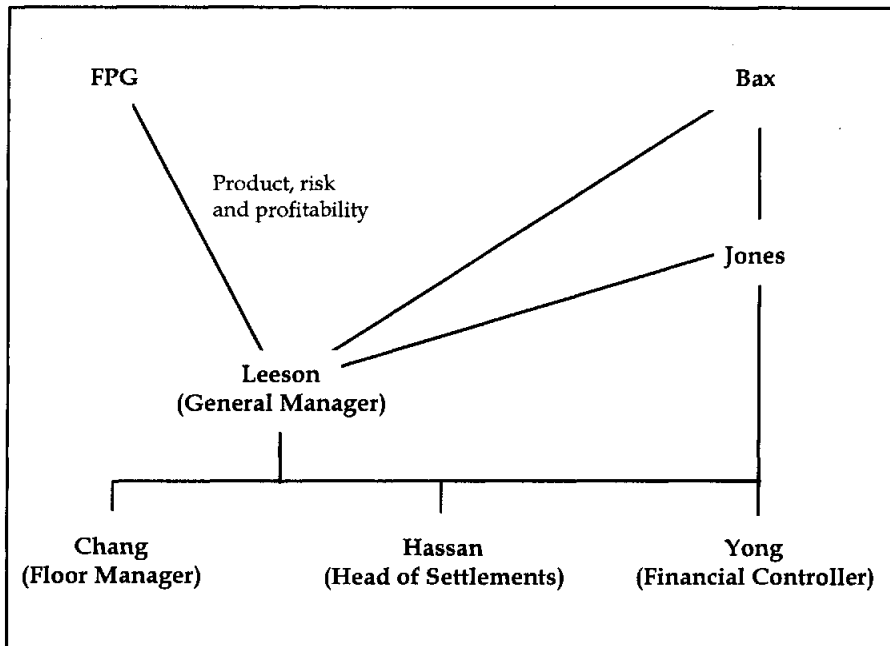
- 2.50 Whilst not all phone conversations were recorded, we were provided with tapes of telephone calls to and from Gueler for the period 23 January 1995 to 2 February 1995. During this period, Gueler received approximately 35 calls from Walz (26 of which were in the first three days when Walz was in Hong Kong) and 27 calls from Leeson. It is clear from these calls that Walz was briefed on Leeson's activity by both Gueler and Leeson. We were also provided with tapes of Walz's phone calls from London during the period from 23 January 1995 to 24 February 1995 during which she spoke to Leeson on at least 11 occasions. Walz also told us that she felt more responsibility for Gueler's activity than for Leeson's: "I certainly did not feel ownership of Nick Leeson or his P&L. I felt ownership of Fernando [Gueler] being [responsible for] monitoring his daily intra-day trading risk".

Management of BFS

- 2.51 Under the matrix organisation of BIB, and before that BSL, the management structure of BFS cannot be considered on a stand alone basis. As described above, this is because responsibility for product profitability was not organised on a location or entity basis but on a global product basis. Also, the directors of BFS either had first line management responsibility for BSS, a larger company than BFS, or represented the wider interests of Barings. None of the directors was a full time executive of BFS. The names of the directors together with their main executive responsibilities in Barings are shown in Appendix X.
- 2.52 We have not had access to the minutes of BFS Board meetings. We have been informed that the BFS Board did not meet on a frequent basis, but met only to fulfil the minimum statutory obligations. Such meetings were not attended by all members of the BFS Board.
- 2.53 From our interviews with Barings' personnel in London and Singapore we understand that, at the time of the collapse, Leeson reported as part of FPG to Ron Baker. He spoke regularly to Gueler and Walz to discuss his day-to-day trading activities and also spoke to Ron Baker. He also reported on operational matters related to BFS locally to Bax and Jones. In a letter to Jones, dated 2 November 1993, Norris told him: "I am very pleased to confirm that we are asking you to assume expanded regional operational management responsibilities. This will involve you becoming director of operations for the southern and western activities of our Asia business with specific responsibilities for operations in offices in Singapore, Kuala Lumpur, Bangkok and Jakarta. James Bax will be assuming overall responsibility within Asia for our operations as regional managing director". Leeson's reporting lines at the date of the collapse, as we understand them, are set out in Figure 2.1.

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Figure: 2.1 Leeson's reporting lines (February 1995)



Source: Inquiry team

Note: There were also support functions' reporting lines to the Group-wide support functions in London

- 2.54 However neither Bax nor Jones consider that he was operationally responsible for Leeson. In a letter Bax has represented to us: "Mr Leeson did not report to [Bax] either direct or through Mr Jones or anyone else on any matters relating to the operations of BFS. On front office matters Mr Leeson reported direct to FPG through either Ms Walz or Mr Ron Baker. On back office matters, he reported either direct to Settlements/Treasury in London and following [Bax's] letter of 3 February 1995 to Mr Norris he should have reported to Mr Jones. On such back office matters that Mr Jones may have needed to refer upwards, he could have gone to Treasury/Operations in London and not to [Bax]". Jones has represented to us in a letter that he regarded his operational role as limited to securities activities in the region; that his role in BFS mainly related to administrative matters and his role did not include day-to-day futures operations.
- 2.55 We have been unable to inspect Leeson's personnel file, which we understand is in Singapore. However, through our interviews with Barings London personnel and access to the SFA's records we have determined Leeson's career history at Barings.
- 2.56 He joined BB&Co in July 1989 to work in futures and options settlements, having previously worked in a similar role for Morgan Stanley in London, from June 1987 to July 1989.
- 2.57 On 1 May 1991 Leeson joined the Business Development Group in London, in charge of special projects and investigations within BB&Co. In September and October 1991 Leeson oversaw parts of an investigation by BSL into the suppression of a late margin report arising from apparent collusion between an employee and a client with regard to an overdrawn balance. Late in 1991 he visited the Jakarta office of BSL, according to Killian, to: "put out ... some settlement fires on the equity side". After he returned to

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London from Jakarta, Barings submitted an application in February 1992 to the SFA to have Leeson recognised as a registered representative. The SFA raised questions concerning an undisclosed outstanding County Court Judgement against Leeson in respect of an unpaid debt. Later in March 1992, after he had expressed his desire to work in Singapore, Leeson was asked by Killian if he would go to BFS to run the back office. Killian said: "Nick's [Leeson] name was put forward to the Management Committee in London and he was approved to go out and do that [run the back office]". The application to the SFA was subsequently withdrawn by Barings in September 1992.

- 2.58 Leeson arrived in Singapore in March 1992. Mr Ian Martin, Group Finance Director, BSL until March 1993, stated in a fax to Jones and Killian on 24 March 1992 that Leeson would: "head up our SIMEX operation and also act as floor manager ... he will report to Simon Jones and Gordon Bowser" [at that time responsible for Futures and Options Settlements in London]. It is not clear why the Group Finance Director was able to make or approve such front office appointments.
- 2.59 In response to this fax, Bax expressed concerns about the reporting lines in Singapore when he wrote a memorandum to Mr Andrew Fraser, Head of Equity Broking and Trading, BIB, and Director of BSL, on 25 March 1992, shortly before Leeson's arrival, in which he stated: "My concern is that once again we are in danger of setting up a structure which will subsequently prove disastrous and with which we will succeed in losing either a lot of money or client goodwill or probably both ... In my view it is critical that we should keep clear reporting lines and if this office is involved in SIMEX at all then Nick [Leeson] should report to Simon [Jones] and then be ultimately responsible for the operations side". It appears that this response was designed to keep Leeson's reporting line within Singapore (to Jones) and is an illustration of the tension at that time between local managers (Bax in this case) and group financial control in London.
- 2.60 Leeson put a request to Bax to take the SIMEX examinations so that he could "wear a badge" on the floor of the exchange. He passed these examinations in late 1992 and began trading on the floor of SIMEX. At about the same time or in early 1993 he was appointed General Manager of BFS. Leeson's reporting lines were not clearly defined or, it seems, adequately understood from the start. Killian told us: "It was probably a conscious decision to have Nick [Leeson] be responsible. Somebody needed to be responsible for all the Singaporean kids on the floor". At this time Killian thought that Leeson was: "under the watchful eye ... of the Singapore branch".
- 2.61 BSS and BFS were located in the same office block but occupied different premises served by different lifts. Both Bax and Jones had their office on the 24th floor. Leeson, when not on the SIMEX floor, worked in the BFS office on the 14th floor.
- 2.62 We have not been permitted access to management or staff in BFS for formal interviews or to the accounting and other records of BFS. Our observations on management and internal controls relating to BFS are, therefore, based on discussions with Barings' staff in London, limited contact with Bax and Jones in Singapore at the outset of the inquiry and their written responses to our preliminary conclusions.
- 2.63 Group management visited Singapore from time to time although most of their time was spent at BSS rather than BFS, at least until late 1994. Typically Peter Baring and

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Tuckey visited Singapore principally to meet clients and to review the Barings operations generally with Bax. Maclean told us he had not visited Singapore for a number of years. Barnett had not visited Singapore since becoming Chief Operating Officer. Gamby and Ron Baker had visited once in 1994, for a few days each. Broadhurst normally visited once a year but in 1994 had made three visits. Barings' management viewed their business in Asia as important to the Group results, although BFS was never discussed at the Asian Management Committee, indicating that London took a direct interest itself in BFS.

- 2.64 BFS was run as a separate operation from BSS although Bax and Jones had, we consider, local responsibility for operational matters and both were directors of the company. There was clearly communication and contact between Leeson and Bax, and between Leeson and Jones; however, it is equally clear that Bax and Jones were much more focused on BSS than BFS. Leeson was in frequent contact with Gueler and Killian in Tokyo until the first half of 1994, and increasingly thereafter with Walz and Ron Baker in London. There was also daily contact between Leeson or his settlements staff, BSJ in Tokyo and Baring Securities Group Treasury (BSGT), a branch of BB&Co, and BSL in London, concerning position reporting and requests for funding.
- 2.65 Although it has been mentioned to us that there were a number of reconciliations of accounting records performed within BFS (to SIMEX statements, bank accounts, and client accounts), the lack of segregation of duties between front office and back office rendered these controls ineffective and allowed information sent to SIMEX, BSJ and BSL to be manipulated, as described in Section 5.

Risk management in BIB

- 2.66 Risk management in BSL was under the supervision of the Risk Committee formed in October 1993. It met daily to discuss the risks in BSL proprietary trading positions and once a week discussed credit issues for which purpose Maclean and Hopkins would attend. From 1 January 1994 the Risk Committee was attended by Ron Baker or Walz to discuss Equity Financial Products trading. The information provided to the Risk Committee comprised gross positions on proprietary trading, counterparty excess reports and daily profit and loss figures.
- 2.67 In November 1994, BSL's Risk Committee was merged with BB&Co's Treasury Committee to form ALCO, which met daily and was attended by an average of five members, although there was no quorum. Others (e.g. Walz, Blyth) were invited to attend depending on the subjects under discussion. The meetings were minuted by Smith. ALCO would review the regular information package containing a summary of the previous day's results, credit issues and forward agenda; the minutes of the previous meeting; reports showing BIB's exposure to market risk; and any other documents presented for consideration. The title and purpose of each of the market risk reports are described in Appendix XI. Examples of the positions reported in respect of 'switching' are described in paragraph 3.47 and relevant ALCO meetings are described in paragraphs 7.29 to 7.53.
- 2.68 Between June 1993 and October 1994, Sacranie had direct responsibility for risk monitoring, reporting initially to Broadhurst and later to Hopkins, who reported to Norris. Broadhurst told us that, at that time, he (Broadhurst) had no previous risk management experience. Commenting on the BSL Risk Committee, Sacranie told us:

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“These Risk Committees started off and there was a lack of financial information for them to use at that time. They somehow just petered away”.

- 2.69 As noted in paragraph 2.35, Hopkins became Head of Group Treasury and Risk in August 1994, at which time he expressed some concern about the low level of experience among staff in Barings’ treasury and risk function. One of the projects which he said was “in train” in late 1994, was to: “research fully all the margin implications of the trading, the volatilities of the instruments that [we] were trading, and to look at the potential for margin calls on positions in order to set appropriate gross limits for the business”. One of the objectives of Barings’ treasury and risk function was to establish independence over the monitoring of risk on a global basis. With this in mind, risk controllers were appointed in Tokyo (covering the Japanese businesses) and in Hong Kong (covering North Asia, excluding Japan). No risk controller was appointed in the Singapore office, the hub of the South Asia region. One of the reasons was that Singapore was viewed very much as an execution centre with no outright directional risk being taken, although at the 12 January 1995 ALCO meeting Katz asked who was responsible for risk control in the South Asian trading centres (Singapore, Thailand, Malaysia, Philippines). The internal audit report on BFS, based on fieldwork in July and August 1994, commented on the need for a risk controller (paragraph 9.24).
- 2.70 Since most of the ‘switching’ business managed by Leeson in Singapore was booked in the name of BSJ, the independent control of the risks in the ‘switching’ business was the responsibility of Mr Vincent Sue, Risk Manager, BSJ. BSJ relied on information provided to it by BFS and did not attempt to perform any independent verification. Sacranie told us: “In hindsight it [no independent review of Singapore] does seem quite a gross oversight, yes, but the texture around that whole thing - the Singapore operation and the background to it - was that it was regarded as being fairly well controlled by Simon Jones and James Bax”.
- 2.71 Following the issue of the final BFS internal audit report in October 1994, which recommended that BFS’s trading be subject to the scrutiny of an independent risk and compliance officer, it was agreed that Mr Gordon Bowser, Risk Manager, Hong Kong, would visit Singapore to assess the risks in the BFS business and then make regular visits thereafter for risk monitoring purposes. Bowser told us that during his initial visit in November 1994 he was told by Jones that Yong would take responsibility for local risk monitoring and that, therefore, he spent most of his visit training Yong. Bowser did not visit Singapore again until the weekend of the collapse. He told the inquiry that Jones gave Yong other work so that it was not planned for her to take on the risk control role until 1995. Jones contends, in a letter to us, that the reason Yong could not take on this role sooner was that her identified replacement was required to give three months notice to his existing employer. By the time of the collapse, Yong had not taken on the role of risk controller. This is considered further in paragraph 9.40.
- 2.72 It was the responsibility of each product group to manage the risks (as distinct from independent control of the risk) arising from the group’s activities. In respect of FPG Ron Baker told us that for 1994 Walz was responsible for risk: “To me, I had [Mr] Mike Thoms [Director of BB&Co, based in Hong Kong], Mark Fisher and Mary Walz looking after the risk in the three businesses that I was running during 1994, which was the Equity Financial Products, Debt Financial Products, and the Emerging Market Debt.

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Mary [Walz] was responsible for the day-to-day management of the risk, reporting to me”.

- 2.73 The independent monitoring and control of risk in respect of the activities of BFS was inadequate. Also, the risk control function in BSJ was rendered ineffective because it relied wholly on information provided by BFS.

Group financial reporting

- 2.74 At the date of the collapse, the financial reporting responsibility in Barings plc was under Barnett, who was assisted by Broadhurst in respect of BIB.
- 2.75 Between February 1992 and March 1993, Broadhurst was Finance Director of BSL, having previously been Financial Controller of BB&Co. He became BSL Group Finance Director in March 1993. His responsibilities encompassed finance and accounting, and, until August 1994, treasury and credit. He was also responsible for market risk from June 1993. The financial reporting structure set up by Broadhurst within BSL was to introduce a financial controller into each of the regional centres, being Hong Kong, Singapore, Tokyo and New York. These financial controllers reported directly to the Chief Operating Officer of their particular region, with a ‘dotted line’ reporting responsibility to Broadhurst.
- 2.76 Although the new IBG/BIB structure was announced in November and December 1993, it was not formally constituted immediately. During 1994, the gradual change to the IBG/BIB structure necessitated a merger of the financial reporting functions of BB&Co and BSL. Until August 1994 the financial reporting of BB&Co and BSL was separate, with Mrs Liz Seal as the Financial Controller of BB&Co and Mr David Crookston as the Financial Controller of BSL. Broadhurst was made responsible for BIB finance and accounting on 6 August 1994, at which time he appointed Seal to be Financial Controller, BIB, responsible for regulatory reporting and group consolidation, and Crookston to be Financial Controller, BIB, responsible for revenue and expense reporting. Also, in August 1994 Hopkins became head of a new department, Group Treasury and Risk when Broadhurst ceased to have formal responsibility for BSL treasury, credit and market risk.
- 2.77 There did not appear to be a strong relationship between the business or product line and the finance function. Norris told us that: “Ron [Baker] was liable from time to time to complain in rather plain terms about things like the Treasury and Financial Control area”.
- 2.78 The new BIB structure did not change the method of reporting from regional offices. Jones continued to report directly to Bax with an indirect reporting line to Barnett and Broadhurst.
- 2.79 Broadhurst has stated that his relationship with Singapore was “very, very poor”, especially with Jones, with whom he was barely on speaking terms. Their relationship had been damaged in May or June 1994 following Broadhurst’s attempts to organise a conference of Financial Controllers, including Yong, which Jones initially refused to allow her to attend; and since that date communication had been carried out via Bax.

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2.80 The financial control function within BIB appears to have been narrowly defined, with little emphasis placed on control. For example, it took no overall responsibility for analysing or questioning the composition of the balance sheets it produced (either for regulatory or management information purposes) or the business rationale for the major profit contributors. It also took no responsibility for making sure that key reconciliations had been performed, other than reconciliations of intercompany accounts, including those with BFS. Following the breakdown of any dialogue between Broadhurst and Jones in Singapore, group financial control over BFS was ineffective.

Barings' remuneration policy

2.81 Barings had a remuneration policy which gave directors and senior employees a significant direct interest in the annual results of the Barings Group. The Barings Group's policy was that approximately 50% of profits before tax after a capital charge went directly into the bonus pool. This pool was allocated according to the performance of each product group and the individuals within that group. Bonuses were available to be paid in cash, if the recipient so decided, although from 1993 an option to receive bonus in a form that could ultimately be converted into listed preference capital was introduced.

2.82 Bonuses represented a significant proportion of total remuneration. At director level the ratio of bonus to base salary was typically at least 75 : 25.

2.83 In late 1994 Norris commissioned a benchmarking study (issued in draft, not finalised) which showed that the level of Barings' employee remuneration compared to its profitability ranked Barings as one of the highest amongst its peer group in the United Kingdom and the United States on this basis.

2.84 Prior to the formation of BIB, BSL had been attempting to establish a more formal and scientific process to determine individual bonuses. Consistently with the informal culture that had existed in BSL, a study in 1993 by external consultants found that BSL lacked a remuneration policy and was generally bad at communicating its approach to remuneration. This study also found that there was a perception of inconsistent assessment and award standards, that the link between individual remuneration and performance was suspect and that the BSL bonus paid in 1992 was not funded by profits earned in that period.

2.85 Based on the consultants' work, a new philosophy and key management objectives were outlined. Specifically, it was noted that BSL would be competitive and "pay the top for top individual performance". The tracking of total remuneration expense against pre-remuneration operating profits was stressed as a key objective, this ratio being the "single most important" one for management. Global consistency and targets by product and function were also regarded as key objectives, as was the establishment of a personnel function.

2.86 We understand that from 1993 the bonus calculations for BSL were more formally driven by function and by product. Profits were allocated to teams within the functional product categories, then bonuses were calculated and individually assigned based on performance. There were major shortcomings in this exercise, notably an ineffective cost allocation system which inhibited accurate profit pools from being

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determined for teams, and a substantial element of discretion was applied to individual cases.

- 2.87 Bonuses for BB&Co were allocated on a different basis from those of BSL. In particular they were on a more discretionary basis. However, the common issues of the allocation of funding costs and the need for a system for team and individual performance measurement were equally applicable.
- 2.88 The issues of divisional versus entity profit pools had been recognised by management, but the gradual establishment of BIB during 1994 caused some confusion as to bonus arrangements for certain divisions which spanned both BSL and BB&Co.
- 2.89 For example, there were significant discussions during 1994 between Norris, Ron Baker and Maclean concerning the allocation of profits for FPG. This resulted from Ron Baker assuming responsibility for the Equity Derivatives Group in BSL. No clear decision appears ever to have been made. Maclean has told us: "Because Baring Securities were giving away this business ... on the assumption that there were profits, which is what it [the business] appeared in the financial accounts to have ... [the profit] was being gained by Baring Brothers. In compensation, those profits were to be shared 50 : 50 for bonus pool purposes". Norris and Ron Baker have conflicting views on the matter, in respect of discussions both between them and with Maclean.

Summary of bonuses

- 2.90 The allocation of bonuses for 1994 to individuals had been determined by the date of the collapse. Furthermore, BB&Co staff had been informed of their bonuses on 24 February 1995. An analysis of proposed 1994 bonuses for directors of BB&Co and employees and directors also of BSL in excess of £250,000 is shown in Figure 2.2. The analysis for directors includes the proposed bonus for Peter Baring who was Chairman of Barings plc.

Figure: 2.2

| Proposed bonus band | Number of directors of BB&Co | Number of employees and directors of BSL |
|---------------------|------------------------------|--|
| £250,000 - £499,999 | 26 | 32 |
| £500,000 - £749,999 | 4 | 1 |
| £750,000 + | 4 | 0 |

Source: Summary prepared by Ms Sheila Millbank, Director of BIB Personnel

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2.91 An analysis of the proposed 1994 bonuses in excess of £750,000 is shown in Figure 2.3.

Figure: 2.3

| Name | Proposed bonus |
|--------------|----------------|
| Tuckey | £1,650,000 |
| Peter Baring | £1,000,000 |
| Norris | £1,000,000 |
| Ron Baker | £880,000 |

Source: Summary prepared by Millbank

2.92 Leeson's bonuses are as shown in Figure 2.4 although he had resigned before his 1994 bonus was paid.

Figure: 2.4

| | |
|-----------------|----------|
| 1994 (proposed) | £450,000 |
| 1993 | £130,000 |
| 1992 | £35,746 |

Source: Summary prepared by Millbank

2.93 We do not have evidence to cause us to conclude that the judgement of management of Barings in London with regard to the control of, or inquiries as to the activities of, BFS was affected by a concern that bonuses might be prejudiced. As to Leeson himself, the bonus system meant that he stood to benefit materially from the false level of profitability reported by him but we are unable to conclude that that was his only or main motivation.

3. AUTHORISED TRADING ACTIVITIES ON SINGAPOREAN AND JAPANESE FUTURES EXCHANGES AND RELATIONSHIPS WITH THIRD PARTY CUSTOMERS

Introduction

- 3.1 This section explains the nature of the trading on SIMEX and the Japanese exchanges carried out with the authorisation of Barings' management on behalf of clients and for Barings' own account. We explain the mechanics of trading in financial futures and options on an exchange and the specifics of the contracts traded on SIMEX and various Japanese exchanges. We examine the types of trading authorised to be carried out by Barings in London and Japan, the way in which this trading was monitored for the purposes of risk management, and the reported profitability of this business. Finally, we set out details of the trading on behalf of customers which BFS was authorised to carry out.

Financial futures and exchange traded options

- 3.2 Financial futures contracts are agreements to buy or sell a standard quantity of a specific financial instrument at a predetermined future date and at a price agreed through a transaction on an exchange. Exchange traded option contracts give the purchaser the right, but not the obligation, to assume a long or short position in the relevant underlying instrument, often a financial futures contract, at a predetermined exercise or strike price, at a time in the future. In return for this right, the purchaser pays a premium to the seller or writer of the option.
- 3.3 All futures and exchange traded option contracts require margin to be posted with the exchange's clearing house. Margin is called by the clearing house in order to provide financial protection in the event of the failure of one of its clearing members. An 'initial margin' is called daily and held, as a core guarantee against an adverse price movement, until the open position in the contract is closed out. Separate from this initial margin is a daily 'variation margin' call for financial futures, which represents the change in the mark-to-market value of the position, such that if the value of a member's outstanding contracts falls it must pay the variation margin as soon as possible to the exchange and similarly will have it credited to its account if its outstanding contracts gain value.
- 3.4 Most exchange clearing houses also have the right to call for variation margin within a trading day (normally called 'intra-day' or 'advance margin'), which must be paid immediately, but this is called only occasionally in very volatile markets when contract prices have moved by a large amount and the clearing house wants to ensure that funds will be available to meet end-of-day variation margin calls. Additionally, advance margin may be called when the exchange is closed for longer than normal (e.g. over a public holiday period).
- 3.5 All contracts are ultimately traded between clearing members of the exchange and the exchange's clearing house, which novates all trades so that it becomes the counterparty to every trade. All trades executed by non-clearing members are 'given-up' to a clearing member to clear, so that non-clearing members effectively have trades

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with their clearing member. Clearing members may trade for their own account ('house' account) as well as for third parties ('client' accounts).

- 3.6 BSL, through various subsidiaries, was a full clearing and trading member of several futures exchanges, including SIMEX, TSE and OSE, and was a trading but non-clearing member of TIFFE. These are the exchanges most relevant to the inquiry. Barings had for some time been pursuing a strategy of building an expertise in executing client business on Pacific-rim futures exchanges and in emerging markets.

The Nikkei 225, Japanese Government Bond and Euroyen contracts

- 3.7 Acting in an agency capacity for clients, BFS would execute transactions in any of the contracts traded on SIMEX. Acting on behalf of other Barings companies, BFS's business was in six main financial futures contracts, and some of the options on those same futures contracts. They were:
- (a) the Nikkei 225 contract traded on SIMEX in Singapore;
 - (b) the Nikkei 225 contract traded on OSE in Japan;
 - (c) the 10 year JGB contract traded on SIMEX in Singapore;
 - (d) the 10 year JGB contract traded on TSE in Japan;
 - (e) the 3 month Euroyen contract traded on SIMEX in Singapore;
 - (f) the 3 month Euroyen contract traded on TIFFE in Japan.
- 3.8 Detailed specifications of the contracts can be found in Appendix V. The three pairs of contracts are identical in essential specifications except that the OSE Nikkei 225 and TSE JGB contracts are twice the notional size of their SIMEX equivalent contracts. Also, the OSE Nikkei 225 contract moves in steps of 10 index points as opposed to 5 index points for the SIMEX contract and therefore the value of a one tick move of the OSE Nikkei 225 contract is four times that of a one tick move of the equivalent SIMEX contract.
- 3.9 There are three important differences affecting the trading of these three pairs of contracts.
- 3.10 The first difference is in the way the various exchanges effect trades. SIMEX contracts are traded in the open-outcry pits at the exchange. This system is effectively an auction, whereby all bids and offers are made openly by outcry and hand signals. In contrast, the contracts on the three Japanese exchanges are all traded on electronic systems, whereby trade orders are entered on terminals from each trading member's office and a computer matches up bids and offers to effect the trades.
- 3.11 The second difference is that there are limits on the extent to which the price of the contracts can move on a daily basis on OSE and TSE contracts, whereas SIMEX and TIFFE contracts are not constrained by any price limits on any one day (although obligatory 15 minute pauses are made after 5% and 10% price moves in the Nikkei 225 contract on SIMEX).
- 3.12 The third difference is that the exchanges each have different margining requirements (Appendices V and VI). Specifically, SIMEX uses the Standard Portfolio Analysis of Risk (SPAN) margining system that calculates initial margin calls based on the aggregate portfolio risk position of an account and on current market volatilities;

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whereas the Japanese exchanges have initial margins based on fixed percentages of each contract's value. The timing of margin payments and recoveries also differs between the exchanges, with variation margin movements only taking place on Trade Date + 3 days on OSE and TSE, compared to Trade Date + 1 day on TIFFE and on SIMEX for US Dollars and Trade Date + 2 days on SIMEX for Yen.

- 3.13 The margining process between the exchanges also differs in the designation of 'house' and 'client' accounts. SIMEX and TIFFE require clearing members to maintain separate accounts for their 'house' and 'client' accounts (i.e. there is a distinction between the margin posted for clients and the margin posted for the clearing member's own trading accounts). SIMEX margins both the 'house' account and the 'client' account on a gross basis. TIFFE margins only the 'client' account on a gross basis and permits the 'house' account to be margined on a net basis, allowing long and short positions in the same contract, but in different 'house' accounts, to be offset. In contrast, clearing members only have to keep one account on both OSE and TSE and can post net margin to the exchange, although clients are still margined on a gross basis by their clearing member.
- 3.14 For this inquiry, the most relevant margining procedures for exchange traded options are those of SIMEX. Buyers of exchange traded options pay the full premium and so do not need to pay any variation margin, simply recouping any value on the sale or exercise of the option. The seller of an option receives the full premium as cash, but is required to post initial margin. This is calculated through the SPAN system to allow for any offsetting open risk positions, but an 'unhedged' short option position would normally require initial margin roughly equal to the market value of the option. The initial margin changes to reflect movements in the market value of a short option position, which is similar in effect to variation margin arising on a futures contract.
- 3.15 Therefore, the ability to generate cash flow through selling options on SIMEX in order to receive premium income is limited, unless there are offsetting positions whereby limited extra initial margin may be required under the SPAN system or the margin is posted in the form of collateral (such as government bonds) rather than by giving the cash premium received straight back to the clearing house. From our work it appears that neither of these possibilities was used to any great extent by BFS to raise actual funding for margin calls, although the receipt of premium income from option sales was used to mask losses through accounting entries over month ends (paragraph 5.64).
- 3.16 BFS did occasionally execute trades on the London International Financial Futures Exchange (LIFFE) in the 10 year JGB contract, but this was not done regularly or in size, so detailed descriptions and analysis are not believed to be relevant to this investigation.

Barings London's activities

- 3.17 Trades that were executed on the Japanese and Singaporean exchanges were booked in the name of BSLL for proprietary trading and in the name of BSL for clients.

Barings London's proprietary trading

- 3.18 BSJ's proprietary traders in Tokyo took positions on the books of BSLL in the various contracts in Japan and Singapore, aiming for outright trading profits which would be

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attributed to the Structured Products Group (SPG) of FPG. This activity was conducted within authorised trading limits and its risk was reported to the BIB Group Treasury and Risk Department, headed by Hopkins, as well as to Ron Baker in FPG. (Some of this business was later transferred to the books of BSJ, as described in paragraph 3.32). The business booked in BSL was the only business that was registered as 'house' business on SIMEX, since BSJ's proprietary business was registered as 'client' business (paragraph 3.34).

Barings London's agency business

- 3.19 BSL was the primary booking entity for almost all of BFS's and BSJ's external clients who executed and/or cleared through BFS (for SIMEX) or BSJ (for the three Japanese exchanges). The agency business, as this was called within Barings, had built up a sizeable number of clients whose accounts were managed operationally by BSL. These clients included First Continental Trading Limited (FCT), a Chicago-based futures trading house (paragraphs 3.22 and 3.69 to 3.71) and SLK (paragraphs 3.69, 3.71 and 5.55). It was BSL that would receive statements from BFS and BSJ and pay or collect margin to or from the clients. In a few cases, BSL advanced credit to a client to finance their margin payments (although the Barings legal entities that were the actual clearing members of the different exchanges, such as BFS and BSJ, were not permitted themselves to finance their clients' margins directly). According to the 'Baring Securities Group Management Accounts' for the year ended 31 December 1994, the commissions earned on 'Futures and Options Sales' were £13.5 million.

BSJ's activities

- 3.20 BSJ conducted both agency and proprietary business on the Japanese and Singaporean exchanges.

BSJ's agency business

- 3.21 Killian was based in Tokyo until March 1994 and continued to work from there for at least one week a month after his relocation back to Portland in the US. Much of the agency business, including that of many US clients, was executed through the broking team under Killian situated in BSJ's offices in Tokyo and Osaka. Although many of the clients were officially clients of BSL and their trades were booked through London, BSJ also had clients of its own.
- 3.22 There was a close relationship between BSJ and FCT, who cleared through Barings but who had their own floor traders on SIMEX and wanted their own office-based traders in Tokyo. Killian offered office space to them in Barings' Tokyo premises and until September 1994 they were physically located in BSJ's Tokyo dealing room, an unusual arrangement for market participants. One of FCT's main activities was arbitraging some of the Japanese and SIMEX markets, including the Nikkei contracts and to a greater extent in 1994 (according to Killian) the JGB contracts. Whilst this was a similar business to BSJ's own (paragraph 3.40), Killian argued that they would do it anyway, whether aided by Barings' infrastructure or someone else's, and the FCT account was a valuable and important one to Barings. In September 1994, as Ron Baker began to take greater control over the whole of the futures business, he moved the FCT traders to a separate floor of BSJ's offices in order to eliminate any conflict of interest.

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- 3.23 The agency business conducted through BSJ was apparently a main contributor to the total revenue for the global agency business, but Ron Baker's communications to Killian from the end of 1994 were to the effect that this was less profitable and attractive than the proprietary trading business (paragraphs 3.50 to 3.66).

BSJ's proprietary cash/futures arbitrage activity

- 3.24 Mr Benjamin Fuchs, FPG Trader, Tokyo, traded a proprietary cash/futures equity arbitrage book, in which baskets of shares from the Nikkei Index were traded against the Nikkei 225 futures contracts. The 1994 reported revenue for this book was £5.5 million.

BSJ's proprietary volatility trading activity

- 3.25 Brindle traded for BSJ's own account a pure 'volatility' book on options on the Nikkei 225 Index and related futures contracts, known as the 'vega book' (paragraphs 4.61 to 4.64 for a description of volatility trading). In mid-August 1994, the booking of this business was moved from BSJ to BSLL in London. Until mid-August 1994 the profits of this book included the profits of the Nikkei inter-exchange arbitrage activity (see below), but an attempt to improve the analysis of profits meant that this activity was reported as a separate profit centre from mid-August 1994. The 1994 reported revenue for this book was £15.8 million.

BSJ's proprietary inter-exchange arbitrage ('switching') activity

- 3.26 Until October 1994, all inter-exchange arbitrage books were considered to be overseen by Gueler as head of the FPG business in BSJ (although Gueler does not accept this with regard to BFS). After October 1994, Walz had this responsibility. Gueler reported functionally up through Walz to Ron Baker, although in practice the trading decisions were delegated to Leeson in BFS. This was because Leeson was in the best position to conduct such business from the floor of SIMEX, having immediate access to SIMEX trading pits and almost instant access down open phone lines from the SIMEX floor to BSJ operators at dealing terminals for the Japanese exchanges. In the confirmation of Market Risk Limits agreed by ALCO in November 1994, Leeson was documented as the trader with responsibility for the intra-day risk limits for this business, which was termed 'switching'.
- 3.27 The activity started during 1993 using Nikkei 225 contracts as BFS saw opportunities to improve the futures hedges initiated by BSJ's traders. The futures hedges were switched between Singapore and Osaka with the simple aim of profiting from temporary price differences between the SIMEX and OSE Nikkei 225 contracts, buying the cheaper contract and selling the more expensive one and then reversing the trade when the price difference had narrowed, or even been eliminated, in calmer markets. There were two main factors causing price differences.
- 3.28 First, the OSE market was the bigger market and tended to attract the bulk of Japanese trading houses' own business, whereas SIMEX had a higher proportion of offshore traders' business and small 'local' activity. Therefore, different demand and supply factors were at work and one market could move first on the back of an order and provide a temporary price difference which arbitrageurs could exploit to bring the prices back into line.

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- 3.29 Secondly, the OSE market, being an electronic exchange, tended to move more slowly than SIMEX, both because of the physical constraint of the speed at which orders could be keyed and transmitted to the electronic exchange, and because OSE could lock, bringing a temporary stop to the executor of trades if the volume of either buy or sell orders at the current market or at best prices became too heavy and insufficient bids or offers could be found to carry on matching trades. This only occurred in fast and volatile markets and, since the Nikkei Index was not very volatile throughout 1994, frequent opportunities for arbitrageurs to exploit the difference did not occur. However, the JGB market remained quite volatile intra-day throughout 1994, presenting more arbitrage opportunities, and the fact that the bulk of BFS's inter-exchange arbitrage profits for 1994 reportedly came from the JGB, and not the Nikkei activity, is consistent with this observation (Figure 3.4).
- 3.30 Although BSJ's other proprietary trading books concentrated on trading the Nikkei Index and the 'switching' business had originated with BFS improving Nikkei futures hedges for the BSJ trading books, this inter-exchange arbitrage activity was also conducted by BFS on BSJ's behalf between the JGB contracts on SIMEX, TSE and occasionally LIFFE. In March 1994, Leeson was formally given intra-day limits for his JGB 'arbitrage trading book' (which was originally booked as a BSSL 'house' account on SIMEX but from the beginning of January 1995 some activity was also booked into BSJ where it was classified as a 'client' account), even though JGB trading is not an equity derivative product and therefore is a surprising activity to be conducted under the SPG's auspices in BSJ. From May 1994 the 'switching' business was further extended to SIMEX and TIFFE Euroyen contracts (although fewer true arbitrage opportunities existed for the Euroyen contracts) when Leeson began a separate Euroyen arbitrage trading book, also in BSSL's books.
- 3.31 In mid-August 1994, Leeson was given a separate Nikkei arbitrage trading book which was booked in BSJ, with the specific purpose of helping identify the profitability of the Nikkei 'switching' activity separately from the profitability of the volatility trading activity. From then onwards BSJ posted the trades based on information sent each evening from BFS, but no trading instructions for any of these three 'switching' books came from BSJ.
- 3.32 Barings' management would have liked to have retained the booking of all 'switching' business in BSSL (in London) for tax reasons, although the separately identified Nikkei 'switching' activity was booked in BSJ from mid-August 1994, followed by part of the JGB 'switching' book in January 1995. This was to alleviate funding pressures and to benefit from the capital adequacy offset that the MoF allowed between positions on the Japanese exchanges and offsetting positions in the equivalent contracts on SIMEX.
- 3.33 SIMEX rules also permit lower margins for the Nikkei 225 and Euroyen contracts traded on SIMEX if they are shown to be offset by related contracts on OSE and TIFFE respectively. BSJ did not utilise this benefit, perhaps because they did not know about the allowance and perhaps because BFS did not volunteer the information since it would have meant less cash margins could have been called by BFS from BSJ. (Paragraph 5.37 describes the importance of this funding source to BFS).
- 3.34 It is also important to note that this proprietary BSJ business was all reported as 'client' business to SIMEX, not 'house' business as might have been expected if this had been treated the same way as the BSSL account which also contained pure proprietary

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Barings business. In contrast, BSJ reported its part of this 'switching' business that was executed on the three Japanese exchanges, along with its other proprietary activity, as 'house' business to the Japanese exchanges, although the distinction mattered little for margining purposes (Appendix VI). The SIMEX part of the inter-exchange arbitrage business was recorded in BFS under sub-account number '92000', whilst the other BSJ proprietary trading books' futures activities were recorded in sub-account number '91000'.

- 3.35 The explanation provided by Leeson and included in the internal audit report on BFS issued in the autumn of 1994 is that arbitrage profits could, and were authorised to, be made in three main ways.
- 3.36 First, from the normal price differences arising from the functioning of the different exchanges (paragraphs 3.28 and 3.29).
- 3.37 Secondly, from facilitating client orders on SIMEX, as this was generally a cheaper exchange on which to deal for non-members, due to lower commissions and generally lower margin requirements as determined by the SPAN margining system. Thus, if BFS received a large order on SIMEX and the liquidity was not available to execute it immediately, BFS would offer to execute the client's order by taking on the other side itself and laying off the risk with the equivalent number of contracts on the more liquid Japanese exchange. BFS would charge the client an extra price tick for doing this (explained to them, we believe) and would seek to unwind it later on when both markets had liquidity.
- 3.38 Thirdly, from proprietary positioning on the back of large orders which BFS possessed (or came to know of) on one of the exchanges, using the order as a stop-loss. For example, if BFS had a large buy order from a client for SIMEX Nikkei contracts, BFS could buy up to the equivalent value of OSE Nikkei contracts for its own account and if the market went up, simply sell them out for a profit on OSE. If the market went down, then they could simply execute the client's order by selling SIMEX contracts to the client (or the other broker with the order) themselves, leaving BFS with an arbitrage position that could be unwound later.
- 3.39 This activity cannot really be described as arbitrage and indeed it is clearly outright proprietary trading (i.e. taking net long or short positions). In fact, this is akin to 'front running' client orders, albeit using a different exchange from that on which the client orders were placed. Killian in particular became very worried by December 1993 that "working the client information curve", as it was put by Ron Baker, was an abuse and if known would damage legitimate agency business. Granger also had concerns that she reported to compliance, and the internal audit report had reviewed a suggestion of 'front running' but found no evidence of clients being disadvantaged.
- 3.40 BSJ was not the only market participant undertaking this inter-exchange arbitrage activity. Indeed FCT were doing it from Barings' own premises in Tokyo and on the floor of SIMEX and several other large foreign trading houses were known to be active in this business. Therefore, price differentials between the equivalent futures contracts did not exist for long.

3. Authorised trading activities

Risk monitoring of 'switching' business

- 3.41 Although management viewed these so-called arbitrage activities as risk free they could never be totally riskless, as some timing gap between executing on two different exchanges was unavoidable. Therefore, on 16 June 1994 Leeson was granted intra-day trading limits to cover temporary open positions of 200 Osaka Nikkei contracts, 100 TSE JGB contracts and 500 Euroyen contracts. Furthermore, the internal audit report stated that BFS was trading unhedged risk positions intra-day based purely upon an assessment of market conditions (presumably by Leeson). Moreover, it described such activity as being "inextricably linked" to the arbitrage activities, a statement which could have been viewed as acknowledgement that Leeson was day-trading by 'lifting one leg' of so-called arbitrage trades, so that he could profit from market moves that his client order flow enabled him to dictate.
- 3.42 It was the responsibility of Gueler in Tokyo to monitor intra-day positions and report the risk to Walz. However, as there were no risk management systems in place, Gueler was required to rely on daily oral feedback received from Leeson via the telephone. As a result of this, it was not possible for Gueler to assess independently whether these limits had been broken. Further, the information used to report the risk at the end of each day was sourced from Singapore and only covered the '92000' account.
- 3.43 There were no gross limits imposed on this business since no outright risk positions were permitted and thus it was deemed to be very low risk. However, the internal audit report that was issued in October 1994 recommended that consideration be given to the establishment of gross limits. This was not pursued and adopted by Group Treasury and Risk so there was nothing against which to measure or compare the size of positions or volumes traded except past position sizes.
- 3.44 On 10 October 1994 Hopkins expressed concern to the Risk Committee over the size of intra-day activity in the JGB arbitrage book in Leeson's absence. The committee noted that the limit was applicable only when Leeson was trading and a lower limit should be put in place when he was absent. However, intra-day limits were never checked and were, according to Hopkins: "frankly, pretty difficult to monitor". In London, only reports of the number of lots dealt at a particular price within the day were available which Hopkins told us was: "useless from an intra-day limit checking perspective".
- 3.45 On 19 October 1994 the Risk Committee discussed Leeson's approach and activities. Ron Baker confirmed that there was no indication of any breach of Leeson's intra-day limit. The Risk Committee agreed that they were generally comfortable with the current level of activity and with the size of the intra-day limit.
- 3.46 On 27 January 1995 Leeson's intra-day Nikkei limit was increased to 500 Osaka contracts by the London ALCO, acknowledging the open risk he was taking. The increase was deemed necessary to unwind the large OSE and SIMEX positions that were then being reported. At no time was the 'switching' activity authorised to have open positions overnight, and indeed matched positions were reported (via Sue) to ALCO at all times in 1994 and 1995 except for minor mistakes of only a few contracts on six occasions, a mismatch of 127 LIFFE JGB contracts for two days in November 1994 (this was an error resulting in a US\$1 million loss) and a 200 Nikkei contract mismatch on 22 February 1995.

3. Authorised trading activities

3.47 The sizes of the 'switching' positions were reported to management in US Dollar equivalents at ALCO. Figure 3.1 shows the size of the positions reported at various dates and Figure 3.2 shows the same positions expressed in SIMEX contract sizes for comparability.

Figure: 3.1

| | US\$ millions | | | | | |
|-----------|-------------------|---------------------|------------|--------------|------------------|------------------|
| | OSE Nikkei 225 | SIMEX Nikkei 225 | TSE JGB | SIMEX JGB | TIFFE Euroyen | SIMEX Euroyen |
| 30 Dec 94 | 691.3 | (691.3) | 46.7 | (46.7) | 196.7 | (196.7) |
| 18 Jan 95 | 114.4 | (114.4) | 161.8 | (161.8) | (50.0) | 50.0 |
| 20 Jan 95 | 1,310.8 | (1,310.8) | (4,099.3) | 4,099.3 | (290.6) | 290.6 |
| 24 Jan 95 | 564.7 | (564.7) | (4,973.9) | 4,973.9 | (481.3) | 481.3 |
| 25 Jan 95 | 1,546.9 | (1,546.9) | (6,839.3) | 6,839.3 | (601.8) | 601.8 |
| 26 Jan 95 | 2,983.3 | (2,983.3) | 245.3 | (245.3) | (451.2) | 451.2 |
| 17 Feb 95 | 3,536.0 | (3,536.0) | (10,244.9) | 10,244.9 | (341.9) | 341.9 |
| 23 Feb 95 | 2,809.0 | (2,809.0) | (8,980.1) | 8,980.1 | 26.5 | (26.5) |

Source: Daily ALCO reporting package.

Note: Before December 1994 the asset and liability management function was carried out by the Risk Committee which only received information on the Nikkei 225 arbitrage book.

Figure: 3.2

| | SIMEX lots | | | | | |
|-----------|-------------------|---------------------|------------|--------------|------------------|------------------|
| | OSE Nikkei 225 | SIMEX Nikkei 225 | TSE JGB | SIMEX JGB | TIFFE Euroyen | SIMEX Euroyen |
| 30 Dec 94 | 6,992 | (6,992) | 186 | (186) | 4,550 | (4,550) |
| 18 Jan 95 | 1,178 | (1,178) | 296 | (296) | (1,150) | 1,150 |
| 20 Jan 95 | 13,786 | (13,786) | (7,520) | 7,520 | (6,702) | 6,702 |
| 24 Jan 95 | 6,240 | (6,240) | (9,178) | 9,178 | (11,165) | 11,165 |
| 25 Jan 95 | 16,958 | (16,958) | (12,578) | 12,578 | (13,915) | 13,915 |
| 26 Jan 95 | 32,820 | (32,820) | 450 | (450) | (10,404) | 10,404 |
| 17 Feb 95 | 38,188 | (38,188) | (18,402) | 18,402 | (7,839) | 7,839 |
| 23 Feb 95 | 30,112 | (30,112) | (15,940) | 15,940 | 601 | (601) |

Source: 'Exchange Arbitrage Closing Positions', prepared by Sue.

3.48 The information in Figure 3.2 includes the 'switching' activity booked in London as well as in Tokyo. It should be noted that, on each day shown, all of these reported positions were fully matched and therefore no market risk was reported.

3.49 BFS did not have any authority to trade option contracts (except as an execution broker for clients) and therefore had no option limits.

3. Authorised trading activities

Profitability of 'switching' business

- 3.50 The profits of the 'switching' business were recorded in SPG (later renamed Equity Financial Products Group) which formed part of FPG. Within SPG, there was a further split between Japan products, Hong Kong products and other OTC products. Of particular relevance to this inquiry is Japan products, which contained the earnings from a number of different strategies traded out of Japan and Singapore, including the Nikkei, JGB and Euroyen 'switching' books.
- 3.51 During 1994, the strategies operated by Leeson were reported to have been extremely profitable. The profits of SPG relative to the profits of the Barings Group and business units within it are shown in Figure 3.3.

Figure 3.3

| | 1994 £'000 | Budget 1994 £'000 | Budget 1995 £'000 |
|---|---------------|-------------------------|-------------------------|
| Barings Group Profit Before Tax (after bonus accrual) | 101,877 | 114,002 | 170,103 |
| Barings Group operating profit | 228,117 | 233,608 | 346,675 |
| which includes: | | | |
| - the Bank Group operating profit | 36,968 | 39,310 | 71,882 |
| which in turn includes: | | | |
| - the Financial Products Group operating profit | 38,629 | 24,630 | 54,595 |
| which in turn includes: | | | |
| - the SPG operating profit | 40,600 | 8,290 | 27,012 |

Source: Management Accounts 1994, Budget (as stated in December 1994 Management Accounts) and Group Budget Profit and Loss Schedule

Note: Operating profit comprises income less direct and allocated expenses but before central overheads, exceptional items and bonus accrual.

- 3.52 It is noted that SPG's profits exceeded those of the whole of FPG, which in turn exceeded the whole of the Bank Group's profits in 1994.
- 3.53 An analysis of the reported revenue for 1994 of the 'switching' activities is as given in Figure 3.4.

3. Authorised trading activities

Figure: 3.4

| | £ millions |
|-------------------|------------|
| JGB arbitrage | 23.4 |
| Nikkei arbitrage | 4.6 |
| Euroyen arbitrage | 0.5 |
| | <hr/> |
| | 28.5 |
| | <hr/> |

Source: Weekly management reports

- 3.54 Leeson's 'switching' activities were reported to have contributed at least £28.5 million of revenue (out of a total reported revenue for the SPG of £52.9 million, compared to a budget of £17.5 million). Indeed, since the Nikkei arbitrage revenue was only identified separately from mid-August to December 1994 (paragraph 3.25), the £4.6 million Nikkei arbitrage revenue in Figure 3.4 understates the contribution attributable to Leeson's activities. The Nikkei arbitrage revenues from January to August 1994 are contained in the £15.8 million revenue of Brindle's option volatility book, but cannot be separately identified and are therefore not included in Figure 3.4. Brindle's own estimate of his revenue was £8 million to £9 million, so the balance was probably attributable to Leeson's 'switching' activity. Furthermore, the relatively low costs of the 'switching' activities (excluding funding costs that were not fully charged back - paragraphs 6.122 to 6.130) meant that Leeson's reported contribution to the profit before tax was an even larger proportion than these revenue figures imply.
- 3.55 It is interesting to note that most of the reported revenue was from JGB arbitrage, although our interviews indicate that management's perception was that the Nikkei arbitrage was the main revenue generator.
- 3.56 Despite the fact that this reported profit represented the bulk of SPG's earnings, no analysis was performed to determine the reasonableness of the profit, although the October 1994 internal audit report on BFS provided explanations which Leeson had given to the writer of that report during July and August 1994 (paragraphs 3.35 to 3.38). These, it seems, were the primary explanations that were used by Barings' management to justify the belief that the profitability was plausible.
- 3.57 Peter Baring told us he found the earnings "pleasantly surprising". Similarly, Maclean in response to the question: "Is it a source of great surprise that there was this apparent disjoint where you could print money in this way day after day?" responded: "Yes ... people talked about it almost incessantly ... I have to say that a load of people - all of us, really - found it very puzzling. But I have to say, equally, and maybe you will say naively, we accepted it". Barnett wondered how the Singapore business could be so profitable and added that it was of: "considerable interest to a large number of people". Walz commented on the level of profitability: "I am sure I have said to Ron [Baker] 'This guy must be busting his intra-day limits or something'". Asked by us who was responsible for understanding the business rationale of, and the size of, the profits generated by the 'switching' activities Walz told us "Ron Baker". Tony Hawes observed to us that: "It was always very noticeable while he [Leeson] was away that the 'switching' book did absolutely nothing at all. It was very apparent to everybody that it was all down to him - the switching activity and the profit it was earning".

3. Authorised trading activities

- 3.58 We asked Tuckey whether the profitability of the 'switching' business was ever discussed in MANCO. Tuckey told us: "It was certainly commented on. The description of it was always consistently described as being a business that had no price risk and no credit risk because it was an equal and opposite transaction business, transacted with two exchanges of undoubted creditworthiness ... It was noted that its size had grown and questions were asked about whether this business was sustainable, what our competitive position was and how vulnerable we were for somebody else to come and take this business and so on. It did not have extensive discussion in the Management Committee, and it was only in January and February [1995] that one or two specific points in relation to it were raised in the Management Committee, in relation to market comments for example on the extent to which Barings were thought to have a large position in the Osaka Exchange".
- 3.59 We also asked whether there had ever been any discussion at MANCO about the long term sustainability of this arbitrage business. Tuckey replied: "In very general terms, yes ... We seemed to be making money out of this business and if we can do it, can't somebody else do it? How can we protect our position? Although we did have a very major position in the market generally, and that was the argument as to why it might be sustainable, yes, those questions in general terms were asked".
- 3.60 Dare told us that EXCO reviewed the Group management accounts and was aware that by 1994 a considerable part of the BIB profits were being generated by the activities in Asia. He indicated that the mix of business resulted in swings in profits and that: "latterly it was obviously accounted [for] by trading of futures and such things in the Far Eastern offices". He told us that: "The volume of profit was somewhat surprising". He noted that Norris gave an explanation as to how the profits were made. Dare recalled: "His explanation was that Barings occupied a niche in the Far Eastern trading markets ... and that there were very few firms like ourselves. They were members of [OSE] ... and ... SIMEX and had developed the business and clientele and reputation to deal in and between those two markets". Dare told us that EXCO accepted the explanation. He told us that: "we were given to be completely satisfied that the risk was low or non-existent".
- 3.61 Ron Baker, who agrees that he was accountable for the profits of the 'switching' activities from 1 January 1994, told us: "At that point in time [early 1994] I never really thought much about why it was so profitable", and he added: "I can only guess as to what might have been going on during 1994, but I do not think in retrospect Nick [Leeson] took much notice or cared much about what I said, to be frank. If I had to tell you now what I thought, I thought Nick [Leeson] was a lone star and did his own thing at the time".
- 3.62 Gueler told us that during October 1994 he called Walz and explained to her that he could not understand the apparent profitability of Leeson's trading strategies. Walz in turn contacted Ron Baker, and then to reassure Gueler, he was sent a fax containing one section of the draft internal audit report, the conclusion of which was: "Nothing we have reviewed suggests that BFS is obtaining an unfair advantage by breaking SIMEX rules nor taking on positions in excess of limits". Gueler told us that Ron Baker then called him and said: "Look, Fernando, we hear what you say, everything is OK in Singapore. Do not worry about Singapore". We asked Ron Baker if Walz or Gueler expressed concern about Leeson's profitability. His response was: "No-one ever expressed it to me as a problem".

3. Authorised trading activities

- 3.63 We asked Killian about the profitability of Leeson's activities. He told us that after the January 1995 profits were reported, when Leeson's revenue was "US\$10 million last week", Ron Baker compared that favourably to the agency sales results. Killian told us he commented to Ron Baker in early February 1995: "Wow! that is impressive ... You know if he makes US\$10 million doing arbitrage in a week, what is that? About US\$½ billion a year. That is pretty good doing arbitrage. That guy is a turbo arbitrageur!"
- 3.64 On 25 January 1995, MANCO discussed the profits and losses experienced in the Far Eastern markets: a short position in Japanese equities on 23 January 1995 had cost US\$1 million and a high level of business had been executed on SIMEX earning a profit of US\$9 million. There is no record of the reasons for the high level of profitability being questioned at the meeting, or the large profits earned from the 'switching' book during the next week being discussed at the following week's meeting.
- 3.65 Certain SIMEX floor traders informed us that most arbitrageurs are really day-traders who can only make large profits by 'lifting a leg' of a trade, thereby taking intra-day open risk positions, sometimes aided by knowledge of large client orders. Given the relative stability and falling volatility of the Nikkei Index through 1994, such levels of profitability from so-called 'riskless arbitrage' should have been viewed as abnormal and questionable and the extraordinary profitability (paragraph 5.12) reported in January and February 1995 deserved the attention of management before the collapse.
- 3.66 Neither Ron Baker nor Walz was familiar with the operations of the SIMEX floor. Both claim that they thought that the significant and large profits were possible from a competitive advantage that BFS had arising out of its good inter-office communications and its large client order flow (paragraphs 3.26 and 3.37 to 3.38). As the exchanges were open and competitive markets, this suggests a lack of understanding of the nature of the business and the risks (including compliance risks) inherent in combining agency and proprietary trading.

Agency/broking activity of BFS

- 3.67 BFS was the execution arm on SIMEX for the agency business booked in BSL, BSJ and Baring Securities Hong Kong (BSHK). The orders were either placed through BSJ (or occasionally BSHK) or came direct to the SIMEX floor where Leeson and his team of six floor traders would execute them. BFS also serviced directly some execution-only clients, which are clients that execute trades on an exchange with one member (for a brokerage fee) but clear and settle their trades through another member (for a clearing fee).

European Bank and Trust Ltd relationship

- 3.68 One execution-only client was a trading entity named European Bank and Trust Ltd (EBT), introduced to Leeson by Nicol of FPG New York. There was no credit relationship between BFS and EBT nor does there seem to have been any written agreement between them. Leeson built up a relationship with Mr Philippe Bonnefoy (known only as Philippe to FPG and management), an EBT trader, and Leeson claimed to be executing large Nikkei 225 option orders for him throughout 1994. It has been confirmed with EBT that it only traded through Leeson from January/February 1994 to 27 June 1994. It is interesting to note that Walz told us that: "Around Christmas time

3. Authorised trading activities

[1994] Nick [Leeson] was insisting that Philippe was going to come in and sell more volatility". Ron Baker told us that: "Nick [Leeson] talked about option trades and about the idea that Philippe and one or two others had about profiting from the low levels of volatility and from declining levels of volatility in the options market in the Yen-based products in the Nikkei during the second half of 1994". Norris was aware of the existence of this customer and was told by Walz that the actual trader was Philippe when he asked some questions in December 1994. Leeson may have used the cover of this past customer relationship to justify other trades that he was executing.

SLK and FCT relationships

- 3.69 BFS had a close relationship with two other clients on the execution side: SLK and FCT. SLK cleared through Barings and rented a trading membership for SIMEX from Barings, but had no office or corporate infrastructure in Singapore. Killian arranged for BFS to provide support and a corporate infrastructure for a few SLK traders, taking them onto the BFS payroll and giving them BFS jackets to wear on the SIMEX floor in return for a monthly fee. The relationship with SLK is important to this inquiry in relation to a transaction that BFS claimed to have arranged between SLK and another client, BNP (paragraphs 5.53 to 5.62).
- 3.70 FCT cleared through BFS but had its own trading membership and local office. We have been informed that the FCT traders had a close relationship with BFS traders on the SIMEX floor, reflecting the association between Barings and FCT that existed elsewhere (paragraph 3.22).
- 3.71 SLK and FCT traded entirely for their own accounts. Although Killian initiated these relationships, it was his understanding that BFS local management was watching over the day-to-day relationships in Singapore, especially with SLK which was using BFS's infrastructure.

BNP relationship

- 3.72 BFS had only one direct clearing client, namely BNP Japan. We have requested copies of the daily statements that BFS sent to BNP Japan. These statements would include requests for margin. We have not been granted access by BNP to these statements or to any other document that would allow us to investigate BNP Japan's trading activities with BFS. Therefore, it is not possible for the inquiry to draw any conclusions about BNP Japan's relationship with BFS.

Summary of BFS's agency/broking activity

- 3.73 For its clearing activities, BFS had five authorised main accounts, namely BSLL (for proprietary business), BSL (for agency business), BSJ (for proprietary business and a small amount of agency business), BSHK (in whose name a small amount of Hong Kong agency business was booked) and BNP Japan. There were also error accounts (BFS account numbers '99900' and '99902') in which the normal errors, that any broker experiences, were booked. The 'hidden' account '88888' that subsequently came to light was reported by BFS to SIMEX as a BSL 'client' account, but BFS did not report it to BSL (paragraphs 5.3 and 5.4) except in the margin file.

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3.74 The total combined order flow and high traded volumes helped BFS gain a rising reputation on the floor of SIMEX as one of the most important trading houses for others to observe and one whose market information was valued. In September 1994, BFS was awarded the title of 'Number One Volume House' by the management of SIMEX at the annual SIMEX dinner.

4. UNAUTHORISED TRADING ACTIVITIES CONDUCTED BY BARING FUTURES (SINGAPORE) PTE LIMITED AND THEIR EFFECT

Introduction

- 4.1 The activities described in Section 3 were those that BFS was authorised to conduct, either on behalf of other group companies or, when acting in an agency capacity, for clients. In fact, BFS also engaged in substantial unauthorised activities by taking proprietary positions on SIMEX in both futures and options contracts. Various means were used to conceal these positions from management; these are described later in Section 5. In this section we analyse the history of the account used to book these unauthorised activities (account '88888') and also analyse the build up of the risk positions and the profits and losses arising in both futures and options from these positions, across the three products used: Nikkei 225, JGB and Euroyen. We explain the trading strategies commonly used by traders in exchange traded futures and options and compare Leeson's pattern of trading to these. We also set out our analysis of the eventual cost of closing out Leeson's positions after the full extent of his unauthorised trading had become apparent. Our analysis of the unauthorised activities has been based on the copies of account '88888' statements obtained by the inquiry. To verify our analysis we would need access to further SIMEX statements, BFS's records and selected BFS directors and employees. We have not been able to obtain such access for the reasons described in paragraph 1.74.
- 4.2 In this section, we have attributed the responsibility for the trading on and accounting for account '88888' to Leeson, although we recognise that not all of this trading may have been executed by him and that others were involved in the accounting and settlement functions. In so doing we largely rely upon the following:
- (a) He was the senior floor trader throughout the period examined;
 - (b) He was the general manager of BFS responsible for the back office;
 - (c) Account '88888' was opened shortly before he began to use it for trading;
 - (d) He took responsibility for arranging funding;
 - (e) Staff in the Singapore office (so far as we have been able to obtain their views) attribute responsibility to him;
 - (f) He represented himself to London as the person who could answer all queries relating to the trading accounts;
 - (g) SIMEX expressed a concern in their letter to BFS of 11 January 1995 that information required by the Exchange could not be provided in his absence.
- 4.3 Paragraphs 4.5 to 4.15 set out how the total losses (i.e. on both futures and options) in account '88888' emerged during the period since the account was opened. Paragraphs 4.17 to 4.49 analyse in detail the build up of the positions and losses in futures contracts and paragraphs 4.50 to 4.94 analyse the build up of the positions and losses

4. Unauthorised trading activities

in option contracts, both analyses being for the period from the beginning of January 1995 to 27 February 1995. Finally, in paragraphs 4.95 to 4.99 we describe how the losses from both futures and options trading developed during late January and early February 1995, leading to the collapse of Barings.

Impact of the Kobe earthquake

- 4.4 The Kobe earthquake on 17 January 1995 had a major effect on the Japanese equity and bond markets. Shortly after the earthquake, the price of Nikkei futures contracts started falling sharply whilst the JGB futures started rising. It appears the market felt, at that time, that the falling Japanese stock market would be detrimental to the growth of the Japanese economy and would therefore result in a decrease in interest rates, causing a stronger bond market.

Account '88888'

- 4.5 We understand that account '88888' was set up at the beginning of July 1992 although we have not seen the account opening form. The account was designated internally as a 'client' account and was described as an error account on BFS's system. It is normal practice for an exchange member to maintain a client 'error' account since out-trades and other differences arise in the course of broking 'client' business. It is, however, apparent that Leeson used this account to create additional profits in the authorised 'switching' account, by 'parking' losses in account '88888', and also to take substantial proprietary positions.
- 4.6 The balance on account '88888' was allowed to grow and the cumulative losses were not recognised in the accounting records, management accounts or financial accounts of BFS or any other Barings Group company.
- 4.7 We have analysed the monthly movements in account '88888' from July 1992 to 27 February 1995 in order to identify the build-up of losses arising from both futures and options transactions. The losses represent the daily realised and unrealised profit and loss on the positions in account '88888'. A summary of the losses at key dates is set out in Figure 4.1, followed by a graph in Figure 4.2 showing the build-up of the cumulative losses during the period since July 1992.

4. Unauthorised trading activities

Figure: 4.1

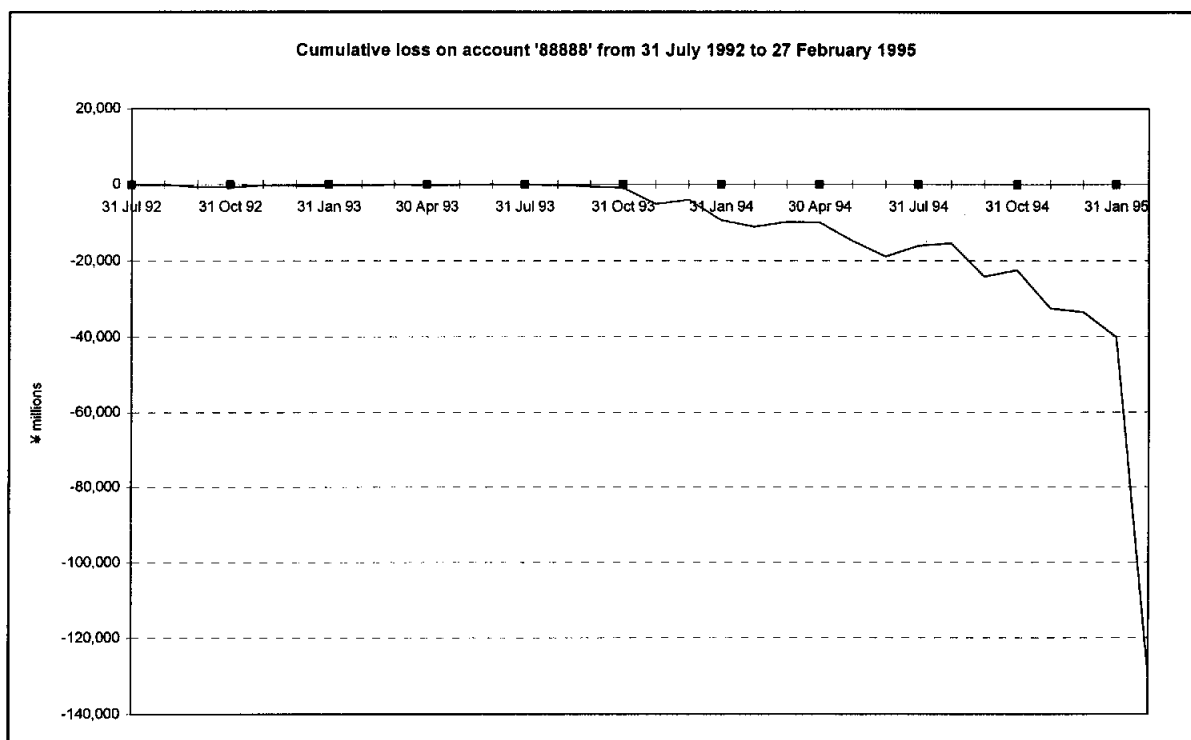
| ¥ millions | 1 Jul 92 to 31 Dec 92 | 1 Jan 93 to 31 Dec 93 | 1 Jan 94 to 30 Jun 94 | 1 Jul 94 to 31 Dec 94 | 1 Jan 95 to 27 Feb 95 |
|---------------------------------|--------------------------|--------------------------|--------------------------|--------------------------|--------------------------|
| Cumulative loss brought forward | - | 395 | 4,032 | 18,920 | 33,502 |
| Loss for the period | 395 | 3,637 | 14,888 | 14,582 | 96,368 |
| Cumulative loss carried forward | 395 | 4,032 | 18,920 | 33,502 | 129,870 |
| £ millions (equivalent) | | | | | |
| Cumulative loss brought forward | - | 2 | 23 | 116 | 208 |
| Loss for the period | 2 | 21 | 93 | 92 | 619 |
| Cumulative loss carried forward | 2 | 23 | 116 | 208 | 827 |

Source: Account '88888' and available SIMEX statements

Note: The losses for the period expressed in Sterling equivalent are translated from Yen at the average rate of exchange for the period. The cumulative losses in Sterling are the totals of the translated losses in £ millions and do not take account of the effect of revaluing these losses at the period end exchange rates. Had this revaluation been carried out, the cumulative loss at 27 February 1995 would have been £846 million instead of £827 million. This difference of £19 million is taken into account in the reconciliation presented in Figure 4.5.

4. Unauthorised trading activities

Figure: 4.2



Source: Account '88888' and available SIMEX statements

- 4.8 We have not analysed the build-up of the constituent parts of these losses prior to 31 December 1994, as essential documentation for earlier periods has not been made available to us. The cumulative loss at 31 December 1994 is analysed in Figure 4.3.

Figure: 4.3

| | ¥ millions | £ millions (equivalent) |
|-------------------------------------|------------|----------------------------|
| Unrealised futures gain | 140 | 1 |
| Unrealised options gain | 10,068 | 63 |
| Realised loss | (43,710) | (272) |
| Cumulative loss at 31 December 1994 | (33,502) | (208) |

Source: Account '88888' and available SIMEX statements

- 4.9 The unrealised gains refer to the mark-to-market gain on open futures and options positions at the 1994 year end. The realised loss refers to transactions which had been closed or which had matured and which, by definition, had been settled with SIMEX in cash.
- 4.10 As the amounts in Figure 4.1 show, the cumulative loss at 31 December 1993 was ¥4,032 million (£23 million), a significant amount in the context of Barings Group profit before tax for the year (£100 million after charging £100 million to the group bonus pool). Thereafter the amount of the cumulative losses increased significantly. In the six months to 30 June 1994, a period for which Barings reported unaudited interim

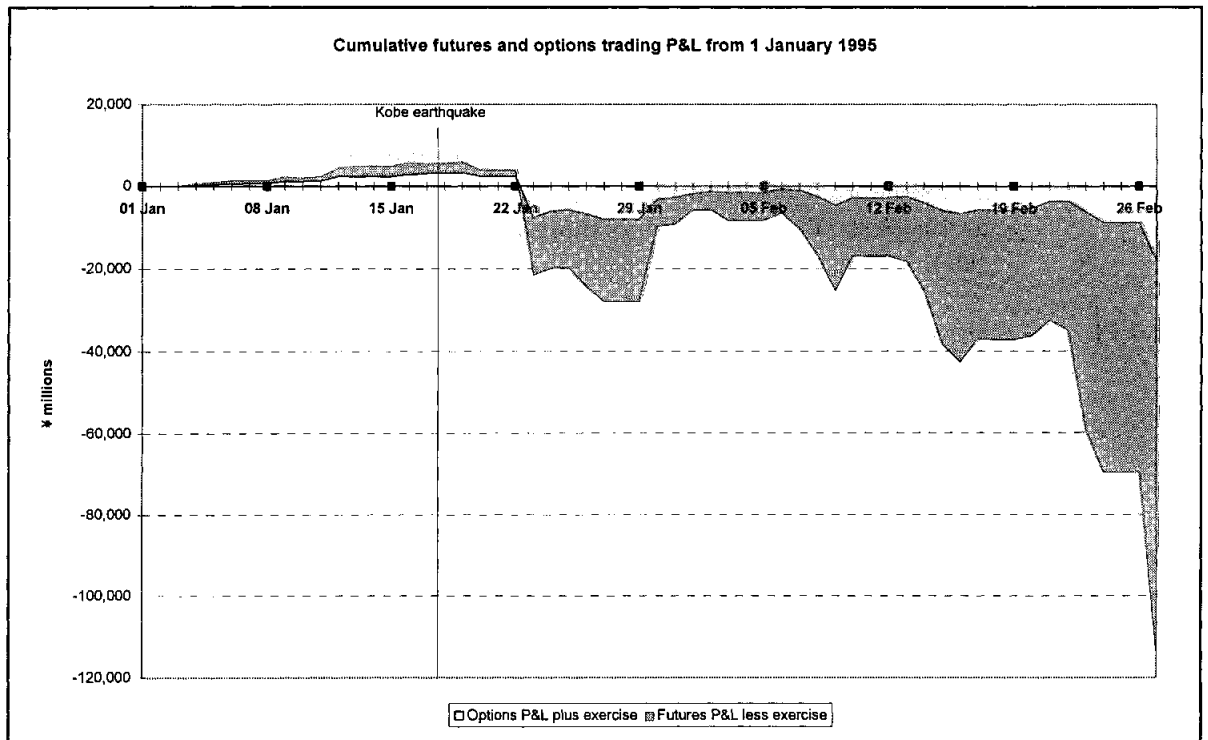
4. Unauthorised trading activities

results, the loss for the period was ¥14,888 million (£93 million) and the cumulative loss was ¥18,920 million (£116 million) compared to reported group profit before tax for the half year of £55 million. At 31 December 1994, the date at which Barings was preparing financial statements, the loss for the year was ¥29,470 million (£185 million) and the cumulative loss was ¥33,502 million (£208 million). According to the draft accounts approved by the Board on 22 February 1995, subject to any final audit adjustments, 1994 group profit before tax was £102 million (after charging £102 million to the group bonus pool) and shareholders' funds were £354 million at 31 December 1994.

- 4.11 However, the magnitude of the loss at 31 December 1994, had the unauthorised positions been discovered at that time, might not have brought about the collapse of Barings, although it would have placed Barings in a serious financial position (Figure 8.1). Over the course of the next two months the losses grew almost three-fold to a final balance of ¥130 billion (£827 million) at 27 February 1995. This included a ¥42.8 billion (£278 million) deterioration between 23 February 1995 and 27 February 1995, as the positions were taken over by SIMEX in highly unfavourable market conditions.
- 4.12 Figure 4.2 shows the cumulative loss on account '88888' from the creation of the account (July 1992) until the collapse of Barings on 27 February 1995. The graph in Figure 4.4 shows the development of these losses specifically from 1 January 1995 until 27 February 1995, split between futures and options.

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Figure: 4.4



Source: Account '88888' and available SIMEX statements

Note: "Nikkei options P&L plus exercise and futures P&L less exercise"

On exercise of Nikkei 225 options, the resulting underlying transactions, being Nikkei 225 futures contracts, enter the futures portfolio as new trades transacted at the option strike price. As these transactions cease to form part of the option portfolio there is an increase/decrease in the market value of this portfolio and a corresponding decrease/increase in the value of the futures portfolio. The effect of this is to transfer a profit or loss equivalent to the market value of the new futures trades. To reflect the performance of each portfolio more accurately a corresponding adjustment is made on each exercise date equivalent to this amount.

- 4.13 The graph demonstrates that the total losses arose primarily from futures positions, most of which were opened from 20 January 1995 onwards.
- 4.14 Following the margin default on 27 February 1995 the 'house' and customer open positions with BFS were taken over by SIMEX. Genuine customer positions were transferred to other clearing members whilst the 'house' positions were liquidated by SIMEX. Over the period to final liquidation the cumulative loss increased by a further ¥6,682 million to ¥136,552 million as a result of further market movements. In addition to this US\$5 million (£3 million) of costs were charged by SIMEX for taking over and closing out the positions. A reconciliation of the cumulative loss at 27 February 1995 to the loss after liquidation is set out in Figure 4.5. In computing the Sterling equivalent of the Yen loss, a further loss arises due to the strengthening of Yen against Sterling.

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Figure: 4.5

| | £ millions |
|-------------------------------------|------------|
| Cumulative loss at 27 February 1995 | 827 |
| Additional losses to close out | 42 |
| Foreign exchange loss | 55 |
| SIMEX costs | 3 |
| Cumulative loss after liquidation | <u>927</u> |

Source: Inquiry team

Note: The foreign exchange loss of £55 million comprises £19 million arising from the revaluation of the Sterling denominated cumulative losses (See footnote to Figure 4.1), and £36 million due to the appreciation of Yen against Sterling from 27 February 1995 until the eventual closing out of the positions in account '88888'.

- 4.15 Account '88888' was used to book all of the transactions that gave rise to these losses. Account '88888' was also used to book adjustments and fictitious transactions which were raised to conceal the account balances daily, both from SIMEX and Barings, and the equity balance of the account at month ends (Section 5).
- 4.16 The remainder of this section analyses separately the futures activity and the options activity which brought about the collapse of Barings. As noted in paragraph 4.8 we have not had access to essential documentation which would have permitted us to analyse these activities in detail prior to 31 December 1994. We deal first with the futures activity (paragraphs 4.17 to 4.49) as this accounted for the majority of the losses at 27 February 1995.

FUTURES ACTIVITY

- 4.17 The futures contracts traded by Leeson through account '88888' from 1 January 1995 were: Nikkei 225, JGB and Euroyen. The positions taken in the Nikkei 225 and the JGB contracts account for almost the entire loss resulting from the futures activity.

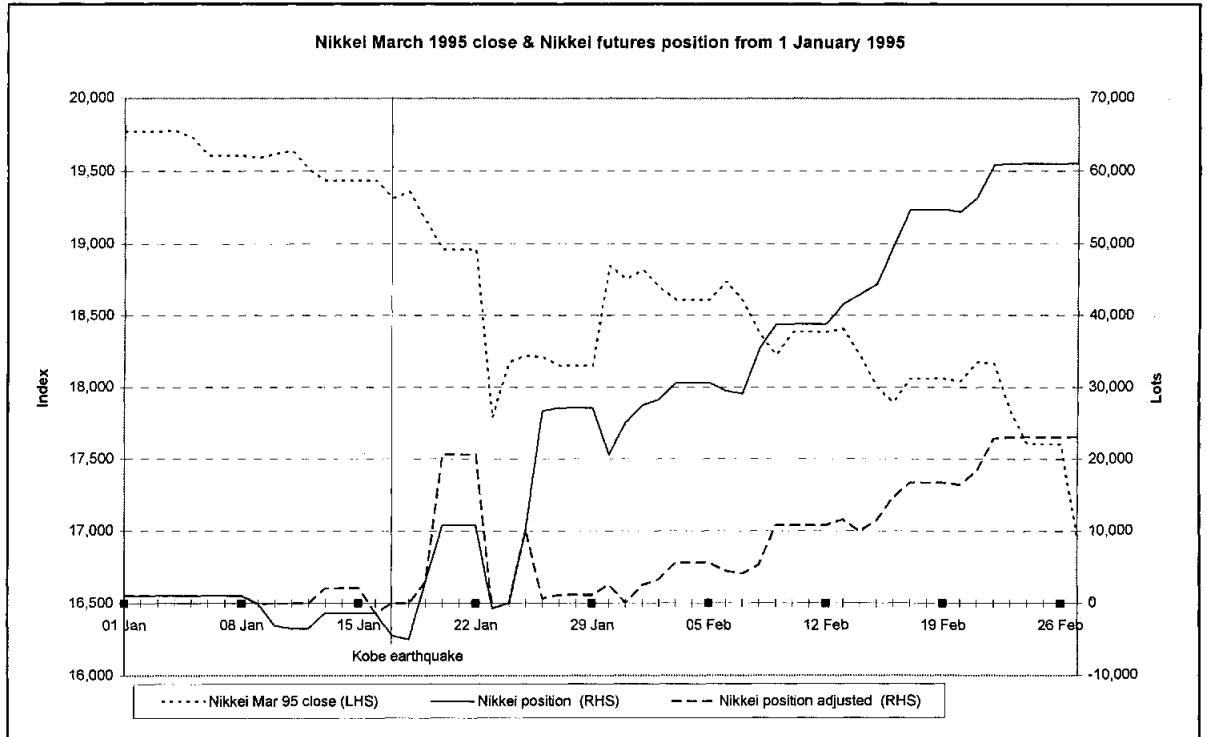
Nikkei futures

- 4.18 At 1 January 1995 the only futures position in account '88888' was a long position of 1,080 March 95 contracts which showed a small unrealised profit of ¥140.4 million (£0.8 million). Over the following two months until the collapse on 26 February 1995, this position built up to a long position of 61,039 contracts (55,399 long March 95 contracts and 5,640 long June 95 contracts) incurring a cumulative loss over this same period of ¥47.96 billion (£308 million). As a result of the significant positions and mounting losses, Leeson arranged for entries to be created to find a means to finance the equity balance (i.e. the loss) and the initial margin calls. As noted in Section 5, Leeson created entries to offset positions between the BSJ 'switching' account (account '92000') and account '88888', to reduce the total initial margin requirement on these two accounts.
- 4.19 The graph in Figure 4.6 shows the build up of the Nikkei futures position before and after the adjusting (offsetting) of transactions referred to above. The graph in

4. Unauthorised trading activities

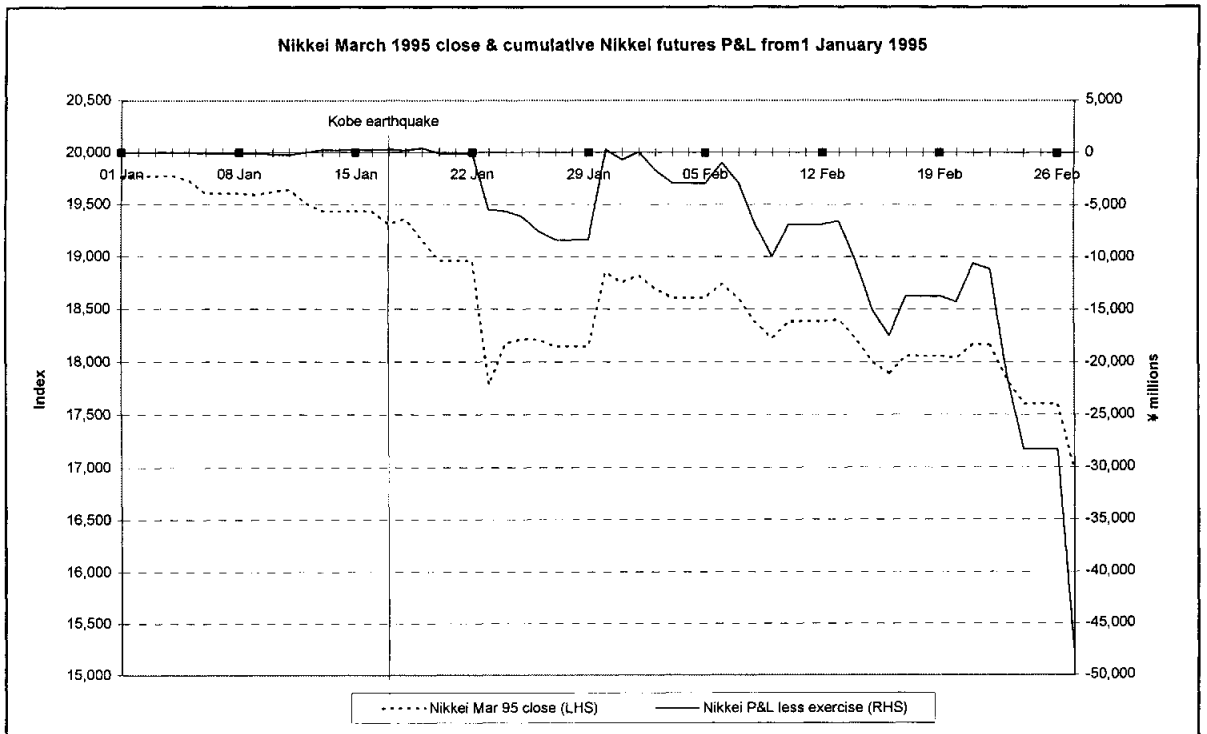
Figure 4.7 shows the cumulative loss from 1 January 1995 to 27 February 1995. The graphs help to identify patterns which are described thereafter.

Figure: 4.6



Source: Account '88888' and available SIMEX statements

Figure: 4.7



Source: Account '88888' and available SIMEX statements

4. Unauthorised trading activities

- 4.20 Following the Kobe earthquake, Leeson rapidly built up a long position on Friday 20 January 1995 of 10,814 March 95 contracts. His motives for this are not known to us, although possible explanations are that he anticipated a recovery in the March 95 futures contract which had fallen 400 points in two days or that he was trying to hold the market up in an attempt to protect the equivalent long position arising from the written option straddles which predated this large futures position (see paragraphs 4.77 to 4.83). When the market opened on Monday 23 January 1995 it was up 30 points and climbed a further 30 points before falling sharply such that it closed 1,175 points down on the day. Leeson closed the position during the day but in doing so he lost ¥5.37 billion (£34 million). It should also be noted that over this short period the option portfolio incurred a loss of ¥10.91 billion (£69 million).
- 4.21 On Tuesday 24 January 1995 the market opened 100 points up and closed up 390 points on the day. Leeson's intra-day trading cost him ¥0.14 billion (£1 million). At the close of day he was 10 March 95 contracts long. Over the next three days until Friday 27 January 1995 Leeson built up a long position of 27,158 March 95 contracts and incurred a further loss of ¥2.74 billion (£17 million).
- 4.22 A closer examination of the trades over the period 23 January 1995 to 27 January 1995 shows a number of cross trades with the account '92000' which had the effect of transferring ¥2.01 billion (£13 million) of profit from account '88888' into account '92000'. Although he reported to Barings' management an arbitrage profit of ¥0.80 billion (£5 million), for the period 23 January 1995 to 27 January 1995, he actually incurred an aggregate loss on account '88888' and account '92000' of ¥7.44 billion (£47 million), comprising the loss on account '88888' shown above offset by the reported profit in the switching account. On 26 January 1995, it was decided by ALCO that Leeson be instructed that: "positions should not be increased from current levels and when possible reduced pending further instructions from ALCO". The ALCO meetings are considered in paragraphs 7.29 to 7.53.
- 4.23 When the market reopened on Monday 30 January 1995 it was 140 points up and closed 700 points up on the day. During the day Leeson closed out 6,567 March 95 contracts and, including his unrealised gain, was ¥8.65 billion (£55 million) up on the day. At this time Leeson had recovered his Nikkei futures trading losses since the Kobe earthquake. However, he continued to build his long futures position over the next four days, so that by Friday 3 February 1995 he had increased his position by 10,012 March 95 contracts to a long position of 30,603 March 95 contracts. Over this same period the market had fallen 240 points and Leeson incurred additional losses of ¥3.23 billion (£21 million).
- 4.24 When the market reopened on Monday 6 February 1995 it was 110 points up and closed 130 points up on the day. Leeson closed out 1,100 March 95 contracts and he was ¥1.97 billion (£13 million) up on the day. This date proved to be very significant. The total cumulative loss from the opening of account '88888' to 6 February 1995 (including all futures and options contracts) was ¥39.52 billion (£253 million). From this date on there was a persistent downward trend in the market. Over the next 16 days Leeson doubled his long position to a total of 55,206 March 95 contracts and 5,640 June 95 contracts.
- 4.25 Over this same period to Wednesday 22 February 1995 the market fell 575 points but Leeson's long position was so large that his loss for the period amounted to

4. Unauthorised trading activities

¥10.19 billion (£64 million). On Thursday 23 February 1995 the market opened 50 points down but then tumbled a further 535 points to its low for the day. At this stage Leeson was losing ¥3.05 billion (£20 million) per 100 points down. After a small rally the market closed 330 points down. Leeson recorded a loss on the day of ¥10.08 billion (£65 million). At this date account '88888' had a position equivalent to 49% of the open interest in the March 95 contract and 24% in the June 95 contract. It was at this point that Leeson left BFS and did not return.

4.26 On Friday 24 February 1995 the market opened 60 points up but then tumbled 365 points to its low of 17,530 before closing 230 points down on the previous close at 17,605. The Nikkei futures book lost a further ¥7.02 billion (£45 million).

4.27 Over the weekend news of the BFS problem and long Nikkei positions had filtered to the market and on Monday 27 February 1995 the market opened 880 points down. Traders were expecting a large sell order to hit the pit but no such order arrived and the market closed 645 points down on the previous close. The Nikkei futures book lost a further ¥19.69 billion (£128 million). At that stage BFS was unable to pay the Yen variation margin call for Thursday 23 February 1995, along with the increased initial margin due as a result of increased volatility, and the position was therefore assumed by SIMEX. On 27 February 1995 SIMEX petitioned the Court to place BFS under judicial management.

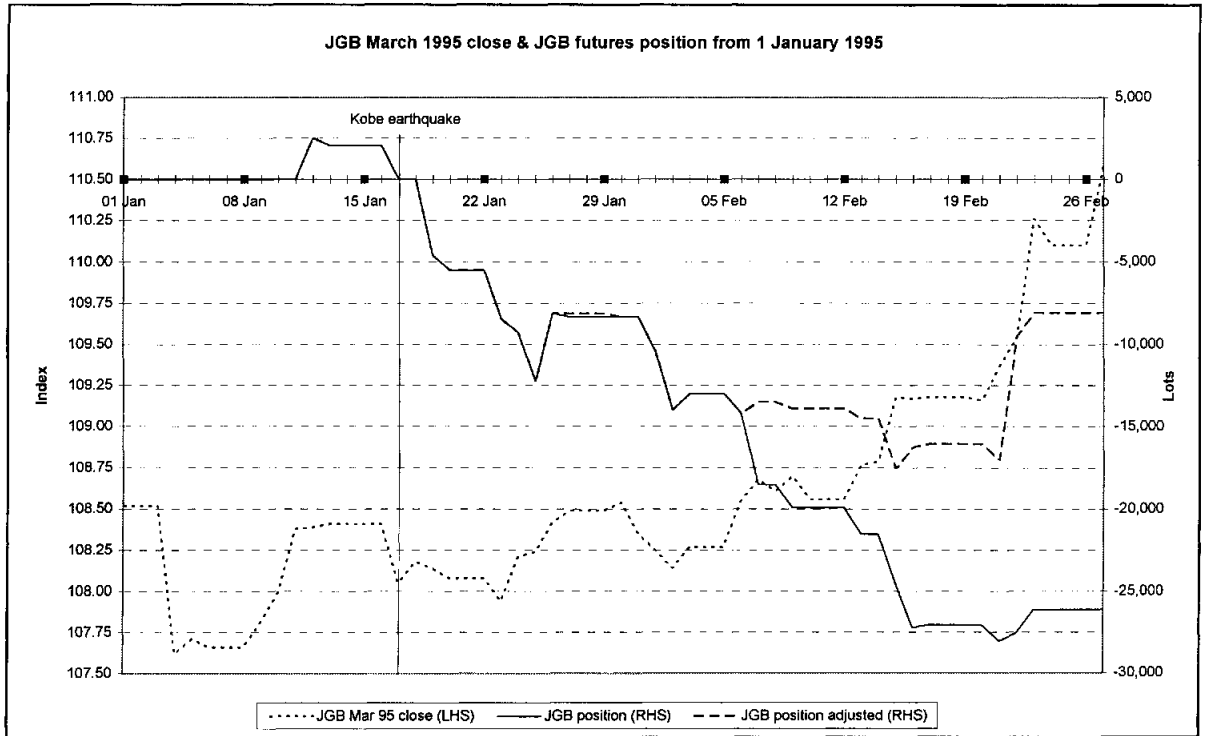
JGB futures

4.28 At 1 January 1995 there were no JGB futures positions in account '88888'. Over the ensuing two months Leeson built up a position which peaked at a short position of 28,034 contracts (22,500 March 95 contracts and 5,534 June 95 contracts) on Tuesday 21 February 1995 falling to a short position of 26,079 contracts by 27 February 1995. The cumulative loss arising on these positions over this period was ¥29.57 billion (£190 million). As with the Nikkei futures position, Leeson required a mechanism to finance the equity balance and initial margin calls. This he did in much the same way by offsetting JGB positions between the BSJ arbitrage account '92000' and account '88888' to reduce the initial margin calls on each account (Section 5).

4.29 The graph in Figure 4.8 shows the build up of the JGB futures position before and after the adjusting (offsetting) transactions referred to above. The graph in Figure 4.9 shows the cumulative profit and loss from 1 January 1995 to 27 February 1995.

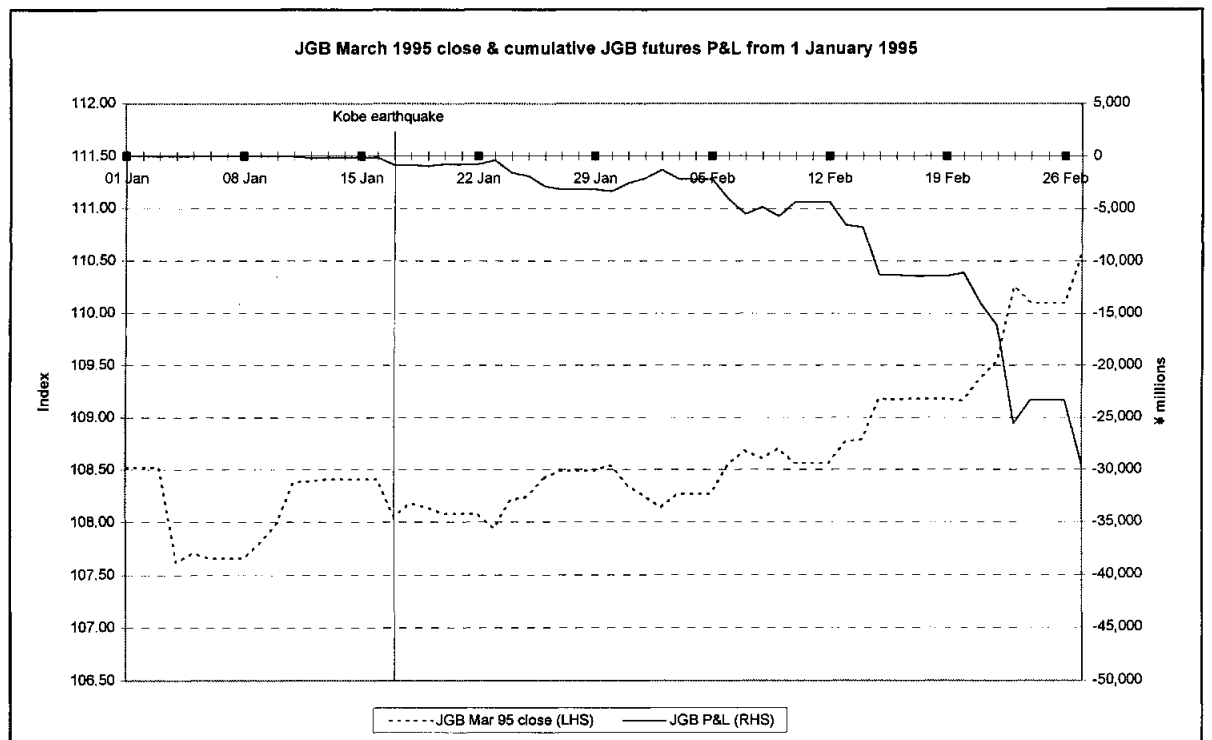
4. Unauthorised trading activities

Figure: 4.8



Source: Account '88888' and available SIMEX statements

Figure: 4.9



Source: Account '88888' and available SIMEX statements

4.30

It should be noted that although the positions in JGB futures were less than half those in Nikkei futures, the value of a one tick movement on a SIMEX JGB contract (¥5,000)

4. Unauthorised trading activities

is twice that of a one tick movement on a SIMEX Nikkei contract (¥2,500). From the graphs the following pattern can be identified.

- 4.31 In the first week of 1995 the JGB market fell 86 points to 107.66. In the first three days of the following week it recovered 72 points. On Thursday 12 January 1995 Leeson took a long position of 2,500 March 95 contracts and the market remained fairly static until it fell 36 points on Tuesday 17 January 1995, when Leeson liquidated his position and realised a loss of ¥0.81 billion (£5.5 million).
- 4.32 On Wednesday 18 January 1995 the market recovered slightly and on Thursday 19 January 1995 Leeson reversed his strategy and started to build up a short position. By Monday 23 January 1995 Leeson held a short position of 8,460 March 95 contracts. Over this period the market fell 24 points and Leeson made a gain of ¥0.47 billion (£3 million).
- 4.33 On Tuesday 24 January 1995 and Wednesday 25 January 1995 the market recovered 30 points but Leeson continued to build up a short position. His short position now stood at 12,260 March 95 contracts and over these two days he lost ¥1.51 billion (£9.5 million).
- 4.34 On Thursday 26 January 1995 the market opened 4 points down but then rose 22 points to the close. Leeson closed out 4,132 contracts but by the end of the day he had incurred a loss of ¥0.97 billion (£6.2 million). On Friday 27 January 1995 and Monday 30 January 1995 the market rose 7 and 5 points respectively causing an additional loss of ¥0.50 billion (£3.2 million).
- 4.35 On Tuesday 31 January 1995 the market trend reversed and fell 19 points. Leeson gained ¥0.79 billion (£5 million). Over the next two days he sold an additional 5,672 March 95 contracts. Over this period the market fell 21 points and Leeson made a profit of ¥1.26 billion (£8 million).
- 4.36 However, from this date on the market trend was upwards. By Tuesday 14 February 1995 the market had risen 65 points. Leeson had continued to grow his short position which stood at 21,500 March 95 contracts. His loss since Thursday 2 February 1995 was ¥5.44 billion (£35 million).
- 4.37 On Wednesday 15 February 1995 the market rose 39 points. Leeson continued to increase his short position so that it stood at 24,536 March 95 contracts and he incurred a loss of ¥4.54 billion (£29 million). At this date he had incurred a total loss of ¥26.64 billion (£170 million) on Nikkei, JGB and Euroyen trading since 31 December 1994. We were told that on this day Railton, who had gone out to Singapore, was trying to reconcile the JGB position.
- 4.38 We believe that in order to disguise this loss Leeson processed a purchase in BFS's system on the same day which was not concluded on the floor of the exchange, of 7,000 March 1995 contracts at 745 points below the market close. This transaction created an apparent gain of ¥26.08 billion (£170 million) and offset his accumulated trading losses for 1995. This transaction was then reversed the following day. For the purposes of the above analysis and the graphs, this entry has been ignored.

4. Unauthorised trading activities

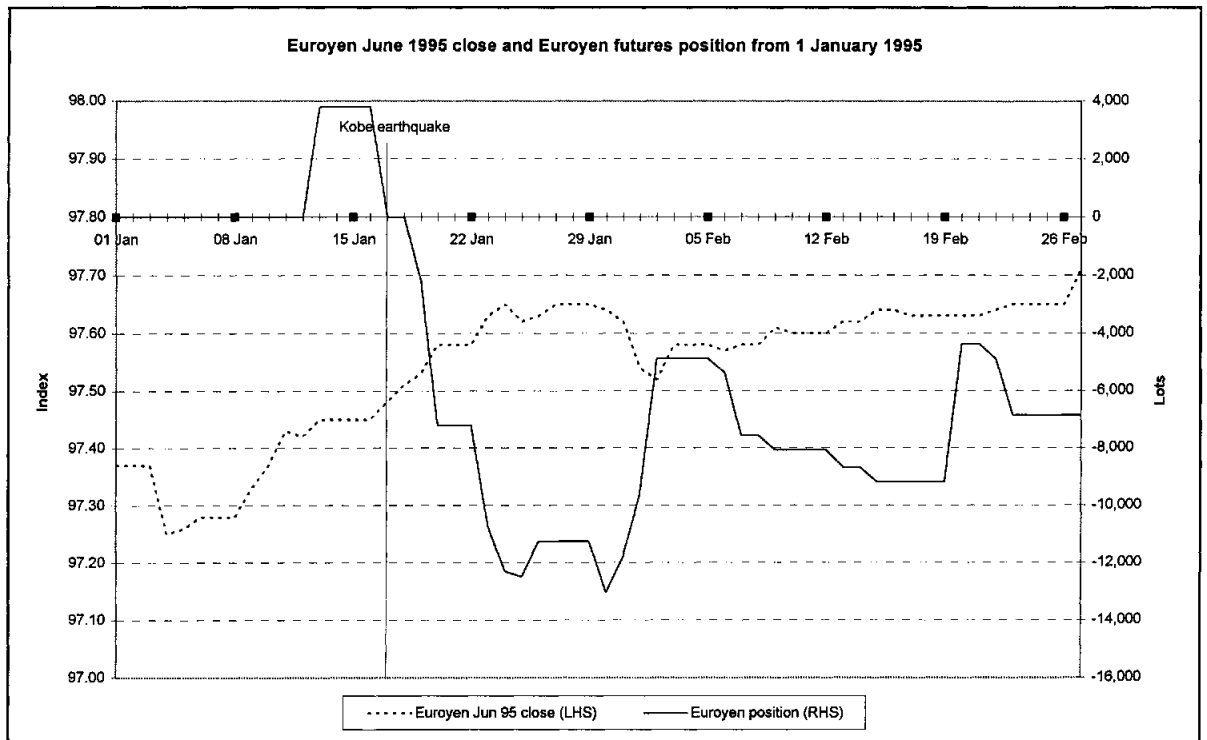
- 4.39 To the close on Monday 20 February 1995 the market was fairly static and fell only 2 points. Over this same period Leeson started to build a short position in the June 95 contract and by Monday 20 February 1995 had a short position of 22,500 March 95 contracts and 4,534 June 95 contracts. Over this period he gained ¥0.20 billion (£1.3 million).
- 4.40 Over the next two days to Wednesday 22 February 1995 the market rallied rising 38 points. Over the same period Leeson closed out 3,700 March 95 contracts and increased his June 95 contract position by 4,200 lots. He incurred a loss of ¥5.07 billion (£33 million) over this period.
- 4.41 On Thursday 23 February 1995 the rally in the market increased sharply and closed 72 points up on the day. At this stage Leeson was losing ¥1.31 billion (£8.5 million) per 10 points up. He closed a further 2,720 March 95 contracts and increased his June 95 contract position by a further 1,265 lots. At this date account '88888' had a position equivalent to 85% of the open interest in the March 95 contract and 88% of the open interest in the June 95 contract. His loss on the day was ¥9.43 billion (£61 million). It was at this point that Leeson left BFS and did not return.
- 4.42 On Friday 24 February 1995 the market fell 16 points which created a gain of ¥2.29 billion (£14.9 million) for the JGB book. However, over the weekend news of the BFS problem and the short JGB position filtered to the market. Traders were expecting a large buy order to hit the pit on Monday 27 February 1995 and the market opened 55 points up and rose a further 22 points before falling back somewhat to close 48 points up on the day. The JGB book incurred a loss of ¥6.26 billion (£41 million). The position was taken over by SIMEX when, on 27 February 1995, BFS was unable to pay the Yen variation margin call for Thursday 23 February 1995 and the increase in the initial margin on the position.

Euroyen futures

- 4.43 At 31 December 1994 there were no open Euroyen futures positions in account '88888'. Over the ensuing two months Leeson traded a position which varied between a long position of 3,600 September 95 contracts and 200 December 95 contracts to a short position of 6,254 June 95 contracts, 2,794 September 95 contracts and 4,000 December 95 contracts. By 27 February 1995 he had a short position of 5,462 June 95 contracts, 1,000 September 95 contracts and 383 December 95 contracts. Leeson did not offset Euroyen positions between the BSLLEuroyen arbitrage account and account '88888' to the same extent as he did the Nikkei and JGB futures positions into account '92000' probably because his activity in Euroyen futures was much lower. His cumulative loss in 1995 on Euroyen futures was ¥0.46 billion (£3 million).
- 4.44 The graph in Figure 4.10 shows the build up of the Euroyen futures position. The graph in Figure 4.11 shows the cumulative profit and loss from 1 January 1995. As there was less activity in the Euroyen future compared to activity in Nikkei and JGB futures, we have changed the scale of these graphs in order to show more clearly the evolution of the loss during the period (Figure 4.11).

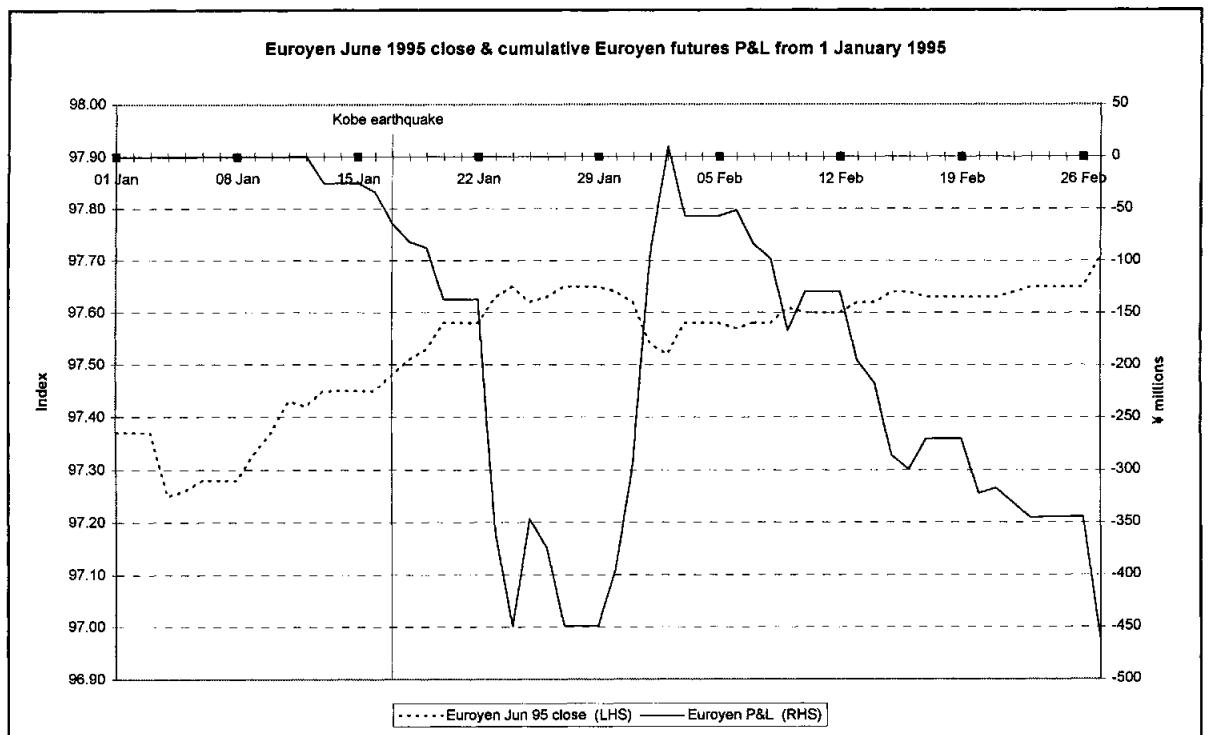
4. Unauthorised trading activities

Figure: 4.10



Source : Account '88888' and available SIMEX statements

Figure: 4.11



Source: Account '88888' and available SIMEX statements

4.45

It should be noted that the positions in Euroyen futures were usually much smaller than those in Nikkei futures. From the above graphs the following pattern can be identified.

4. Unauthorised trading activities

- 4.46 On Friday 13 January 1995, Leeson built up a long position of 3,800 contracts. He liquidated the position on Tuesday 17 January 1995 in a static market and incurred a small loss of ¥0.06 billion (£0.40 million).
- 4.47 From Wednesday 18 January 1995 to Tuesday 24 January 1995 he built up a short position of 12,304 contracts in a rising market and incurred a loss of ¥0.39 billion (£2.5 million).
- 4.48 Over the three days to Friday 27 January 1995 he adjusted his position as the market oscillated slightly. His net result hardly changed. Then from Monday 30 January 1995 to Thursday 2 February 1995, when the market fell 13 points, he closed out 6,386 contracts and generated a profit of ¥0.46 billion (£2.9 million). At this point he had recovered his earlier losses.
- 4.49 From Thursday 2 February 1995 through to Friday 17 February 1995 he allowed his short position to continue growing in a rising market, presumably expecting the trend to reverse. Over this period he incurred losses of ¥0.28 billion (£1.8 million). During the following week Leeson readjusted his position as the market moved slightly, incurring additional losses of ¥0.08 billion (£0.5 million). As at 23 February 1995 account '88888' had a position equivalent to 5% of the open interest in the June 95 contract, 1% in the September contract and 1% in the December contract. The market did not move on Friday 24 February 1995. However, on Monday 27 February 1995 it opened 8 points higher and closed 6 points up on the previous close. The Euroyen book incurred an additional loss of ¥0.12 billion (£0.8 million).

OPTIONS ACTIVITY

Introduction

- 4.50 As noted in Section 3, BFS was not authorised by Barings' management to transact options in any capacity other than as an agency broker acting on behalf of customers, including other Barings companies. A considerable volume of customer related activity did take place throughout 1994 and continued during the period immediately preceding the failure of Barings. The fact that Leeson was active in the option products available on SIMEX would not therefore of itself have been inconsistent with the business objectives authorised by management.
- 4.51 However, from around the end of 1992, Leeson started to sell options on the Nikkei 225 futures contract, a strategy to which he consistently adhered throughout the period ending 23 February 1995. The unauthorised transactions were booked to account '88888'.
- 4.52 We have not identified evidence of options trading other than on SIMEX. The only OTC transaction we noted in account '88888' appears to have been fabricated by Leeson to conceal the individual realised losses at the 1994 year end. This is fully explained in Section 5 which considers the concealment techniques employed by Leeson and in Section 7.

Evaluation of options trading strategy in account '88888'

- 4.53 We have performed a review of options trading in account '88888' to determine whether a clear and definable pattern of transactions exists.

4. Unauthorised trading activities

- 4.54 Before describing the results of that review it is necessary to define the broad categories into which users of the options markets fall, and to consider some of the technical aspects of options trading, since an understanding of the key variables is required to assess the positions Leeson had in account '88888'.
- 4.55 It is clear that the options traded and strategies adopted by Leeson were very simple in comparison to the complex derivative products and structures developed in recent years by the financial markets.

Market users

- 4.56 Broadly speaking, participants in options markets fall into three categories:
- (a) Hedgers;
 - (b) Speculators;
 - (c) Volatility traders.
- 4.57 *Hedgers* often attempt to protect an underlying balance sheet or contingent position by purchasing an option which reduces their exposure. Sometimes they may write options which correspond to that exposure, a technique known as a 'covered write'. The hedger's objectives are defensive although many strategies have been developed which involve accepting limited risk to reduce the costs of protective strategies.
- 4.58 *Speculators* use options to take directional views on the market. Typically they prefer to buy options though the more sophisticated may sometimes choose to sell if they feel options are too expensive. Combinations of options and cash market positions are often employed.
- 4.59 *Volatility traders* look to take advantage of what they regard as mispriced options. Options become more expensive when markets are volatile or when there is an expectation that they may become so. Options become cheaper when markets are stable or when there is an expectation that they may become so. Most large option books at significant financial institutions would represent volatility trading though typically traders may also have limits to take speculative positions based on directional views of the markets they trade.
- 4.60 In practice there are significant crossovers between the three categories of user identified above.

Trading volatility

- 4.61 The market benchmark in determining whether options are expensive or cheap is known as 'implied volatility'. This is the one input to the price of an option which is a matter of judgment rather than a matter of fact.
- 4.62 Theoretically, the measure of market volatility which ought to be used to price an option would be the actual observed volatility of the underlying cash instrument from which the option is derived. In practice, the level of volatility which option premia imply may be higher or lower than the actual. This is a function of expectation as to future market volatility and also of supply and demand.

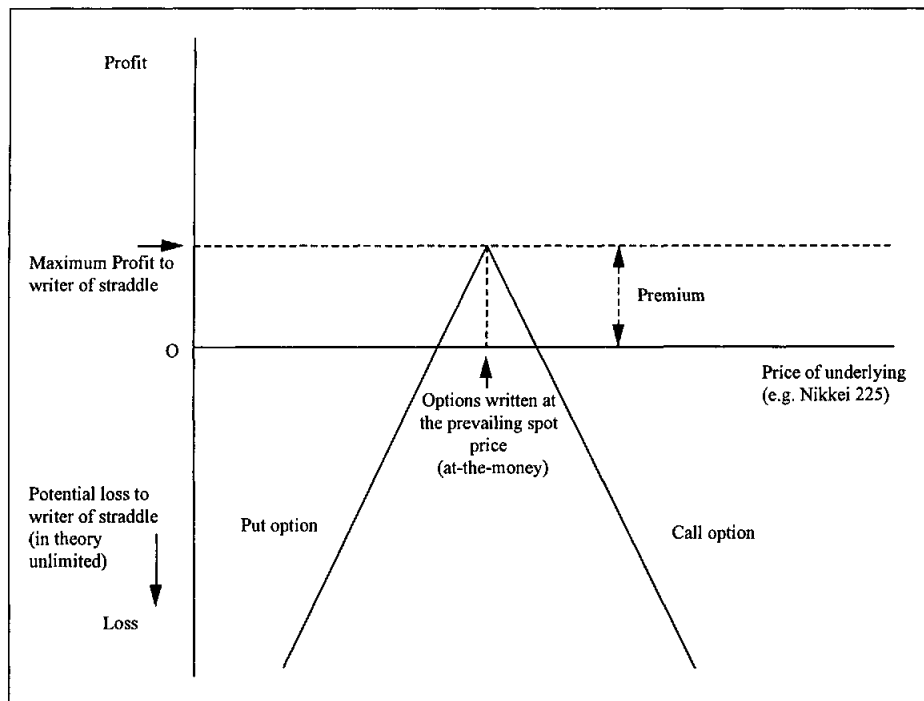
4. Unauthorised trading activities

- 4.63 The portfolio of a net buyer of options is said to be 'long volatility'. A position of this nature benefits when markets move more than is generally expected, causing implied volatilities and hence option premia to rise.
- 4.64 The portfolio of a net seller of options is said to be 'short volatility'. A position of this nature benefits where markets move less than is generally expected, causing implied volatilities and hence option premia to fall.

Leeson's strategy

- 4.65 Leeson's strategy falls into the category of a volatility trader who believed the Nikkei 225 would not move materially from its trading range and that implied volatility was accordingly trading at levels which could not be sustained. Throughout the period since 1 January 1994 he was consistently 'short volatility'. This view was expressed by writing 'straddles'.
- 4.66 A straddle is executed by selling a call option and a put option with the same strike price. The strikes will normally be at a level which corresponds to the price at which the underlying market is trading at the time the trade is executed. Where this is the case the straddle is described as being 'at-the-money'. So long as the underlying, in this case the Nikkei 225 index, remains within the range defined by the premium received, the writer will make a profit - the optimum outcome being where the underlying at the expiry date settles precisely at the strike and neither the call nor the put is exercised. In this event the writer retains the entire premium.
- 4.67 A graphical presentation of the profit and loss profile of a written straddle position is shown in Figure 4.12.

Figure: 4.12



Source: Inquiry team

4. Unauthorised trading activities

Risk implications

- 4.68 As with all options strategies involving the outright or 'naked' sale of options the potential profit is limited to the premium received. The straddle is one of the most aggressive techniques used for shorting volatility and exposes the writer to considerable risk where markets move in a sudden and unexpected fashion.
- 4.69 This risk is generally expressed by computing an equivalent futures or cash market exposure (known as 'delta') for a given level of the underlying market. Risk limits in options portfolios are often set by reference to delta and its rate of change (known as 'gamma').
- 4.70 In the case of a written straddle on the Nikkei 225, a fall in the index will cause the writer to have the equivalent of a long position in the Nikkei 225 because the sold put has moved into the money, whereas a rise in the index will cause the equivalent of a short position because the sold call has moved into the money. Delta and gamma tell the trader what the equivalent exposure is and how quickly it changes. In the case of an option on a futures contract like the Nikkei options traded by Leeson, these two key variables would be expressed in terms of equivalent futures contracts. The practical effect of these sensitivities is demonstrated by the analysis of Leeson's equivalent futures positions and trading profit and loss contained in the graphs presented in Figures 4.15 and 4.16 where the impact of sharp movements in the index can be related to the explanation of delta and gamma given here. Similarly, the benefit of being short volatility during periods of relative stability can be seen as the position picks up the benefits of the erosion of the value of options over time (commonly referred to as time decay, or 'theta').
- 4.71 Most option traders will hedge their delta exposure by buying (when the market is rising) or selling (when the market is falling) in the underlying cash or futures market. Where a short volatility position is being managed, the profitability of the portfolio is determined by the extent to which the daily earnings of time value inherent in the options premium exceeds the costs of hedging.
- 4.72 It appears that Leeson did not attempt to hedge his portfolio as the profit and loss swings show a very high degree of correlation to moves in the index as shown in Figure 4.16.
- 4.73 A further significant element of risk in a trading position of this type is exposure to changes in the level of implied volatility, which also affects the calculation of delta and gamma risk. This is referred to as 'vega' and is usually used to quantify the exposure of a portfolio to a 1% move up or down in the level of implied volatility.
- 4.74 Leeson had taken in a substantial amount of premium, apparently in the hope that the market would remain sufficiently stable over time to allow the options to expire close enough to their respective strike prices for his strategy to be profitable.
- 4.75 The risk inherent in taking a position of this nature is a sudden and unexpected move in the market. The Kobe earthquake caused precisely that, as concerns about its long term effects on the Japanese economy and the continuing strength of the Yen caused the Nikkei index to fall sharply below 17,000 towards the end of February 1995.

4. Unauthorised trading activities

- 4.76 The strategy Leeson followed is not inherently complex and is one with which any options professional would be very familiar. However, to manage an exposure of the size that Leeson constructed is technically and mentally demanding. By way of background it should be noted that Leeson did not apparently use a pricing model and did not have a risk management system capable of calculating the sensitivities described above. This is unusual for a genuine trading activity.

Analysis of trading position

- 4.77 The objective of our work performed on option trading recorded within account '88888' has been to establish the composition of the open position as at 24 February 1995, to determine over what time frame the position had been constructed, and to evaluate the position against market rates for January and February 1995, which were identified as the months in which sharp falls in the Nikkei would have caused significant oscillations in profit and loss.

Analysis of open position at 24 February 1995, by strike price and month of expiry

- 4.78 The analysis in Figure 4.13 shows the open short position in call options and put options at 24 February 1995, by strike price and month of expiry, on Nikkei 225 futures contracts (i.e. if the options are exercised by the holder, BFS would be obliged to sell (for a call option) or buy (for a put option) a predetermined amount of Nikkei 225 futures contracts at the predetermined strike price, which by definition would be unfavourable to BFS).

4. Unauthorised trading activities

Figure: 4.13

| Expiry | Strike | Calls | Puts |
|--------|--------|-----------------|-----------------|
| Mar 95 | 17,500 | 0 | (400) |
| | 18,000 | (3,260) | (90) |
| | 18,500 | (3,700) | (3,500) |
| | 19,000 | (200) | 0 |
| | 19,500 | (950) | (950) |
| | 20,000 | (800) | (800) |
| | 20,500 | (950) | (912) |
| | 21,000 | (400) | (400) |
| Apr 95 | 19,000 | (1,490) | (1,490) |
| Jun 95 | 18,500 | (2,500) | (2,500) |
| | 19,000 | (3,000) | (3,000) |
| | 19,500 | (1,500) | 0 |
| | 20,000 | (1,500) | (1,500) |
| | 20,500 | (1,100) | (1,100) |
| | 21,500 | (1,900) | (1,900) |
| | 22,000 | (250) | 0 |
| Sep 95 | 18,500 | (2,000) | (2,000) |
| | 19,000 | (2,000) | (2,000) |
| | 19,500 | (2,600) | (2,600) |
| | 20,000 | (2,000) | (2,000) |
| | 20,500 | (1,625) | (1,625) |
| Dec 95 | 19,000 | (3,400) | (3,400) |
| | 19,500 | (800) | (800) |
| Total | | <u>(37,925)</u> | <u>(32,967)</u> |

Source: Account '88888' and available SIMEX statements

- 4.79 The overall position was short a total of 37,925 call options (having a notional value in the underlying cash instruments of ¥334 billion - £2.17 billion) and 32,967 put options (having a notional value in the underlying cash instruments of ¥290 billion - £1.88 billion), across expiries stretching out to December 1995. The delta equivalent (i.e. the equivalent futures position) at 24 February 1995 was a long position of 14,946 contracts with a notional value in the underlying cash instruments of ¥132 billion (£0.86 billion).
- 4.80 At close of business on 24 February 1995, the value of the Nikkei 225 March 95 futures contract was 17,605, leaving all but the first of the put options listed above as in-the-money (these options having a strike price of 17,500 and hence being below the spot price).

4. Unauthorised trading activities

4.81 From 16 February 1995, there was also an immaterial JGB option position in account '88888'.

Analysis of build-up of open Nikkei option position at 24 February 1995, by month of expiry

4.82 The table in Figure 4.14 shows the build-up of the total open Nikkei option positions (i.e. puts plus calls) at 24 February 1995, detailing the total number of options transacted, by month of expiry.

Figure: 4.14

| Transaction month | | Mar 95 | Apr 95 | Jun 95 | Sep 95 | Dec 95 | Total |
|-------------------|-----|--------|--------|--------|--------|--------|--------|
| 1994 | Jan | 2,562 | | | | | 2,562 |
| | Feb | 2,800 | | | | | 2,800 |
| | Jun | 800 | | 6,000 | 3,250 | | 10,050 |
| | Sep | | | 4,500 | 9,200 | | 13,700 |
| | Oct | | | 250 | | | 250 |
| | Nov | 7,000 | | 11,000 | 4,000 | | 22,000 |
| | Dec | | | | 4,000 | 8,400 | 12,400 |
| 1995 | Jan | 1,300 | | | | | 1,300 |
| | Feb | 2,850 | 2,980 | | | | 5,830 |
| Total | | 17,312 | 2,980 | 21,750 | 20,450 | 8,400 | 70,892 |

Source: Account '88888' and available SIMEX statements

4.83 The total number of contracts open at 24 February 1995 was 70,892 representing 37,925 call options and 32,967 put options. The table demonstrates that Leeson accumulated the position in account '88888' over many months extending back to January 1994. In January 1995 and February 1995 there was little options activity in comparison with prior months.

Revaluation of position to SIMEX settlement prices from 1 January 1995 to 27 February 1995

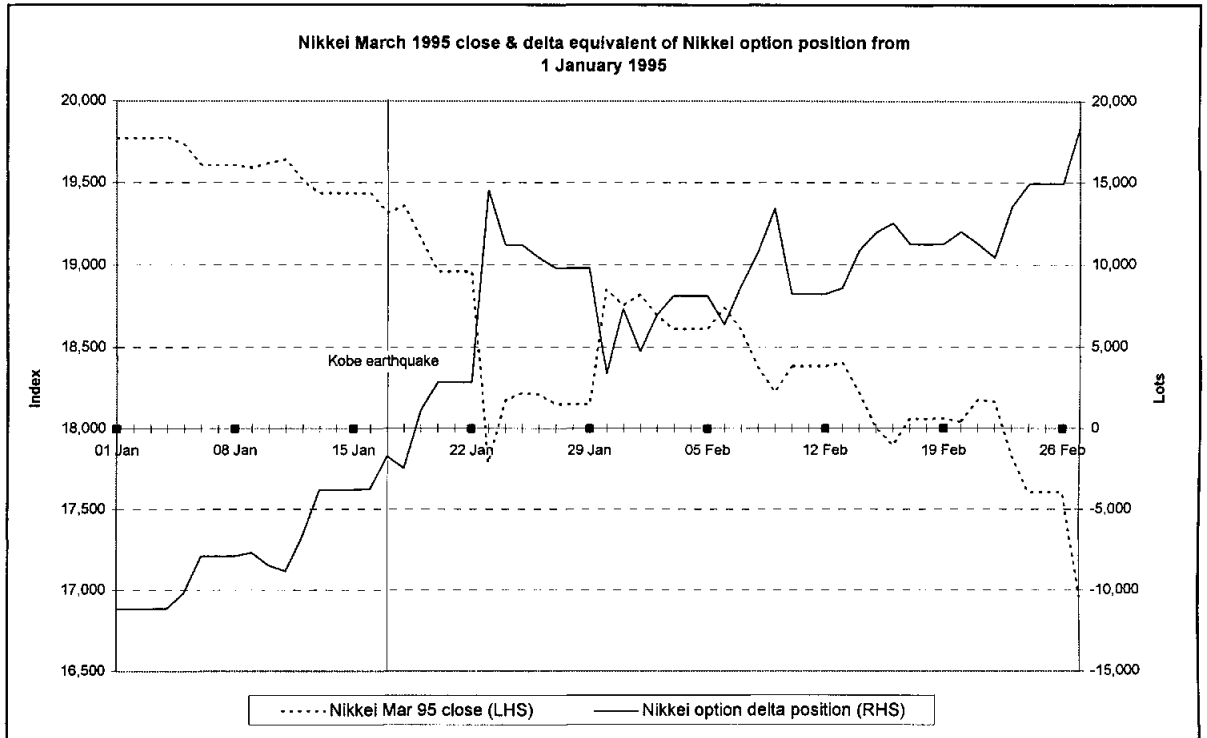
4.84 As at 31 December 1994 the options positions had a mark-to-market profit of ¥10.07 billion (£64 million). This arose from the year end value of the options being ¥25.72 billion (£164 million) compared to option premium received at the time the options were written of ¥35.79 billion (£228 million).

Options result

4.85 Detailed in Figures 4.15 and 4.16 are two graphs: the first (Figure 4.15) shows the change in the delta equivalent of the options portfolio; and the second (Figure 4.16) shows the cumulative profit and loss from 1 January 1995.

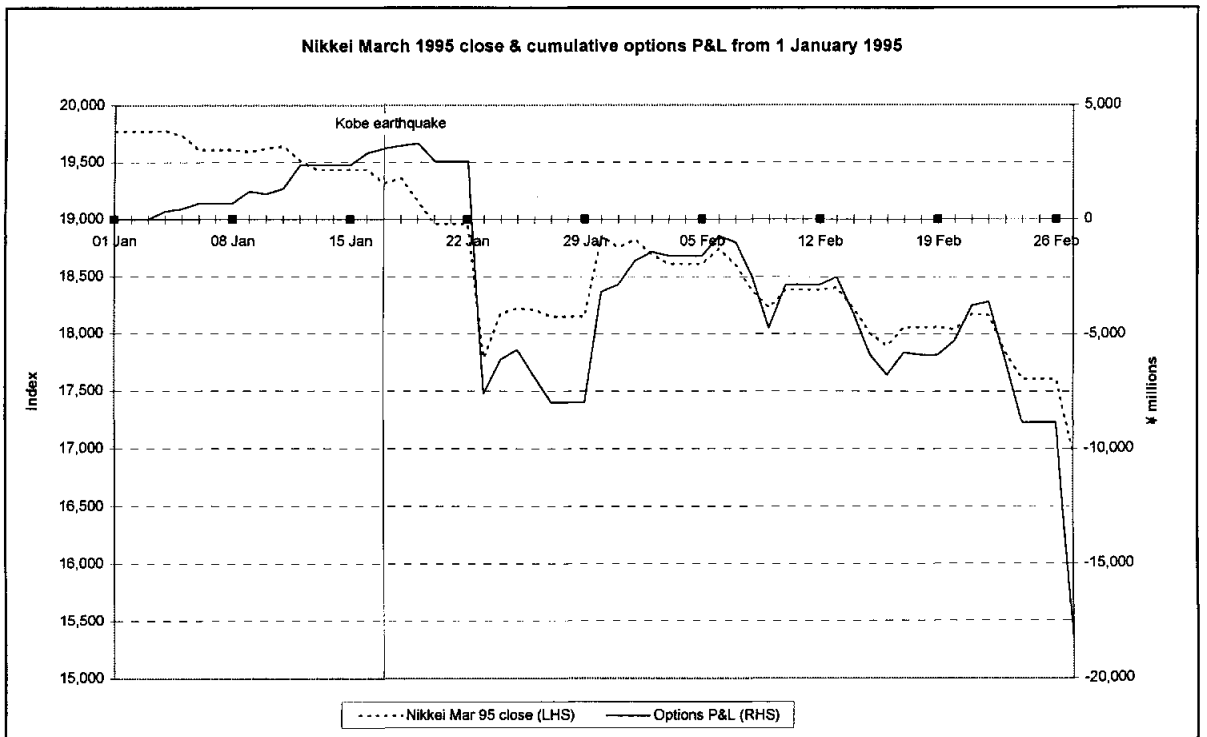
4. Unauthorised trading activities

Figure: 4.15



Source: Account '88888' and available SIMEX statements

Figure: 4.16



Source: Account '88888' and available SIMEX statements

4.86

From the graphs in Figures 4.15 and 4.16 a trading pattern can be identified and is described below. At 1 January 1995 Leeson's Nikkei option portfolio had a delta equivalent short position of 11,162 contracts. Over the period to 18 January 1995 the

4. Unauthorised trading activities

value of the Nikkei futures contract fell from 19,770 to 19,360. The closing price of 19,360 approximately represented the weighted average strike price of his straddle positions. As a result of this, his cumulative profit was close to its maximum of ¥3.1 billion (£20 million), being equivalent to the apex of the graph shown in Figure 4.12, and the delta equivalent position was close to zero.

- 4.87 Following this date, the index fell 1,575 points and volatilities increased dramatically as a result of the Kobe earthquake. Leeson's option portfolio suffered on both counts and he sustained a loss of ¥10.86 billion (£68 million) for the five days to 23 January 1995. At this date his option delta equivalent position had changed to a long position of 14,553 contracts. His risk was substantial at this point in time but there is no evidence from our analysis of his futures trading that this was delta hedged as he was overall a large net buyer of Nikkei futures contracts. Over the next seven days to 30 January 1995 the index recovered 1,065 points and volatilities eased slightly. As a result of this Leeson's options made a profit of ¥4.48 billion (£28 million) and his delta equivalent position reduced to long 3,379 contracts.
- 4.88 Over the next seven days to 6 February 1995 the index fell 110 points and volatilities eased off further. As a result his delta equivalent position increased to long 6,380 contracts but he recorded a profit of ¥2.4 billion (£15 million). At this date Leeson had almost recovered his 1995 option trading losses.
- 4.89 In the period from 7 February 1995 to 22 February 1995 his cumulative profit and loss followed the change in the index fairly closely. Over this period his delta equivalent position increased to long 10,433 contracts and he incurred losses of ¥2.8 billion (£18 million).
- 4.90 On 23 February 1995 the market fell 330 points and volatilities increased. As a result of the large negative gamma on Leeson's option portfolio, the delta equivalent position increased to long 13,535 contracts. He sustained a loss on the day of ¥2.6 billion (£17 million). It was on this date that Leeson left BFS and did not return.
- 4.91 On 24 February 1995 the market fell a further 230 points and the delta equivalent position increased to long 14,946 contracts. The option portfolio incurred a further loss of ¥2.7 billion (£18 million).
- 4.92 On 27 February 1995 the market fell a further 645 points and volatilities increased even higher. The delta equivalent position grew substantially to long 18,312 contracts. The option portfolio incurred a loss of ¥9.4 billion (£61 million).

4. Unauthorised trading activities

4.93 From 1 January 1995 to 27 February 1995 the loss on the options portfolio amounted to ¥18.38 billion (£118 million). This loss can be summarised as follows:

Figure: 4.17

| | | ¥ billions | ¥ billions |
|---|-------|------------|------------|
| Theoretical value at 1 January 1995 | Calls | 16.99 | |
| | Puts | 8.73 | 25.72 |
| Theoretical value at 27 February 1995 | Calls | (3.26) | |
| | Puts | (41.31) | (44.57) |
| Premium received 1 January 1995 to 27 February 1995 | | | 1.65 |
| Adjustments (options assigned and opening transactions) | | | (1.18) |
| Loss for the period 1 January 1995 to 27 February 1995 | | | (18.38) |

Source: Account '88888' and available SIMEX statements

4.94 The total cumulative loss (i.e. since the opening of account '88888') on the options outstanding at 27 February 1995 was approximately ¥8.31 billion (£51 million).

THE COLLAPSE

4.95 As Figure 4.1 and subsequent analysis showed on 1 January 1995 Leeson had built up substantial losses in account '88888'. This account included a significant proprietary option position at this date. Following the Kobe earthquake Leeson may have attempted to profit from what he may have believed was an undervalued Nikkei index and an overvalued JGB market by taking long and short positions respectively. On Monday 23 January 1995 when the Nikkei index fell 1,175 points Leeson lost a total of ¥16.11 billion (£102 million). By Friday 27 January 1995 he was down a further ¥6.09 billion (£38.4 million). In just 27 days he had taken the loss which arose from 30 months of activity from ¥33.50 billion (£208 million) at the end of 1994 to ¥53.67 billion (£337 million). From Tuesday 10 January 1995 he started to offset positions on account '92000' and account '88888' for SIMEX margining purposes.

4.96 On Monday 30 January 1995 there was a sharp rise in the Nikkei and a sharp fall in the JGB allowing him to recover ¥13.34 billion (£85 million). However, he was still running large positions and he held onto them rather than closing them out. The JGB market moved in his favour for the next 3 days but the Nikkei moved against him. By Thursday 2 February 1995 he had recovered an additional ¥2.24 billion (£14 million). However, after this date both markets moved against him. Rather than cut his losses he continued to build his long Nikkei and short JGB positions.

4.97 On Tuesday 7 February 1995 he lost ¥3.70 billion (£24 million), and on Wednesday 8 February 1995 he lost a further ¥4.80 billion (£31 million). On Thursday 9 February 1995 he lost ¥6.30 billion (£42 million). At this stage his cumulative loss was almost as large as that incurred to Friday 27 January 1995. On Friday 10 February 1995 the

4. Unauthorised trading activities

Nikkei rose and the JGB fell allowing him to recover ¥6.44 billion (£41 million) due to the size of his positions. However, on Tuesday 14 February 1995 the Nikkei fell rapidly and on Wednesday 15 February 1995 the Nikkei fell and the JGB rose. Over these 2 days Leeson lost ¥16.76 billion (£109 million). Leeson at the time was presumably finding it difficult to obtain sufficient funding. On Wednesday 15 February 1995 he processed the fictitious JGB contract (paragraph 4.38) which realised ¥26.08 billion (£170 million) profit in account '88888'. This, however, was reversed out the following day. On Thursday 16 February 1995 he added a further 2,700 contracts to the short JGB position and on Friday 17 February 1995 he added a further 5,099 contracts to the long Nikkei position.

- 4.98 Up to Wednesday 22 February 1995 little happened to his profit and loss as the markets were fairly static; however, he continued to build up his long Nikkei position. Then on Thursday 23 February 1995 the JGB rose 72 points and the Nikkei fell a further 330 points. In one day he incurred a loss of ¥22.14 billion (£144 million) and it was at this point that he left BFS, never to return. On Friday 24 February 1995 the Nikkei continued to fall but the JGB market fell slightly too. The loss on the day was ¥7.40 billion (£48 million).
- 4.99 On Monday 27 February 1995 after the market had become aware of BFS's problems and its positions, there was a large fall in the Nikkei and a large rise in the JGB. This caused the largest daily profit and loss movement over the period to arise, a loss of ¥35.42 billion (£231 million).

5. CONCEALMENT OF TRADING ACTIVITIES IN BARING FUTURES (SINGAPORE) PTE LIMITED

5.1 In this section we describe the techniques used by Leeson to conceal his unauthorised trading from Barings' management, the method he employed to reduce the margins due to SIMEX and the method he employed to enhance his reported profitability.

Concealment of account '88888'

5.2 The analysis in Section 4 shows that the London client account '88888' maintained within BFS had been used by Leeson for over two and a half years to take unauthorised trading positions. The fact that Leeson was able to conceal the positions and losses recorded in this account caused the collapse of Barings on 26 February 1995.

5.3 Account '88888' was set up in July 1992. Bax has told us that he understands that account '88888' was originally opened as an error account. As such it is not likely, he believes, that it was opened by Leeson, but rather by the person who established BFS's operational systems. At its inception, the account was included in the following reports, sent electronically each day by BFS to London:

| Report | Content |
|--------------|--|
| Trade file | Activity for the day |
| Price file | Closing settlement prices |
| Margin file | Initial and maintenance margin by account and currency |
| London gross | Details of positions |

However, we were informed by Dr. Edmund Wong, a systems consultant to BFS, that he received, on or around 8 July 1992, specific instructions from Leeson to change the software program to exclude account '88888' from all these reports, with the exception of the margin file (paragraph 6.131 to 6.138). We were told by Wong that this continued to be the case throughout the period up to the collapse on 26 February 1995. It appears, therefore, that Leeson intended to use account '88888' for unauthorised activity from the outset, and that the action noted above was designed to exclude the account from the books and records of Barings.

5.4 In London, Barings' management and other personnel have said that at no time until Thursday 23 February 1995 were they aware of the existence of account '88888'. However, as noted in paragraph 5.3, the margin file sent to London did include account '88888' but we were told that this was not noticed or appreciated.

5.5 In Singapore, reference was made to account '88888' in a letter from SIMEX to Jones dated 11 January 1995. SIMEX expressed concern about the funding of margin in respect of the 'BSL - Customer Segregated Account' and suggested it appeared that BFS might be financing the margins of customers - which is against the rules of SIMEX - to the extent of US\$100 million. This amount was computed purely by reference to account '88888' and ignored the margin attributable to bona fide customer accounts in the 'BSL - Customer Segregated Account'. Jones responded to SIMEX on 25 January 1995, addressing some of the matters raised in the 11 January 1995 letter, but not referring to account '88888'. Jones told us that this response was drafted by Leeson

5. Concealment of trading activities

although he added the suggestion at the end of the letter that there be a meeting with SIMEX to clarify matters.

- 5.6 In interviews, London personnel (other than Tony Hawes and Railton) have said that they were not aware of the SIMEX letter of 11 January 1995 before the collapse. Tony Hawes told us it may have been mentioned to him by Jones during his visit in the week of 6 February 1995 (paragraph 11.107). As mentioned in paragraph 11.109, Railton was shown the letter by Jones in the week beginning 13 February 1995.
- 5.7 We are also aware that Jones received a letter from SIMEX in September 1993 concerning certain breaches of SIMEX rules identified during a visit by SIMEX auditors. One of the breaches related to recording of transactions and referred to a trade ticket dated 18 February 1993 (attached to the letter) which was for account '88888'. There is, therefore, evidence to suggest that Jones was aware of the existence of account '88888', although not whether he was aware of the use to which it was being put.
- 5.8 Within BFS, settlements staff responsible for processing SIMEX transactions were all aware of the existence of account '88888' as they were booking trades and adjustments to those trades on a regular basis from the date the account was opened. It is likely that a significant number of the floor trading team were also aware of the account, as many of them would have been involved in the preparation of trading tickets and the daily blotter which summarised the day's trading activity. Despite the increasingly unusual nature of some of the transactions and the adjustments to recorded trades that Leeson gave instructions to be made, it should be said that none of these employees seem to have found it necessary to raise these issues with any member of management. Thus while the existence of the account was a matter of common knowledge to those involved in the day-to-day business of BFS, Leeson was able to conceal its existence from the rest of Barings.

Manipulation of trade prices

- 5.9 As reported in paragraph 3.26, Leeson was authorised to conduct inter-exchange arbitrage business ('switching' in Barings' terminology) between SIMEX and three Japanese exchanges (OSE for Nikkei 225, TSE for JGBs and TIFFE for Euroyen). Until August 1994 no separate record of the profitability of these 'switching' activities was maintained in the accounts of Barings in London, although we understand the dealers in Tokyo kept an informal record of the profits generated. The results were included in the total results for the volatility and cash/futures arbitrage book in BSJ. From August 1994 a separate record was maintained within the books of BSJ and reported daily to London.
- 5.10 During 1992, 1993 and 1994 these proprietary trading activities were sometimes recorded in BSLL and at other times in BSJ depending on tax, regulatory or margining considerations. For example, in August 1994 the Nikkei 225 volatility trading book was moved from BSJ's accounts to BSLL to take advantage of a lower tax rate.
- 5.11 At 24 February 1995, the Nikkei 225 'switching' book and part of the JGB 'switching' book were recorded within the BSJ accounts. The Euroyen 'switching' book and the remainder of the JGB 'switching' book were recorded in BSLL's accounts.

5. Concealment of trading activities

5.12 The reported profitability of these activities from the second quarter of 1994 to 24 February 1995, are shown in Figure 5.1.

Figure: 5.1

| £000s | 1994 | | | Total | 1995 |
|--|----------------|----------------|----------------|--------|-------------------|
| | 2nd Quarter | 3rd Quarter | 4th Quarter | | to 24 February |
| Euroyen | 169 | 220 | 156 | 545 | 1,111 |
| JGB | 5,100 | 9,208 | 9,078 | 23,386 | 6,653 |
| Nikkei 225 | - | 638 | 3,960 | 4,598 | 10,803 |
| Profit on Leeson's 'switching' book | 5,269 | 10,066 | 13,194 | 28,529 | 18,567 |

Source: Barings Revenue Department:

'Weekly profit and loss report' for year ended 31 December 1994

'Daily profit and loss report': 1 January 1995 - 24 February 1995

Note: 'Switching' profits on Nikkei 225 were not separately identified until August 1994 (paragraph 3.54)

5.13 In order to maintain the reported profitability of the authorised inter-exchange arbitrage business, it appears that Leeson made unauthorised adjustments to the price of transactions concluded on the floor of SIMEX and caused trades to be entered into the books and records of BFS which were not genuine transactions.

5.14 The vehicle used to effect this deception was the cross trade. A cross trade is a transaction concluded across the floor of the Exchange by a Member who has matching buy and sell orders for the same contract and at the same price, for two different customer accounts. Under SIMEX rules, the bid and offer of a cross trade must be declared three times by open outcry in the pit. If the bid or offer is not taken up, the member is allowed to cross the transaction at the stated price between the two accounts. Generally, a cross trade involves two floor traders of the same firm taking either side of the trade thereby transferring a position through the Exchange between two customer accounts of the same member firm.

5.15 BFS entered into a significant volume of cross transactions between account '88888' and account '92000' (BSJ - Nikkei and JGB Arbitrage), account '98007' (BSLL - JGB Arbitrage) and account '98008' (BSLL - Euroyen Arbitrage). The SIMEX statements available to us in respect of 1995 detailing daily activity on the floor show a clear pattern of crosses transacted between floor traders with BFS mnemonics.

5.16 A cross trade has to be executed at the market price. 'Off-market' crosses are not allowed by the Exchange. Many of the crosses transacted by BFS appear to have taken place in the 'post-settlement period', a period of three to five minutes after the official close where trading is allowed only at the official settlement price. It is likely that Leeson chose this period as being one where other market operators were least likely to wish to participate in the transaction, which they are entitled to do under the rules of SIMEX.

5. Concealment of trading activities

- 5.17 It appears that after the conclusion of the trade, Leeson would instruct the settlements staff to break down the total number of contracts into several different trades, and to change the trade prices thereon to cause profits to be credited to 'switching' accounts referred to above and losses to be charged to account '88888'. Thus while the cross trades on the Exchange appeared on the face of it to be genuine and within the rules of the Exchange, the books and records of BFS, maintained in the Contac system, a settlement system used extensively by SIMEX members, reflected pairs of transactions adding up to the same number of lots at prices bearing no relation to those executed on the floor.
- 5.18 Alternatively, Leeson would enter into cross trades of smaller size than the above but when these were entered into the Contac system he would arrange for the price to be amended, again enabling profit to be credited to the 'switching' account and losses to be charged to account '88888'.
- 5.19 As an example of this manipulation, the reported profit of the Nikkei 225 'switching' book (account '92000') between 20 January 1995 and 26 January 1995, inclusive, was ¥848 million (£5.3 million). From a review of the SIMEX statements during this period we have identified cross trades in Nikkei 225 futures contracts between account '92000' and account '88888' which created profits in account '92000' of some ¥2,245 million (£14.2 million), ¥1,397 million (£8.8 million) more than the total reported profit. The analysis of this ¥2,245 million is given in Figure 5.2.

Figure: 5.2

| Date | No. of contracts in account '88888' | | Price per SIMEX | Average price per CONTAC | Value per SIMEX ¥ millions | Value per CONTAC ¥ millions | Profit/(loss) to '92000' ¥ millions |
|--------|-------------------------------------|-------|-----------------|--------------------------|-------------------------------|--------------------------------|--|
| | Buy | Sell | | | | | |
| 20 Jan | 6,984 | | 18,950 | 19,019 | 66,173 | 66,413 | 240 |
| 23 Jan | 3,000 | | 17,810 | 18,815 | 26,715 | 28,223 | 1,508 |
| 23 Jan | | 8,082 | 17,810 | 18,147 | (71,970) | (73,332) | (1,362) |
| 25 Jan | 10,047 | | 18,220 | 18,318 | 91,528 | 92,020 | 492 |
| 26 Jan | 16,276 | | 18,210 | 18,378 | 148,193 | 149,560 | 1,367 |
| | | | | | | | 2,245 |

Source: Accounts '88888' and '92000' and available SIMEX statements.

Note: The trading unit of the Nikkei 225 futures contract on SIMEX is 500 times the futures price (Appendix V).

- 5.20 The column headed "No. of contracts in account '88888'" represents the size of Nikkei 225 cross trades traded on the floor of SIMEX for the dates shown, with the other side being in account '92000'. In each instance, the entries in the Contac system reflected a number of spurious contract amounts at prices different to those transacted on the floor, but reconciling to the total lot size originally traded. This had the effect of giving the impression from a review of the reported trades in account '92000' that these had taken place at different times during the day. This was necessary to deceive BSJ into

5. Concealment of trading activities

believing the reported profitability in account '92000' was a result of authorised arbitrage activity.

- 5.21 The effect of this manipulation was to inflate reported profits in account '92000' at the expense of account '88888', which was also incurring substantial losses from the unauthorised trading positions taken by Leeson.
- 5.22 In addition to crossing trades on SIMEX between account '88888' and the 'switching' accounts, Leeson also entered fictitious trades between these accounts which were never crossed on the floor of the Exchange (i.e. 'off-market' crosses). The effect of these was again to credit the 'switching' accounts with profits whilst charging account '88888' with losses. As noted in paragraph 5.16 SIMEX did not permit 'off-market' crosses.
- 5.23 We have reviewed statements of transactions for account '88888' for the period 1 January 1995 to 27 February 1995, inclusive, in order to separately identify the 'market' and 'off-market' cross trades. From this analysis we have computed the amount of fictitious profits recognised in the 'switching' accounts and contrasted this with the 'switching' profits actually reported to management.

Figure: 5.3

| £'000s | Nikkei 225 | JGB | Euroyen | Total |
|------------------------|------------|----------|---------|----------|
| Reported profit | 10,803 | 6,653 | 1,111 | 18,567 |
| Less fictitious profit | (26,085) | (15,983) | (1,664) | (43,732) |
| Effective loss | (15,282) | (9,330) | (553) | (25,165) |

Source: Barings Revenue Department plus Account '88888' and available SIMEX statements

Note: For 'off-market' cross trades the fictitious profit has been computed by reference to the SIMEX settlement price as it would have been possible for Leeson to have crossed these at this price in the post settlement period.

- 5.24 The analysis in Figure 5.3 shows that although Leeson reported significant profits on the 'switching' activities, their effective result was a loss of £25 million.

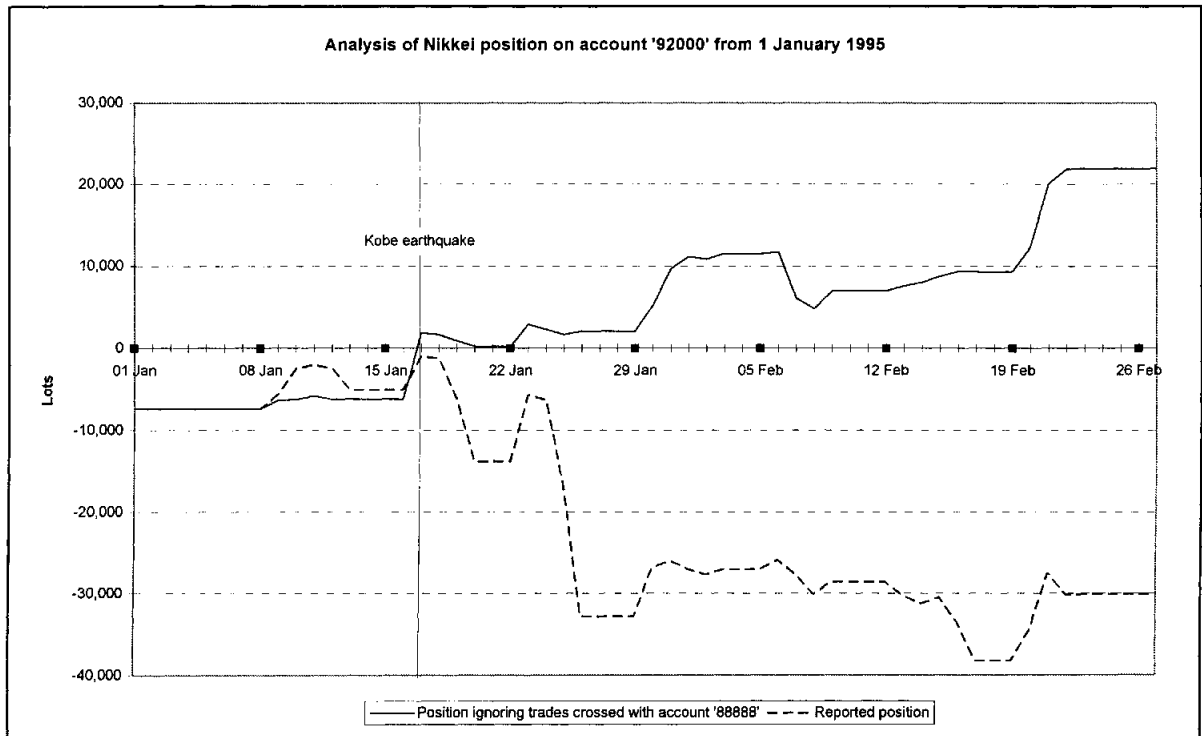
Effect of cross trades on Barings' risk position

- 5.25 Management of Barings understood that Leeson's 'switching' activities involved taking a position in SIMEX and taking an equal and opposite position in OSE, TSE or TIFFE depending on the contract type. It transpires that many of the positions which should have been placed in SIMEX were never concluded with other market participants but were merely crossed between the appropriate 'switching' account and account '88888'. As a result Barings did not match-off most of its market risk arising on the Japanese exchanges by 'switching' in SIMEX.
- 5.26 Figure 5.4 shows the position on account '92000' which arose from Nikkei trades not crossed into '88888' plus the Nikkei position actually reported to management. The

5. Concealment of trading activities

difference between the two lines represents the size of the Nikkei cross trades concluded.

Figure: 5.4

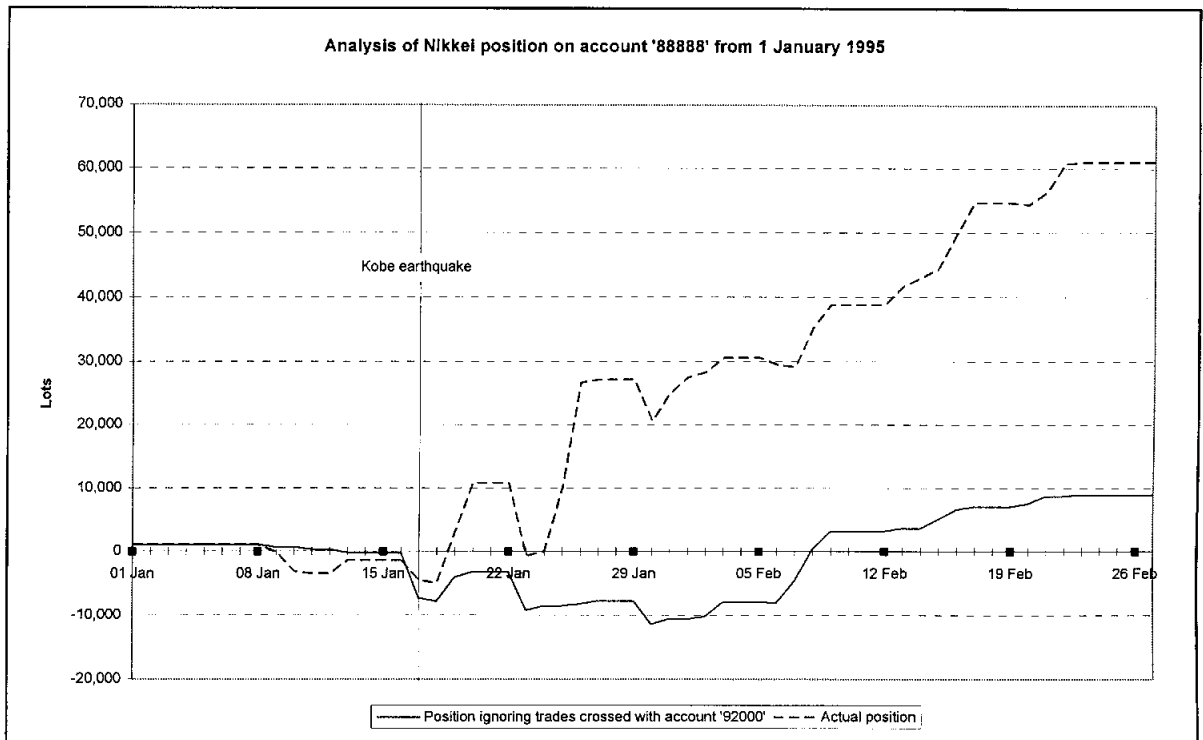


Source: Account '88888' and account '92000' statements

- 5.27 The graph shows that at 24 February 1995, whilst management thought that on SIMEX, as a result of Nikkei 'switching', there was a short position of 30,112 contracts, there was in fact a long position of 21,928 contracts after omission of the trades crossed with account '88888'. The graph further shows that, between 17 January 1995 and 29 January 1995, when the bulk of the 'switching' position arose in account '92000', in fact the position resulted almost entirely from cross trades.
- 5.28 The graph in Figure 5.5 is similar to that illustrated in Figure 5.4 except it shows the position on account '88888' which arose from Nikkei trades not crossed into account '92000' and the unreported Nikkei position described in Section 4. The difference between the two lines again represents the size of the Nikkei cross trades.

5. Concealment of trading activities

Figure: 5.5



Source: Account '88888' and account '92000' statements

5.29 The graph shows that at 24 February 1995, although the actual Nikkei risk position recorded in account '88888' was a long position of 61,039 contracts, after omission of the cross trades there was a long position of just 8,999 contracts.

5.30 Paragraphs 5.25 to 5.29 show that the true risk position for Barings on Nikkei at 24 February 1995 was split between both SIMEX and OSE. This split is summarised in Figure 5.6.

Figure 5.6

| | Number of contracts |
|----------------------------------|---------------------|
| Risk position in account '92000' | 21,928 |
| Risk position in account '88888' | 8,999 |
| Risk position on SIMEX | 30,927 |
| Risk position on OSE | 30,112 |
| Total risk position | 61,039 |

Source: Inquiry team

5.31 This amount is consistent with the analysis in Section 4 where the unreported Nikkei position on this date was a long position of 61,039 contracts. It transpires that as the Nikkei 'switching' position on OSE was always equal and opposite to the Nikkei

5. Concealment of trading activities

position in account '92000' that the positions in account '88888' correctly represent the unreported positions and profit and loss over the period.

- 5.32 A similar analysis can be performed for the JGB and Euroyen 'switching' activities and this again shows that much of the risk thought by management to have been laid off in SIMEX was in fact crossed into account '88888'. This left uncovered market risk on the related positions on the Japanese exchanges.
- 5.33 This meant that the cumulative loss of £927 million was not solely realised on SIMEX but also on the Japanese exchanges.

Concealment from SIMEX

- 5.34 SIMEX rules require the clearing house to call margin from its Members on each customer and house account. In calculating margin requirements, SIMEX adopts a system known as 'gross margining'. Under this system, SIMEX rules require Members to account separately for the trading positions of their customers and for their own house positions. Further, the margins for customers are computed on an account by account basis, namely one customer's long position may not be used to offset another customer's short position for the purposes of computing margin due to the clearing house.
- 5.35 For the purpose of computing the total amount of margin payable by the Member, the clearing house relies on the open long positions reported by the Member. This report is called the 'Position Change Sheet' (PCS) and is submitted by each Member to SIMEX at the end of the trade day. This shows the 'Reported Final Long Position' (RFL) of customer and house accounts as a total figure for each commodity and each delivery month. The clearing house used the PCS to calculate BFS's margin requirements for both customer and house accounts.
- 5.36 Both the BSJ proprietary 'switching' account '92000' and account '88888' were set up at SIMEX as customer accounts. As such, SIMEX rules would not permit offset of a long position on account '88888' with a short position on account '92000' for the purposes of calculating the RFL to be submitted to the clearing house.
- 5.37 The sources of funding provided to BFS are shown in paragraph 6.20 and Figure 6.4. Up to January 1995 it appears that margin calls, although exacerbated by accumulating losses on account '88888', could be met with funds provided by BSL, known as the 'top up' (paragraph 6.68), unreconciled US Dollar funds provided by BSL (paragraph 6.64), and with surplus margin which BSJ did not reclaim on its SIMEX positions. However, as margin calls attributable to account '88888' positions started to increase substantially, it became necessary for Leeson to find a way of reducing the margin calls made by the clearing house as it became harder for him to finance his unauthorised positions.
- 5.38 Accordingly, from 10 January 1995, Leeson instructed BFS settlements staff to make adjustments between the position in account '88888' and the position in account '92000', offsetting the long Nikkei 225 position in the former against the short position in the latter. Similarly, from 6 February 1995 the short JGB position on account '88888' was offset against the long JGB position on account '92000'. These adjustments were made prior to the submission of the PCS to the clearing house and resulted in a much

5. Concealment of trading activities

lower RFL being reported than was actually the case. This substantially reduced the total margin requirement and on six separate occasions between 26 January 1995 and 20 February 1995 caused SIMEX to remit substantial amounts of excess margin to BFS where no such excess margin was, in fact, due to the company.

- 5.39 The transactions involved in this process were off-market cross trades and not genuine market transactions conducted on the floor of SIMEX. Following submission of the PCS, these entries were reversed so that the daily activity statement for account '92000' sent to BSJ did not include evidence of these adjustments. The trades were priced at the settlement price for the day and as they were reversed out the following day did not result in the transfer of any profit or loss. On 17 February 1995, BFS had difficulty sending routine information to SIMEX as the modem link was down. It transpires that the daily activity statement was not sent to BSJ for this date and that the one sent for the following business day included the adjusting trades. However, as the final positions reconciled to BSJ's records they did not attempt to resolve differences in the trades shown as they were informed that there had been a systems problem.
- 5.40 The effect of the falsification of the PCS was to deceive SIMEX as to the total amount of the margin requirement on the customer and house positions of BFS. At 23 February 1995 we estimate that the margin requirement made by SIMEX was understated by an amount in excess of £250 million.

Link between cross trades and adjusting trades

- 5.41 The effect of the SIMEX cross trades between account '88888' and account '92000' was significantly to inflate the positions in those accounts and, due to the SIMEX system of gross margining, substantially to increase the potential margin calls. Although Leeson needed the extra margin that BFS could call from BSJ on account '92000' to finance his losses, he did not have access to the funding to support SIMEX's potential margin calls. Therefore, he raised the end-of-day adjusting entries referred to in paragraphs 5.38 to 5.40. A comparison of the cross trades to the adjusting entries shows that there was a close relationship between the position created through cross trades and the adjusting trades.

Manipulation of the books and records of BFS

- 5.42 As a result of the unauthorised trading activity undertaken by Leeson in account '88888', an equity balance arose on the account which Leeson had to conceal. It would not otherwise have been possible to reconcile the SIMEX account without exposing the true balance on account '88888'. Effectively, Leeson had to find a way of hiding the losses incurred on his unauthorised trading. He achieved this by creating false journal entries, fabricating transactions and writing options. As part of this concealment of the true underlying balance on account '88888' Leeson also deceived the external auditors and management of Barings either by effecting alterations to the books and records of BFS or by altering and manufacturing documents.
- 5.43 Since February 1993 the month end equity balance on account '88888' was masked, generally by a month end journal adjustment crediting account '88888', bringing that account to zero, and debiting the SIMEX clearing bank account (with Citibank) as maintained in the books of BFS. If the balance had not been masked, it would not have

5. Concealment of trading activities

been possible to reconcile the SIMEX account without exposing the true balance on account '88888'.

- 5.44 The month-end closing equity balance on account '88888' represents the sum of the following:
- Balance brought forward
 - Realised profit and loss in month
 - Premiums on options purchased and sold
 - Cash paid and received
 - Adjustments
 - Unrealised profit and loss at month end.
- 5.45 Immediately following month end, the journal adjustment described above was shown as a reconciling item on the routine month-end bank reconciliation carried out by settlements staff and reviewed and signed off by Leeson. On the first day of the following month a reversing journal entry for value last day of the previous month was raised. The effect was to overstate cash and understate losses at each month end in the books and management accounts of BFS.
- 5.46 From the opening of account '88888' in July 1992 to February 1993 similar month-end journal entries were processed although they did not have the effect of clearing the equity balance on that account to nil. Since we have not had access to the records of BFS, we have not been able to determine where the balance on account '88888' was shown during this period in the month end accounts of BFS.
- 5.47 From February 1993 to January 1995 (24 months) the masking technique described above was used to eliminate the balance on account '88888', at all but the following month ends:
- 1993: March, May, August, September, November, December
1994: March, June, December.
- 5.48 However, in all these cases except November 1993 (when there was a small equity balance of ¥100,000) the balance on account '88888' was nil. Given the pattern of the account this is an unlikely coincidence and suggests that other methods of masking the real balance were employed. One such method, the writing of options, is discussed in paragraph 5.63.
- 5.49 In addition to month end transactions, a further reversing transaction arose on Wednesday 15 February 1995 when Leeson processed a purchase of 7,000 JGB March 1995 contracts at 745 points below the market close (paragraph 4.38). This transaction created a gain of ¥26.08 billion (£167 million) which largely offset his accumulated trading losses of ¥26.64 billion (£171 million) for 1995. This transaction was then reversed the following day.
- Confirmation of account '88888' balance at 30 September 1992**
- 5.50 As early as 30 September 1992, it appears that there was a balance on account '88888' which needed to be concealed from BFS's auditors, D&T, by the production of a false confirmation. Bowser informed us that, subsequent to the collapse, the CAD have

5. Concealment of trading activities

shown him two documents: first his confirmation to Leeson of balances on BSLL-Non Segregated Account (account '99002') at 30 September 1992; and secondly his purported confirmation to Leeson of balances on another BSLL account (account '88888') at 30 September 1992. On 2 October 1992, Leeson purportedly wrote to Bowser, who was at that time Derivatives Controller in London, requesting him to confirm various balances at 30 September 1992 relating to BSLL-Non Segregated Account (account '99002'), for BFS's auditors D&T. Bowser does not recall receiving this particular confirmation request since he would have had a number of such requests as a matter of routine. On the assumption that he did receive it, he would have given the request to a clerk to check off the balances to the BSLL records and would then have returned the request to Leeson, with the balances ticked and the request signed and dated by him. The confirmation provided to us by Bowser, shows three tick marks identified as 'checked to broker's report' and is signed by Bowser and dated by him, 2 October 1992.

5.51 Bowser told us he does not recall receiving a confirmation request in respect of account '88888', since if he had done he would not have recognised the account number and would have queried it with Leeson. He therefore does not accept that he signed such a confirmation. Furthermore the '2' in the date (2 October) had purportedly been replaced with a '7' (7 October). Bowser says that he has usually written seven in the continental style of '7' and so he believes that the date was not written by him.

5.52 The confirmation of the account '88888' balance appears to have been a false confirmation and, given Leeson's other involvement with account '88888', we attribute responsibility for this to him. This appears to have been evidence of concealment at an early stage.

Manipulation of 1994 year end receivable balance

5.53 At 31 December 1994 the balance on account '88888' was reduced to nil by a credit purported to represent a premium on a written put option on the Nikkei 225.

5.54 A review of the Contac system print out of account '88888' at 31 December 1994 shows the sale of 2,000 put options on the Nikkei 225 with a strike price of 21,500 and a premium of ¥7.778 billion (£50 million) receivable on 30 December 1994. We have not located this transaction on any SIMEX statement. An amount of ¥7.778 billion is also shown as fees receivable in the balance sheet of BFS at 31 December 1994. The purported transaction was reversed on 3 January 1995.

5.55 We understand that these entries and balances were queried by C&L Singapore in an internal memorandum dated 27 January 1995. C&L Singapore requested support for the collectability of the ¥7.778 billion receivable. According to Jones in an informal meeting with us, Leeson explained the receivable broadly as follows: BFS had acted as an agent in an option deal between SLK and BNP Japan. In October 1994 BNP Japan sold to BFS 200 ¥50,000 call options on the Nikkei 225 for maturity 30 December 1994 with a strike price of 19,728.34 resulting in a total premium of ¥7.778 billion. At the same time SLK purchased an option from BFS on similar terms for which the total premium payable and receivable was ¥7.778 billion. The options matured out of the money on 30 December 1994 and were not exercised. The explanation given to C&L Singapore apparently described a different option to the transaction Leeson processed at the year end, although it had the same premium receivable.

5. Concealment of trading activities

- 5.56 Jones said that Leeson told him BFS incorrectly processed the option with BNP and on 3 December 1994 the funds relating to the premium on the options sold were paid away. Leeson is then said to have gone to Jones and Bax on 1 February 1995 with a handwritten note explaining the transaction and to say that he had done a pair of transactions for which he had not obtained authorisation and that he needed their help to satisfy the auditors. According to Jones, believing that the transaction was genuine, it was agreed that retrospective approval should be obtained from Ron Baker and that the monies would be collected from SLK.
- 5.57 Subsequently, a fax dated 2 February 1995 addressed from Ron Baker to Bax and Leeson was purportedly received by BFS stating: "As Head of the Financial Products Group I confirm my knowledge and approval of the Nikkei OTC Option deal with Spear Leeds Kellogg".
- [signed, allegedly]
- "Ron".
- 5.58 Ron Baker informed us that he is absolutely certain that these documents, both the memorandum and the fax cover sheet that accompanied it, are false. Ron Baker's secretary has stated that she has no record of these documents being typed or faxed by her.
- 5.59 A fax dated 1 February 1995 purportedly received by BFS from Mr Richard Hogan, Managing Director of SLK, confirmed an outstanding balance of ¥7.778 billion due from SLK to BFS and that the amount would be paid by 2 February 1995. In the left hand corner of this fax is reference to the name input into the sending fax machine as 'Nick and Lisa'. We have spoken with representatives of SLK who informed us that SLK was unaware of any OTC option transaction or receivable at 31 December 1994 and that no fax confirmations of such balances originated from SLK.
- 5.60 Finally, a fax of receipts and payments made on 2 February 1995 was described as being received by BFS which showed certain movements in the BFS Citibank account including a receipt of ¥7.778 billion and a payment of ¥7.878 billion. We were informed by Jones that this Citibank document was altered so as to disguise the fact that the receipt and payment were in fact transfers to another BFS bank account. The receipt was purported to represent repayment of the amount receivable from SLK.
- 5.61 We have been told by Gamby and others that materials suggesting that the letter from SLK and the Citibank bank documents were fabricated were found in Leeson's desk when opened on 26 February 1995, as described earlier in paragraph 1.65.
- 5.62 The actions of Barings' management and of C&L in respect of the above purported transaction and the related documents, and the reporting of the issue in London are covered in more detail in paragraphs 7.54 to 7.99 and 10.39 to 10.57.

Writing of options

- 5.63 From the opening of account '88888' in July 1992, a large number of written option transactions were booked to this account. Option premiums would have been received and credited to the equity account. The amount of the premium at the inception of the transaction conceptually represents the unrealised loss on the position

5. Concealment of trading activities

after crediting the premium as realised profit. This is because if the position were to be closed out, a similar premium would have to be paid. However, as no settlement or variation margin is paid or received on the option position, there is no corresponding debit to the equity account. Instead, SIMEX calls for an amount of initial margin to cover the unrealised loss. Then as the value of written options changes, the amount of initial margin deposited varies accordingly.

5.64 As noted in paragraph 5.43 it was necessary for the equity balance on account '88888' to be zero at month and year ends to avoid detection. This was achieved at a number of month ends and the 1993 year end by writing sufficient options to enable the total of realised losses and unrealised futures gains or losses on this account to be offset by the premiums received.

5.65 The link between the equity balance on account '88888' and the cumulative loss at 31 December 1993 is shown in Figure 5.7, at which date Leeson had no open futures positions in account '88888'.

Figure: 5.7

| | ¥ millions |
|---|----------------|
| Realised loss | (4,511) |
| Unrealised futures gain (loss) | - |
| Premium on written options open at 31 December 1993 | 4,511 |
| Equity balance | <u>-</u> |
| Option market value | (4,032) |
| Cumulative loss | <u>(4,032)</u> |

Source: Account '88888' and available SIMEX statements

5.66 Thus although the equity balance was nil the cumulative loss was effectively included in the balance of initial margin deposited at SIMEX.

5.67 Similarly, at the 1994 year end this technique was used to partially disguise the loss. Figure 5.8 shows the link between the equity balance on this account and the cumulative loss at 31 December 1994.

5. Concealment of trading activities

Figure: 5.8

| | ¥ millions |
|---|-----------------|
| Realised loss | (43,710) |
| Unrealised futures gain | 140 |
| Premium on written options open at 31 December 1994 | 35,792 |
| Equity balance | <u>(7,778)</u> |
| Option market value | <u>(25,724)</u> |
| Cumulative loss | <u>(33,502)</u> |

Source: Account '88888' and available SIMEX statements

5.68 Thus the negative equity balance of ¥7.778 billion, which would have represented unidentified cash paid to SIMEX, was matched by the SLK option transaction and the remainder of the loss was included in the balance of initial margin deposited at SIMEX.

The effect of concealment

5.69 The effect of the methods applied to conceal the activity, balances and losses on account '88888' is that since its inception the account would not have featured within the management or financial accounts of BFS, and would not have appeared on any management exception reports.

6. FUNDING OF BARING FUTURES (SINGAPORE) PTE LIMITED

Introduction

- 6.1 Sections 3 and 4 of this report describe the nature of the trading conducted by BFS. One feature of this type of trading is the requirement for clearing members of a futures exchange to deposit funds with the exchange. This funding, known as 'margin', is both a form of collateral and a way of settling both realised and unrealised profit and loss on positions. It is required to be deposited by exchanges to ensure that clearing members have sufficient resources to support any open positions. The level of this funding may be substantial, particularly for loss making positions. BFS's unaudited balance sheet at 24 February 1995 recorded that it had some £468 million of margin money with SIMEX. In London the funding was arranged by Group Treasury and remitted by Futures and Options Settlements. In Tokyo BSJ Futures and Options Settlements approved the funding which was then remitted to BFS by BSJ Cash Management (its own treasury).
- 6.2 This section of the report describes the requirements for margin funding on SIMEX, the sources of funds that supported BFS's trading activities, and the nature of funding of BFS by BSJ, BSLL and BSL. The section then describes the build up of funds provided to BFS, and the degree of control over the total funding of BFS's trading activities. We then describe the nature of the individual requests for funding from BFS to BSLL and BSL in London and BSJ in Tokyo and the way these payments were authorised and accounted for in Barings in London. The transfers created a balance known as the 'top up' account in an accounting report. We explain this and the lack of a key reconciliation procedure. We describe the credit implications of the funding of BFS and funding cost issues. Finally, we consider margin data, which was regularly sent to BSL from BFS and which contained information on account '88888'.

The requirement for margin funding on SIMEX

- 6.3 Members use their own funds to finance margin calls if the open positions are house positions, i.e. for their own account, or obtain funds from their clients on whose behalf the positions have been opened.
- 6.4 In common with other futures exchanges, SIMEX requires its members to deposit the following types of margin when opening a position and according to price movements in the market:
- (a) Initial margin to cover all positions taken on the Exchange. SIMEX regulations stipulate that this should be paid one day (for US Dollars) and two days (for Yen) after the position is opened. The amount of margin is recalculated daily and is maintained until the position is closed. BFS usually paid this type of margin in US Dollars;
 - (b) Variation margin is paid to, or received from, SIMEX in respect of mark-to-market losses or profits respectively on existing open positions. This is due one day (for US Dollars) and two days (for Yen) after the relevant price movement. BFS usually paid or received this margin in Yen;

6. Funding of BFS

- (c) Advance margin is occasionally called by SIMEX, and is payable for value the same day, for example when there are large price fluctuations on the Exchange during a trading day or when the Exchange is closed for holidays and general market volatility is perceived to be high. This type of margin represents an advance on variation or initial margin, and therefore reduces the amount of any margin paid subsequently. BFS settled advance margin calls in US Dollars. It should be noted that during the period 1 January 1995 to 24 February 1995, there was only one occasion when SIMEX requested substantial advance margin, this was immediately prior to the Chinese New Year holiday (31 January 1995 and 1 February 1995).

6.5 Most margins are paid in cash. However, SIMEX allows a proportion of the margin to be deposited in the form of letters of credit or government bonds.

The source of funding that supported BFS's trading activities

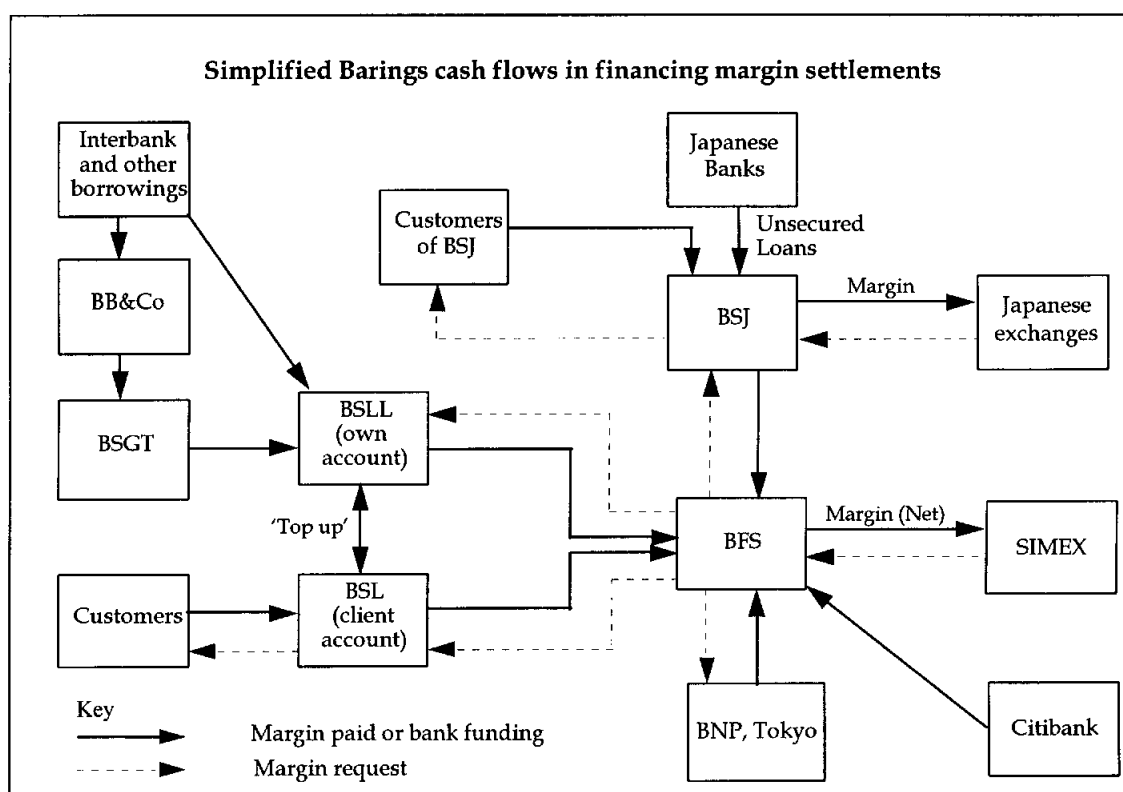
6.6 All margins placed by BFS with SIMEX appear to have been sourced from either:

- (a) third party clients of BSL, BSJ or BFS (which only had one client of its own, BNP in Tokyo); or
- (b) Barings companies, who borrowed some of the funds from other banks or other Group companies.

6.7 The flow of funds to the exchanges is illustrated in the diagram in Figure 6.1.

6. Funding of BFS

Figure: 6.1



Source: Inquiry team based on discussions with Barings personnel

Note (1): Margin is covered both by cash and collateral in the form of JGBs or letters of credit

Note (2): In addition BSJ placed bonds with SIMEX, either directly or via BSL

Note (3): The BSLL and BSL accounts shown above are based on book entries (accounting records), as explained in paragraphs 6.55 and 6.56.

Note (4): BSL and BSLL also remitted funds to BSJ (not shown in the diagram) in respect of client and proprietary business.

The nature of funding by BSJ, BSLL and BSL

6.8 The nature and source of funding for each of these companies is summarised as follows:

BSJ

6.9 From 30 January 1995 to 24 February 1995, BSJ had a reported equity balance of not less than ¥12.3 billion (£80 million) with BFS which by 24 February 1995 had risen to ¥45 billion (£300 million). Essentially this balance consisted of monies paid directly to BFS and BSJ's realised and unrealised profits from its reported trading activities (paragraphs 3.26 to 3.40). These monies were ostensibly to fund the margin that BSJ's positions on SIMEX required. Most of the BSJ positions related to the 'switching' book and were funded mainly by unsecured borrowings from Japanese banks. A very small proportion related to third party customers of BSJ.

6.10 A significant reported surplus arose in 1995 on the equity balance to the extent that there were realised profits (which had not been remitted to BSJ by BFS) and unrealised profits. This surplus was mainly due to the apparent profitability of BSJ's short Nikkei

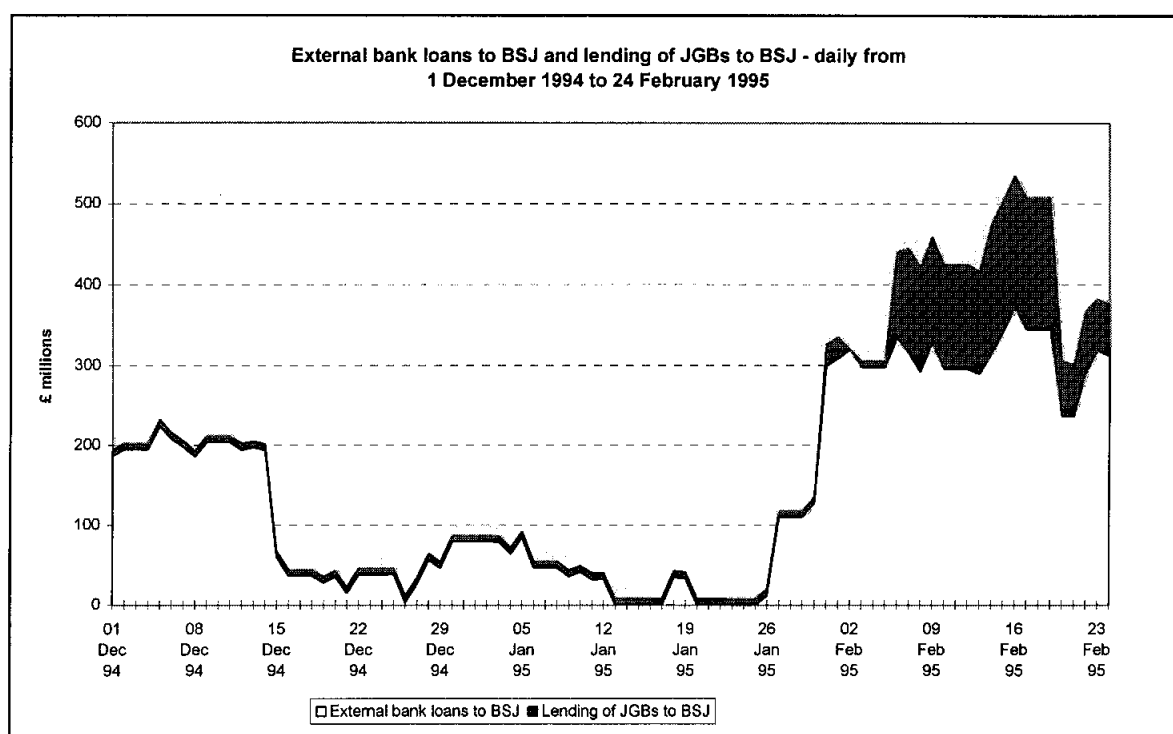
6. Funding of BFS

225 position and long JGB position in the 'switching' account on SIMEX. BSJ understood this surplus to exist on the basis of reported positions in account '92000'. As outlined in Section 5, these profits were falsified at the expense of account '88888'.

- 6.11 Although some of this surplus was returned to BSJ, on 24 February 1995 the unrepaid surplus had risen to approximately ¥20.4 billion (£133 million). We have been advised by Mr Satoshi Yamada, Futures and Options Settlements Manager, BSJ, and Sue, that significant excess margin was maintained with BFS to ensure that any intra-day calls from SIMEX could be met immediately. (BSJ advised us that it otherwise could take more than one day to transfer funds to BFS, which did not allow them to meet all margin calls for SIMEX on time.)
- 6.12 This situation was known within Barings in London but Barings' overall position was not properly considered. A fax from Leeson and Jones to Hopkins and Tony Hawes (copied to Bax, Walz and Gamby) dated 27 January 1995 noted that: "recently Tokyo has kept excess balances with BFS". David Hughes told us that in the week commencing 20 February 1995: "The treasurer in Tokyo had actually spoken with Tony Hawes about it [the excess funds left with BFS]. I think he was extremely upset at the fact that they had money that they were expecting to be repaid from Singapore that was not actually repaid to them. That was specifically mentioned to me by Tony Hawes".
- 6.13 This situation resulted in significant excess funds being tied up in Singapore. On 17 February 1995 BSJ had a reported equity balance of ¥38 billion (£253 million) at BFS when the margin apparently required by SIMEX was ¥30 billion (£200 million). BSJ then requested the return of ¥5 billion (£33 million). This cash was not received until 22 February 1995, two days later than expected; the reason given for the delay was that there had been a bank holiday in New York. This did not cause undue alarm in BSJ, as similar problems had been experienced in the past. Between 17 February 1995 and 24 February 1995 the equity balance on BSJ's positions increased from ¥38 billion (£253 million) to ¥45 billion (£300 million), which represented the total funding extended by BSJ to BFS.
- 6.14 The other side of the profitable legs of the 'switching' activities on SIMEX were loss making trades for BSJ on the Japanese futures exchanges. As Leeson built up 'switching' positions to facilitate the funding and concealment of his unauthorised trading activities, so the retention of BSJ's positive variation margin on SIMEX (the excess balance referred to in paragraph 6.10) became ever more important for him, and the resulting corollary was that BSJ had to finance increasing negative variation margin on the Japanese exchanges.
- 6.15 BSJ funded the margins on SIMEX and the Japanese exchanges by borrowing funds and JGBs from Japanese banks. The chart in Figure 6.2 illustrates the build-up of funds from external banks and of JGBs over the period 1 December 1994 to 24 February 1995.

6. Funding of BFS

Figure: 6.2



Source: Inquiry team based on analysis prepared by Barings

- 6.16 The borrowings increased dramatically from 26 January 1995, principally due to the build-up of the Nikkei and JGB 'switching' positions and the unauthorised trading positions, as described in Section 4. The level of bank loans and JGB borrowings, however, fell towards the end of February 1995 due principally to the reduction in the margin requirements of the Japanese exchanges and reduced 'switching' positions.

BSLL

- 6.17 BSLL was the entity used by Barings in London for the booking of proprietary trading. Barings' traders in Asia traded various strategies and products on SIMEX for the house (paragraph 3.18), which were funded by external borrowings and internal funds through BSGT.

BSL

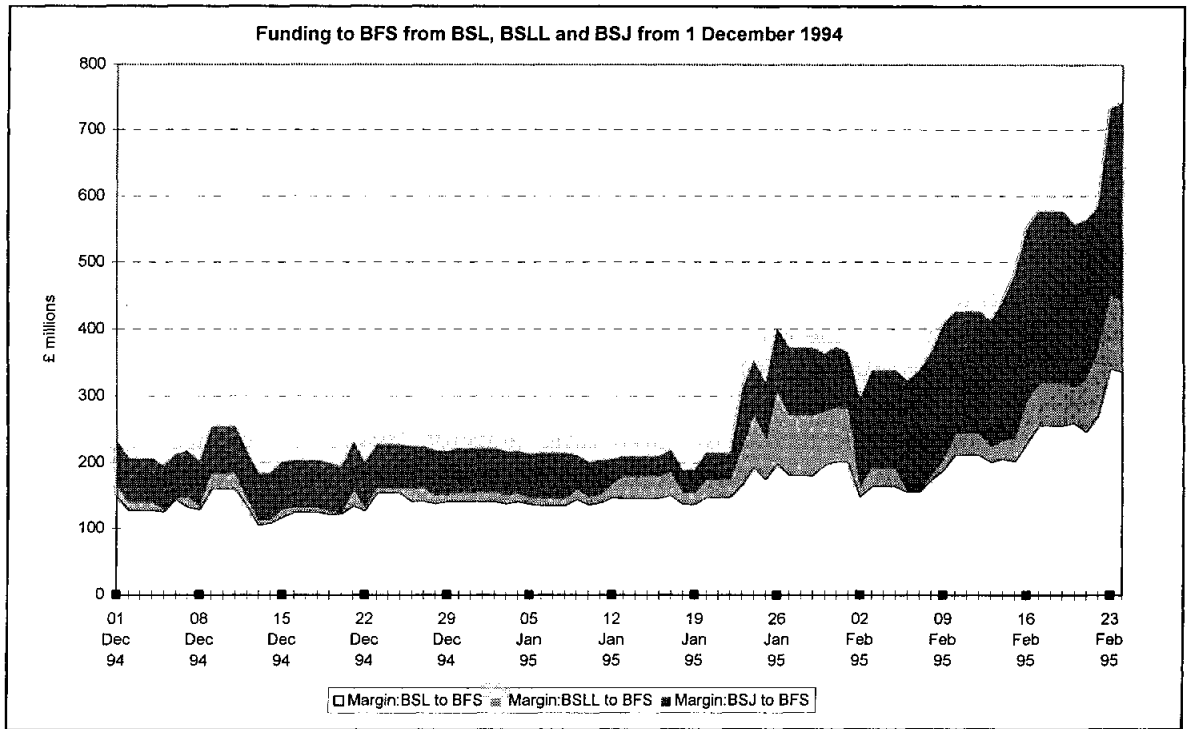
- 6.18 All trades for third party clients of Barings in London were recorded in BSL's accounting records. The margin funding requirements for these clients positions on SIMEX were initially funded by BSL, who would then reclaim these funds from its clients. As described below, BSL funded a great deal more than this.

The build-up of funds provided to BFS

- 6.19 The chart in Figure 6.3 illustrates the build-up of funding provided to BFS by BSL, BSLL and BSJ over the period 1 December 1994 to 24 February 1995.

6. Funding of BFS

Figure: 6.3



Source: Inquiry team based on analysis prepared by Barings

6.20

The cumulative funding of BFS at three different dates is reproduced in tabular form in Figure 6.4. The accounting treatment of the funding in London is considered in paragraphs 6.62 to 6.80.

Figure: 6.4

| Company | Cumulative funding of BFS | | |
|---------|---------------------------|-------------------------|-------------------------|
| | 7 Jan 94 £ millions | 31 Dec 94 £ millions | 24 Feb 95 £ millions |
| BSLL | 7 | 13 | 105 |
| BSL | 33 | 142 | 337 |
| BSJ | (1) | 66 | 300 |
| Total | <u>39</u> | <u>221</u> | <u>742</u> |

Source: Inquiry team based on analysis prepared by Barings

6.21

The funding was high at 31 December 1994 and increased dramatically over the first two months of 1995, by some £521 million to £742 million. At 24 February 1995 this funding represented over twice the reported capital of the Barings Group.

Control over the total funding of BFS's trading activities

6.22

The responsibility for arranging the funding of BSLL and BSL and monitoring the Group position including BSJ was largely that of BIB Group Treasury. Tony Hawes

6. Funding of BFS

told us that one of his duties was to: “fund the businesses of IBG [now renamed BIB]”. He added that: “The largest cash demand by far came from the structured products part of the Financial Products Group”. Ron Baker managed FPG, which included the trading activities in BFS. Tony Hawes went on to say that: “There were three books within the Structured Products Group that were cash hungry: the volatility book, the index arbitrage book and the SIMEX switching activity”. (SPG is described in paragraph 2.46.)

- 6.23 We have been told that BIB attempted to control the overall level of funding for BFS’s trading. Broadhurst explained: “There was initially a funding limit for those businesses, the Ron Baker businesses, of US\$400 million, however [the funding limit] with specific ALCO permission [was] up to US\$600 million”.
- 6.24 Hopkins told us that the ‘switching’ activity: “was not structured against a pre-set [funding] limit but subject to daily review”. He went on to tell us that this review would have considered the ‘Daily Global Large Exposure Report’ (paragraph 11.42) which purported to show the house positions against such exchanges but not exposures relating to client positions.
- 6.25 Tony Hawes said that it was possible to set funding limits for each of the three books described above, but that: “It would seem more sensible to be aware of the overall [funding] constraint and let the Structured Products Group choose how ... to use the scarce resource between their three cash hungry businesses”. He added: “It was not necessarily a hard [funding] limit because there were ways of rebooking business ... to make better use of the funding available”.
- 6.26 We understand that the relationship between Tony Hawes, who arranged the funding, and Ron Baker and Walz, who were seeking the funding, was not good. Norris stated that: “That was a bad relationship ... [and] ... a very important [one]”.
- 6.27 Walz appears to have had a great deal of contact with Tony Hawes. She recalls that when trying to get funding: “The best way to sum it up is to say it was always a painful process”. She told us that she would like to have been able to say: “At the end of the day I have US\$100 million of equity. Fund it. Bang. That is it”. She added: “It was not like that”. Tony Hawes recalls that: “They [Ron Baker and Walz] were quite demanding in what they expected from Treasury”. Ron Baker told us that he never needed to apply pressure to Tony Hawes to ensure funding was made available to meet margin calls as Walz dealt closely with Tony Hawes: “I never personally discussed it with Tony. Mary and Tony had a dialogue on Treasury requirements of the business. Mary was aggressive and definitely had an attitude about the way in which treasury was run”. Ron Baker also told us that he did not consider the funding of SPG’s activities was a problem. He told us: “I did not feel that throughout 1994 there was a problem with regard to the funding. The business was making good money on top of its funding costs”.
- 6.28 Through the latter part of 1994 and early 1995 the demands for funding increased. Tony Hawes told us that: “They [Ron Baker and Walz] did not really have to make a case. It was generally accepted that if possible we should put more funding in place. It was something that was accepted by the Asset and Liability Committee”.

6. Funding of BFS

- 6.29 Norris told us that his concern in 1995 in relation to the size of the positions taken by BFS was not the total funding required, but the effect that a volatile market would have and the possibility of: "an intra-day margin call which our available funding in Singapore might not accommodate".
- 6.30 Michael Baring said he was also concerned: "Whether we would make the variation margin on time ... We never specifically talked about the size of the position. People asked, and certainly I asked again in terms of was there a limit on gross contracts; was there a limit on cash? I was informed there was a limit on cash".
- 6.31 Maclean, when discussing the growing need for margin funding in 1995, said: "At the time I was generally aware that it was increasing, yes. There was no particular problem about it, but, yes, it had been increasing".
- 6.32 The minutes of the EXCO meeting on 1 February 1995 recorded that: "The volume of trading by the Structured Products Group on SIMEX and Osaka was exceptionally high last week and earned revenue of £10 million. We are allowing the positions to run off as our cash resources could have been insufficient to deal with immediate funding requirements".
- 6.33 Ron Baker told us: "I am not walking away from the fact that I knew that there were margin calls and I knew that there were hundreds of millions of dollars involved in the margin calls that would be required in January and February [1995]. It was not something that I felt any responsibility for working out the details of".
- 6.34 As we described in paragraph 1.51, one of the reasons for Tony Hawes's visit to Singapore in February 1995 was to arrange higher intra-day overdraft limits to support BFS's increasing requirements.
- 6.35 We do not consider that there was any effective limit placed on the funding of BFS's 'switching' activities.

Specific daily requests for funding

BSJ

- 6.36 Statements were faxed by BFS to BSJ at the end of each day. These statements included details of the day's trades, outstanding positions, realised and unrealised profits, BSJ's equity balance with BFS and requests for additional margin in Yen. BFS statements received in Tokyo were compared by Futures and Options Settlements in BSJ to spreadsheets detailing SIMEX trading. These spreadsheets, prepared by BSJ trading assistants and which constituted BSJ's records of SIMEX trades, were sourced directly from BFS in respect of BSJ's 'switching' account. We understand that BSJ remitted funds to BFS on the basis of the daily statements although no independent recalculation of the margin requirements was made in BSJ, as BSJ did not have the SPAN margining program. Following approval by BSJ Futures and Options Settlements, the fund transfers were executed by the BSJ Cash Management department.

6. Funding of BFS

Barings in London

- 6.37 The requests for funding were received in London from BFS initially by fax and later by cc mail (a computerised electronic mail system linking Barings' offices around the world) before the start of business each morning. These were in respect of the close of business the previous day in Singapore. Two requests were usually received each day, one in respect of Yen funding and one in respect of US Dollar funding. We understand that these requests were sometimes superseded by later requests, either a further cc mail or a telephone conversation.
- 6.38 Railton told us he recalled telling David Hughes and Granger that Leeson: "asks us for a certain amount of money or estimates a certain amount of money and then we find that it is completely different at the end of the day ... We had no other source of information apart from Nick Leeson advising us how much it was".

Yen requests

- 6.39 BSL clients' trades on SIMEX were effected by BFS. The details of these trades were passed onto the London Futures and Options Settlements Department (managed by Granger) by BFS. The details were then downloaded into the First Futures system in London. First Futures is a purchased software package designed to record and monitor futures and options transactions. The package is designed primarily to be used to record agency business but Barings also used the package to record their 'house' trading. The package records and monitors positions and margin balances and can be used to calculate amounts due from clients by way of margin on a daily basis. The package also automatically summarises positions by customer to provide relevant general ledger account balances.
- 6.40 At the end of each day, a report entitled the 'London Gross Report' was produced in Singapore by BFS and was sent to the Futures and Options Settlements Department in London. This report summarised the day's transactions and all movements on open positions held, both proprietary and client.
- 6.41 A Yen funding request was sent from BFS to the London Futures and Options Settlements Department, in accordance with the daily 'London Gross Report'.
- 6.42 The 'London Gross Report' and the associated funding request were reconciled by London settlements staff to the First Futures report produced in London, and the balance paid. The payment authorisation procedure is described in paragraphs 6.55 to 6.61.
- 6.43 The Yen margining requirements consisted of initial and variation margin calls as well as realised profits/losses. These could apparently be reconciled to individual client positions which were identified on the First Futures report produced in London. However, the First Futures report was sourced directly from information provided by BFS in Singapore. Consequently, although the margining requirements for all clients with account numbers accepted by the First Futures system were reconciled in London and funded accordingly, the omission of account '88888' was not identified by a reconciliation process that relied for all its key information on BFS.

6. Funding of BFS

US Dollar requests

- 6.44 The US Dollar requests sent by BFS to BSL were first used on 12 January 1994, although they were not sent regularly until 16 February 1994. We understand that the staff in London were not able to reconcile these requests to any trading records. Initially, the requests for US Dollar funding did not break down the amount between proprietary and client business. Granger described how they would: "just say 'Please pay - in this example - US\$33 million to our customer account'".
- 6.45 In late 1994 the format of these requests changed at the request of Tony Hawes and more detail was provided. David Hughes told us that the US Dollar requests were broken down following a visit he and Tony Hawes made to Singapore in October 1994. He said that: "Tony Hawes was not happy with the way the margin was being called and we needed this split between the house and the client and the breakdown of the actual monies being called and how it had been applied, what it was for". Despite receiving the additional information contained in the breakdown of the funding requests neither Granger (in Futures and Options Settlements) nor Tony Hawes (in Treasury) made any attempt to use it; had they done so they would have discovered it was meaningless.
- 6.46 We described in paragraph 1.56 how Railton discovered in February 1995 that the breakdown of the total US Dollar request was meaningless, and that the BFS clerk knew the total funding requirement for that day and made up the individual figures in the breakdown to add up to the required total. Granger, who had been told of problems by Railton (see paragraph 6.51), had some doubts concerning the breakdown earlier on. On 24 January 1995 she sent a cc mail to David Hughes and Tony Hawes with regard to the payment of a US Dollar funding request. She wrote "Awaiting breakdown from my buddy Nick [Leeson] ... (once they creatively allocate the numbers)". She told us that she had said this because: "Tony and I were trying to pin Nick [Leeson] down on how he actually calculated the numbers". David Hughes told us that he took this message to mean that: "Obviously Brenda [Granger] was expressing her concern that the figures coming out of Singapore were not correct".
- 6.47 Granger (who, according to Gamby, authorised most of these payments from BSL bank accounts - paragraph 6.58) recalled that she spoke to Leeson about these requests and said: "You are asking me for more money than I can collect in; so it is looking as if I have client debtors, which I do not. Nick [Leeson's] basic explanation was, 'Brenda, London is the cash cow. You are funding Singapore.' He told me that BFS had no funding lines, so BFS would have to come to London for the funds". Granger thought that these requests were to enable BFS to fund Barings' house positions, including BSJ. She told us: "It did not matter to me if Treasury was lending money to Singapore to fund Tokyo's business. As a company I am sure that is allowable: it just bothered me the way that the money was flowing, that it should all come through the house". Railton recalls being told by Granger that BSL was funding a Tokyo account.
- 6.48 Tony Hawes confirmed that Granger raised this concern on several occasions, that funds from client bank accounts should not be funding house positions.
- 6.49 From November 1994 the US Dollar funding requests usually split the amount being requested (itself usually a round sum amount) 50:50 between a request for client accounts and that for the house positions. Tony Hawes confirmed that when he

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identified this feature of the requests: "That was one of the main reasons why during February [1995] I paid two visits to Singapore". If the US Dollar funding requests had been in relation to genuine positions taken by clients and house, on any one day we consider it unlikely for the margin requests for these two sets of positions to be identical; as for having the requests split 50:50 most days, this in our view is beyond all possibility. Tony Hawes appears to agree with this view. He told us that: "It was just one of the factors that made me distrust this information ... It was too much of a coincidence. On a number of occasions, almost - but not quite - almost every day, there were equal amounts required from house account and customer account ... Throughout I put it down to poor book-keeping and sloppy treasury management in Baring Futures [BFS]".

- 6.50 David Hughes also told us that the 50:50 split: "was a cause for concern ... we said, this cannot be right". He explained that: "I did not think we could have house positions and client positions running totally in tandem". Granger confirmed that she would have spoken to David Hughes about the split. She added: "We would joke about Singapore, 'Why don't we send somebody's mother [anyone] out there to run the department since Nick [Leeson] is so busy now?'".
- 6.51 Railton was questioning the funding requests in London from late 1994. In a cc mail message dated 28 December 1994 from Railton to Granger, Railton stated in connection with: "some thoughts in the way [BFS] is handling ... US [Dollars]" that there was a problem with the accuracy of the figures. He wrote: "I looked at the figures for the 22 Dec [1994] and 28 Dec [1994] and both the MOS [Mutual Offset] and BNP funding figures were the same, so I went back to the 15th, same again. My point is that I think this is inaccurate, I doubt very much if they were really the same for this period and it's the same for the FCT JGB funding figure". He suggested that Futures and Options Settlements should tell Leeson that: "We want to keep a much tighter grip on the USD figures. We need to be able to justify why [BFS] wants a certain amount of USD on a particular day ... The best case scenario is that Nick [Leeson] is calling for the right USD but is changing the wrong figures on his breakdown spreadsheet, worst case is that its plain rubbish". He also noted that BFS were: "not paying us the USD interest that they earn".
- 6.52 On 3 January 1995 Railton sent a cc mail to Leeson asking: "how you come to the USD funding figure on a daily basis. A lot of the figures do not appear to move very often ... the ideal situation would be for us to reconcile the USD funding figures. I think this would be good generally for us and also for SFA requirements". In the event these problems were only addressed when Railton visited Singapore. Gamby told us that he did not see the funding requests from BFS. In a letter to us Gamby stated that Granger had expressed concerns: "in relation to the flow of information that was coming out of [BFS]". Gamby also stated that he: "ensured that these concerns were effectively addressed" and that this "culminated" in his "sending Tony Railton to Singapore for the purpose of looking at how [BFS] operated with a view to being able to liaise on a daily basis with Brenda Granger to ensure that steps were taken to impact the flow of information from BFS to London."
- 6.53 In summary, BSL was unable to determine how much of the US Dollar funding requests was for margin on client positions, and how much was not. The majority of the funding sent in this way was used to fund the unauthorised trading concealed within account '88888'. Further, the funds were paid away without any independent

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check on their validity and, as discussed later, with no attempt to reconcile the request to any known trading positions.

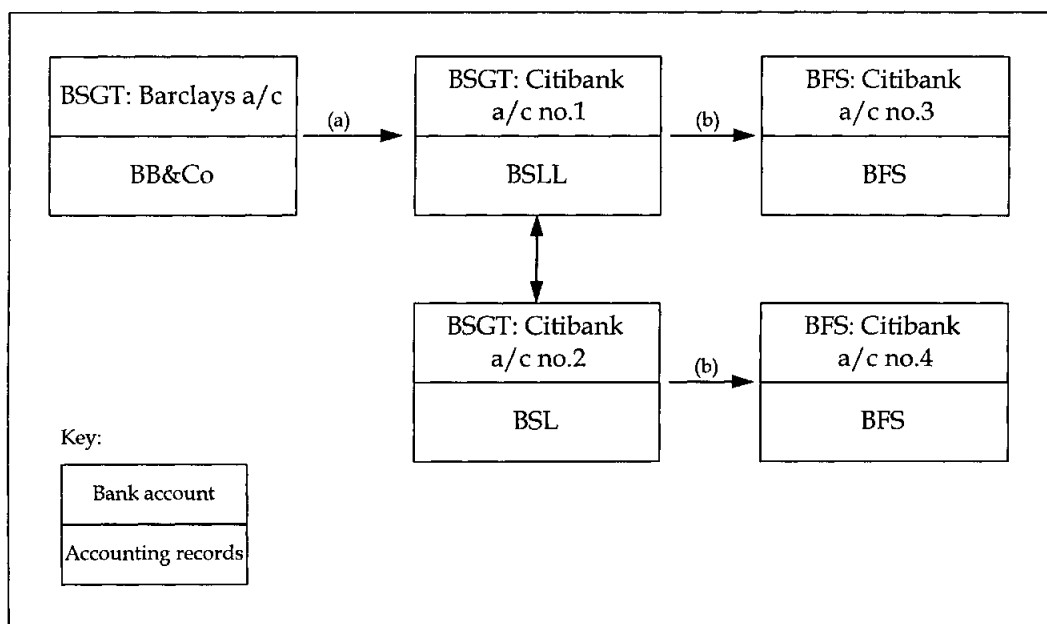
- 6.54 If the Futures and Options Settlements Department in London had used the SPAN margining program (paragraph 3.12) to recalculate the initial margin calls, they would have been able to identify that the amount of margin requested by BFS was significantly in excess of that called for under SIMEX's margining rules. We do not know why this was not done, although Railton told us that unsuccessful attempts were made in late 1994 to apply the system to the data provided by Singapore.

Payment authorisation

- 6.55 The flow of funds from Barings in London occurred in two stages, according to the bank transfers and book entries we have seen. First, funds were paid by BSGT, a branch of BB&Co, into the BSLL bank account and the client portion of the funding was transferred from the BSLL bank account to the BSL bank account. Secondly, funds were transferred from the BSLL and BSL bank accounts into the BFS Citibank accounts (and vice versa). The BSLL and BSL bank accounts were in the name of BSGT, although they only appeared in the accounting records of BSLL and BSL. Therefore for accounting purposes these accounts were considered to have belonged to BSLL and BSL respectively. For clarity, we refer to these accounts as the BSLL and BSL bank accounts.

- 6.56 On the basis of the description in paragraph 6.55, the diagram in Figure 6.5 below illustrates the internal flow of funds from one account to another in respect of US\$ funding.

Figure: 6.5



Source: Inquiry team based on discussions with Barings' personnel

Note (1): a, b - see paragraphs 6.57 to 6.59

Note (2): Bank account numbers 1, 2, 3, 4 are notional numbers for four separate Citibank accounts.

- 6.57 The payments from BSGT to BSLL were made by the SWIFT (Society for Worldwide Interbank Financial Telecommunications) system (payment (a) in Figure 6.5). A

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SWIFT payment advice was prepared by a BSGT clerk. Once prepared the clerk signed the advice and presented it to an 'A' signatory for further authorisation. The normal signatories for these payments were Mr Geoff Clark, BSGT, and David Hughes, both 'A' signatories in BSGT. These payments ensured that BSLL and BSL had sufficient funding to meet the necessary payments to BFS.

- 6.58 The payments made from BSLL and BSL to BFS were also made by SWIFT (payment (b) in Figure 6.5). A clerk prepared the payment advice, signed it as a 'B' signatory and presented it to an 'A' signatory for approval. We understand that Granger usually signed as the 'A' signatory.
- 6.59 We have reviewed a sample of 'A' and 'B' signatures on SWIFT request forms for the (b) transfers in Figure 6.5 for the period 1 December 1994 to 24 February 1995. In the case of 'A' signatories we have not always been able to match the signatures visually to the list of authorised signatories, although Granger told us she recognised them. We understand that Granger, Railton and Mr Trevor Wallace, Futures and Options Settlements Clerk, were removed from the list of authorised signatories following the move to 8 Bishopsgate from 1 America Square during December 1994. The names of Granger and Wallace were reinstated onto the list during February 1995, but Railton's was not. All three of the above acted as 'A' signatories at various times throughout the period reviewed.
- 6.60 There was no specific requirement for higher authorisation by a more senior employee for high value transfers. Barings' Futures and Options Settlements Department authorised the transfers of several hundred million pounds to BFS, which helped to fund BFS's unauthorised trading activities.
- 6.61 Gamby told us that there was no requirement for a higher level of signatory based on amounts transferred. Barnett told us that he was: "not familiar with the funds' movement authorisation procedure within the Group" and that he did not get involved with: "day to day operational issues".

Accounting treatment and the 'K2/P4' balance

- 6.62 It is necessary to explain how these payments were accounted for in the records of BSL and BSLL.

BSLL

- 6.63 Where proprietary trading was undertaken, this was recorded in the books of BSJ or BSLL. In the case of BSLL, requests for margins were received and the monies were paid over to BFS and recorded in BSLL as a decrease in the bank balance with a corresponding increase in the balance on the intercompany account 'Margin with Group Companies', in this case BFS.
- 6.64 The 'Margin with Group Companies' balance at 31 December 1994 in respect of BSLL was £13 million, of which £3 million related to US Dollar funding requests. The 'Margin with Group Companies' balance at 24 February 1995 in respect of BSLL had increased to £105 million, the majority of which (£82 million) related to US Dollar funding requests. These amounts were recorded in a US Dollar house collateral account termed 'BSSHSECOLL'. It would have been difficult to associate this

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US Dollar funding with unauthorised trading without recalculating the actual margin required using the SPAN margining program (paragraph 6.54).

BSL

- 6.65 In cases where BSL identified that it had paid monies in respect of client trading (as in the case of the Yen requests described above), it would call for the margin from its clients. The receipt of those monies would be recorded as an increase in the bank balance offsetting the payment to BFS and as an increase in the amounts received from the clients (recorded in an account called 'Segregated Clients').
- 6.66 In the records of BSL, the payment (b) in Figure 6.5 was recorded as a reduction in BSL's bank balance and an increase in the balance on the intercompany account 'Margins with Group Companies', in this case BFS. Thus these payments increased the amount that was owed to BSL by BFS.
- 6.67 As set out in paragraph 6.44, the US Dollar funding requests were paid out to BFS. However, BSL was unable to allocate these requests to individual clients and only a small proportion was recovered from clients. The balance of £306 million, on 24 February 1995, was not allocated to individual clients. Within the accounting records of BSL this discrepancy would not have been apparent, as the payments out were merely added to the 'Margins with Group Companies' caption in the balance sheet and, in particular, within this caption, the US Dollar segregated cash collateral account termed 'BSINGCOLL' (paragraph 11.81).
- 6.68 Another accounting report, the solo balance sheet, showed as a separate item the difference between the funds transferred to BFS as margin and the monies collected from BSL's clients. This difference, which appeared in the on-balance sheet account 'P4' (client loans) and in the off-balance sheet account 'K2' (loan contra), on the solo balance sheet, was derived from the difference between the general ledger accounts 'Margins with Group Companies' and 'Segregated Client Bank Accounts', and the account 'Segregated Clients'. It was sometimes referred to as the 'top up' account by BSL employees and it is a term we use in this report in this context.
- 6.69 This difference had arisen during the period when the solo balance sheet was being designed at Barings. A minute of a 'Solo Consolidation Working Meeting' on 14 April 1993 recorded that: "The balancing of Fiduciary Funds in BU3 [Agency Derivatives] by the creation of a loan to represent the top up of segregated funds. In order to meet the deadline, in the short term this can be achieved by establishing the loan for the amount required to balance Fiduciary Funds. Longer term the reasons for the imbalance must be explained satisfactorily and corrected". As we now know, this had not been achieved by the time of the collapse. The minute recorded that Broadhurst, Ms Deidre O'Donaghue (Head of BIB and BSL Credit Unit in London), Tony Hawes, Miss Lynn Henderson (Assistant Director in Financial Control), Mr Peter Hynd (Assistant Director, IT) and Mrs Valerie Thomas (Compliance Officer, BIB, and Assistant Director of BB&Co.) were present at the meeting. According to O'Donaghue, the imbalance at this time was between £8 million and £10 million, and was believed to represent timing differences on client business. The solo consolidation steering committee included, amongst others, for BSL: Norris, Broadhurst and Farley; and for BB&Co: Maclean, Hopkins, Tony Hawes, Barnett and Russell.

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- 6.70 As part of the solo consolidation process (described in Sections 11 and 12) a solo balance sheet was produced, detailing individual entity balance sheets for BSL, BSGT and BSL. This was produced in London on a daily basis by the Regulatory Reporting Department. This balance sheet had a limited circulation within Barings and was regarded as a Bank regulatory tool, although it provided funding information for the Treasury Department. Barnett told us that he had never seen this balance sheet, although he was involved in the solo consolidation working group.
- 6.71 Broadhurst (up to February 1994 when the 'top up' balance was £20 million) and Seal saw the solo balance sheet from time to time. The solo balance sheets for BSGT and BSL were consolidated together with BB&Co and Baring Brothers BV (a funding vehicle) on a weekly basis to form a solo consolidation balance sheet known internally as Schedule A. In both Schedule A and the monthly management accounts the 'top up' was not shown separately but was included within the caption 'advances'.
- 6.72 The solo consolidation process combined the financial positions of BSL, BB&Co (including BSGT) and Baring Brothers BV. Prior to solo consolidation, balances between BB&Co and BSL, such as 'top up' funding, were shown explicitly. Maclean commented to us that: "Solo consolidation ... is one of the factors at the heart of this problem, this crisis". This is considered further in paragraphs 11.21 to 11.29.
- 6.73 A key indicator of the problems experienced by Barings was the large amount of funding being provided to BFS, apparently in respect of advance margin on client business. In the daily solo balance sheet this account was visible, if a little confusing in presentation. The accounting treatment was both off balance sheet (loan contra or 'K2') and on balance sheet (client loans or 'P4').
- 6.74 The mismatch between margins placed with BFS and the identified client segregated funds relating to those margins can be calculated from the off balance sheet 'Fiduciary Funds' shown in the daily solo balance sheet, as illustrated in Figure 6.6. It is also shown in a bar chart in paragraph 11.88, Figure 11.5.

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Figure: 6.6

| Solo line reference | Description | 31 Dec 1993 £'000 | 31 Mar 1994 £'000 | 30 Jun 1994 £'000 | 30 Sep 1994 £'000 | 30 Dec 1994 £'000 | 30 Jan 1995 £'000 | 24 Feb 1995 £'000 |
|--|------------------------------|----------------------|----------------------|----------------------|----------------------|----------------------|----------------------|----------------------|
| Z1 | Client Bank Accounts | 57,287 | 28,343 | 58,320 | 41,656 | 83,901 | 36,378 | 22,955 |
| Z3 | Margins with Group Companies | 132,449 | 225,126 | 334,385 | 280,654 | 231,690 | 313,450 | 502,560 |
| Z4 | Margins with Brokers | 16,393 | 26,962 | 12,026 | 7,939 | 8,751 | 7,116 | 2,391 |
| Total Fiduciary Funds (Off Balance sheet assets) | | 206,129 | 280,431 | 404,731 | 330,249 | 324,342 | 356,944 | 527,906 |
| K1 | Segregated Clients | (162,074) | (194,414) | (280,429) | (184,502) | (198,980) | (204,445) | (219,331) |
| K3 | Pending Settlement | (22,337) | (11,252) | (4,008) | (2,154) | (5,322) | (2,144) | (2,266) |
| Total Fiduciary Funds (Off Balance sheet liabilities) | | (184,411) | (205,666) | (284,437) | (186,656) | (204,302) | (206,589) | (221,597) |
| Mismatch (equal to the solo lines K2/P4) | | 21,718 | 74,765 | 120,294 | 143,593 | 120,040 | 150,355 | 306,309 |

Source: Daily solo balance sheet

Note (1): line K2 is described as 'loan contra' (off balance sheet)

Note (2): line P4 is described as 'client loans' (on balance sheet)

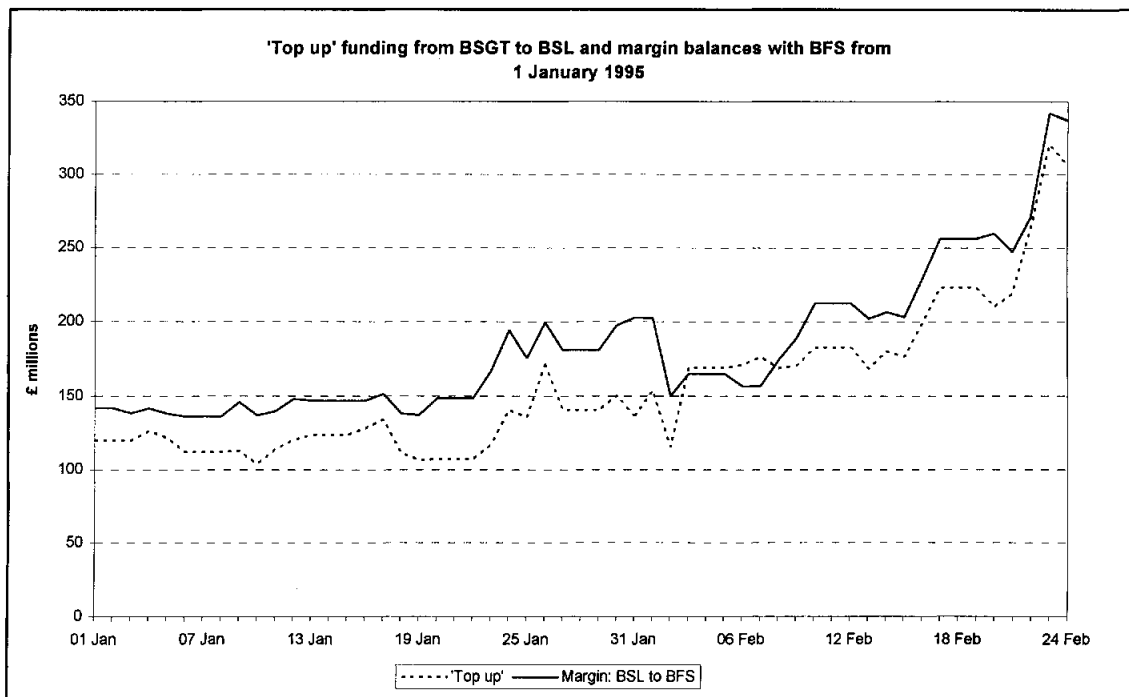
- 6.75 As noted in paragraph 6.71, a weekly solo consolidated balance sheet was prepared ('Schedule A'). The solo line P4 was included in this balance sheet as part of the consolidated advances to clients (less than 7 days), figure, and was, in fact, a material component of the balance. For example, at 30 June 1994 and 30 December 1994, consolidated advances to clients (less than 7 days) were £232 million and £177 million respectively.
- 6.76 The mismatch was believed by management to represent the margin paid to BFS for client business, but which had not been recovered from clients, although some staff were aware that client business represented a much smaller amount. Granger confirmed that she believed that some of this balance was funding 'house' trading by BSJ, and that it was in the wrong category on the solo consolidation balance sheet. This mismatch was not, however, reconciled to individual client balances and Broadhurst acknowledged to us: "I had no idea that they were not being reconciled". He later added that on a daily basis, Granger would have sent a list of known client debtors to BSL Credit and Group Treasury. It was assumed that this would then have been reconciled by one of Futures and Options Settlements, Finance, Credit or Treasury departments against the total client loans. We were told by representatives of each of these departments that this never happened.
- 6.77 Because of this mismatch a journal entry had to be processed to transfer the 'K2' balance into the solo balance sheet, where it was shown as client loans ('P4'). Without this entry the balance sheet would not have balanced. Hereafter, in this report we refer to the 'K2/P4' or 'top up' account.

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6.78 Tony Hawes stated that: "In the course of the agency derivatives business we collected segregated funds from clients and we put margins with Group companies and other exchanges to collateralise the customers' securities [traded futures and options] transactions ... we very often had to put up margin with the Group companies or with exchanges in advance of receiving those funds from customers, or sometimes ... because margin was required today to be repaid tomorrow we did not collect the money from the customers at all ... This method of operating was ... not properly controlled".

6.79 The chart in Figure 6.7 below illustrates the growth of the 'top up' during the period 1 January 1995 to 24 February 1995.

Figure: 6.7



Source: Inquiry team based on analysis prepared by Barings.

6.80 As noted in paragraph 6.77 the 'top up' was shown separately as 'client loans' in the daily solo balance sheet. In the weekly Schedule A balance sheet it was included as part of advances to customers, less than 7 days. It was similarly disclosed in the monthly management accounts. In the annual consolidated statutory accounts 'top up' was not separately identified but was mostly reflected as margins placed with exchanges.

The absence of a key funding reconciliation

6.81 It is apparent that BSL and BB&Co staff did not reconcile to client records this 'top up' balance. Any reconciliation would have been impossible without knowledge of the transactions in account '88888'. Granger confirmed that she was not able to do it. She added: "I did not look at this as a reconciliation problem for myself. All the reconciliations that we do are done daily. I reconciled the total amount of cash I had on deposit there, and that reconciled to the amount of cash I had sent down there".

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She added that the total amount of cash on deposit was reconciled to BFS broker statements.

- 6.82 We asked Railton if it was oversimplifying matters to say that if Singapore requested money it was paid. He told us: "On the dollars, if they requested the funds, then we paid them, yes".
- 6.83 Gamby said that he was aware that the Financial Control Department performed a reconciliation of the intercompany balances in the books between BFS and BSL. This only ensured that both sets of books reflected the monies going from London to Singapore. They were not reconciled to the underlying transactions. Gamby told us that in January 1995 Granger told him about 'top up' as: "something that was like an intra-day margin call from the Exchange". Gamby told us he received assurances at the time that Granger was in regular contact with Tony Hawes regarding the funding "that was going down there". He accepted however that it is now clear that: "we were not in a position in London to actually check the validity of the sums in total being requested, because we had missing bits of information and [were] incapable of undertaking the actual SPAN margining routines in any case in London". Gamby said he had no direct conversation with Tony Hawes regarding it.
- 6.84 Tony Hawes claims to have known that this reconciliation was not being done from some time in 1993 and for the whole of 1994. He claims to have talked to Bowser (who at the time of the collapse was Risk Manager in Hong Kong, but who was then in the Futures and Options Settlements Department in London) in the second half of 1993 and in 1994. Tony Hawes told us that in his opinion the responsibility: "ought to have been [with] Futures and Options Settlements. I think it very likely that no specific arrangements were made for anybody to reconcile it".
- 6.85 Tony Hawes told us that: "We were also financing the advance margin calls and things like the [Eurodollar contract] MOS [mutual offset business] which we did not see in London. We just accepted his [Leeson's] word that the figures required ran into millions. Yes, we just about accepted what he said". Tony Hawes also noted: "The weakness was that the money ostensibly sent down for the client was not being tied down to a particular client. That was a fundamental weakness".
- 6.86 Hopkins told us that responsibility for the reconciliation was: "very unclear. You could say that it was a finance function responsibility; you could say that it was a Futures and Options Settlements responsibility; you could say it was a Treasury responsibility. I think it was probably the responsibility of all three, but this is certainly something that we wanted to resolve".
- 6.87 Barnett told us that in his opinion the: "responsibility for reconciliation lay ... I would have expected it to have been in Singapore rather than in London. As between the treasury desk and the settlements desk in London, I do not have a view as to ... It is clear that one of them should have been doing it and the other clearly need not have done it". As we now know, it was not done. Tuckey also told us that he would have expected the reconciliation to be performed.
- 6.88 Tony Hawes briefed James Baker in a meeting prior to James Baker's July/August 1994 internal audit visit to BFS. The note produced by James Baker, the accuracy of which was confirmed to us by Tony Hawes, recording the meeting includes the following

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comment: "One specific concern in the futures area is the level of margin calls paid by BSL London without knowing precisely on whose behalf the cash is being paid ... Tony [Hawes] simply receives a request for US\$ to make up the shortfall and has to satisfy the demand at very short notice, sometimes even during SIMEX trading hours. The request is in a lump sum form and the payment is debited to a 'Loans to Customers' account. Tony [Hawes] would at least like to know how much of the payment is for house positions and how much for customers". James Baker told us that: "[Tony Hawes] had really just explained to me a little tip of the iceberg and given me the day-to-day shortages that occur ... I was as surprised to learn as anyone else about accumulated balances that had lasted for weeks, months, a year, without being addressed".

- 6.89 Gamby told us that the reconciliation was not done because: "There is information on here [the cc mail funding request from Singapore] that London would not be able to verify ... Anything that relates to advance margin; anything that relates to BNP [Japan] being the local client; anything that relates to FCT funding, which was the Tokyo client". He admitted that: "Nothing happened to the difference, basically [between the amount he knew was for London customers and the total amount paid over]".
- 6.90 In a letter to us Hopkins stated that: "[I] was extremely concerned to learn, upon taking up [my] post in September 1994, of the unreconciled balances. [I] was not prepared to permit the unreconciled balances to remain unresolved, as had apparently been the case for some very considerable time before [my] appointment".
- 6.91 Hopkins told us that he recalls Tony Hawes telling him that: "Despite a number of attempts we were not able to reconcile the amount of funding we were putting up". Hopkins agreed that BSL funded calls coming from Singapore for margin advances without anyone in London knowing precisely what they were in respect of.
- 6.92 Figure 6.7 shows that at 24 February 1995 of the total funding to BFS of some £337 million only £31 million had been recovered from individual BSL clients (represented by the difference between total margin and 'top up'). The balance or 'top up' of some £306 million, was perceived by some in BSL to be 'owed by clients'. Review of the chart indicates that from 1 January 1995 to 24 February 1995 the proportion of genuine client monies which were transferred to BFS fell as a proportion of the total funding. There is no clear explanation as to why Barings' management did not question why BSL should be apparently lending over £300 million to its clients to trade on SIMEX, when it had only collected some £31 million from clients for those trades.
- 6.93 The principal reason for the excessive funding was the need to finance the equity balance and initial margin requirement relating to account '88888'. Up to January 1995 the margin calls on account '88888' were met with funds provided by BSL (the 'top up'), funds provided by BSLL, and with BSJ's apparent excess margin at SIMEX. Later, when the SIMEX margin calls on account '88888' increased substantially and it was difficult to finance by this method alone, BFS created artificial end of day transactions to net down the balance between account '88888' and the SIMEX 'switching' account '92000' (Section 5), thereby reducing the margin calls from SIMEX.
- 6.94 It was not until Railton went to Singapore in February 1995 that a proper investigation into the funding of margins was conducted leading, as we describe in paragraphs 1.51

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to 1.60, to the discovery of the unauthorised funding, some eight months after Tony Hawes expressed his concerns to James Baker.

- 6.95 The failure to reconcile the 'top up' account allowed BFS to continue requesting, and receiving, US Dollar funding from without serious challenge. In our view, a methodical and determined attempt to perform this task in 1994 would most likely have revealed the meaningless breakdown of the US Dollar requests and caused management to question the whole rationale for the requests. This failure highlights what Tony Hawes has previously referred to as a "fundamental weakness" in Barings' credit control procedures. These are described in paragraphs 6.96 to 6.112.

Credit risk on client margins

- 6.96 Barings was exposed to the risk of financial loss through the failure of its counterparties or customers to meet their obligations. BB&Co's exposures were monitored by the Credit Committee, assisted by BB&Co's Credit Unit. In early 1994 BSL's exposures were monitored by BSL's Risk Committee and when that committee ceased to exist in mid-1994, Russell told us that: "The primary focus for counter-party credit and issue of risk was that committee [the Credit Committee]".
- 6.97 The credit aspects of the 'top up' balance were never formally reviewed or ever considered by the Credit Committee. If the Credit Committee had considered the implications of the 'top up' account during 1994, and had asked to review the creditworthiness of the constituent parts of that balance, the impossibility of the task might have initiated more rigorous attempts to reconcile or even understand the balance. In any event the 'top up' problem would have been brought to the attention of more senior management in Barings, including Maclean.
- 6.98 There is general agreement that it was the responsibility of BSL's Credit Unit to bring the credit implications of the 'top up' to the Credit Committee although the Credit Committee did not use the information available to it in the weekly and monthly balance sheets to identify significant items for review.
- 6.99 In December 1993 O'Donaghue was appointed head of BSL's Credit Unit and initially she reported to Tony Hawes. She told us that she: "was very much involved in setting up or re-establishing the London credit". She also told us that she had no previous credit experience nor had any detailed job specification or written terms of reference. In July 1994 Blyth joined IBG to: "head up the part [of IBG] looking at counterparty risk across the whole of the Investment Bank's sphere of activities", from when O'Donaghue reported to Blyth. He told us that the: "mandate which was given to me was to try and bring the best of banking, tight credit controls, into Barings Securities' activities".
- 6.100 Blyth had two reporting lines. The first was initially to Tony Hawes and then from August 1994 to Hopkins, the newly appointed head of GTR. The second was to Russell, who on 23 August 1994 was announced, in an internal memorandum from Norris, as becoming head of BIB credit, taking up the position (at the latest) on 1 January 1995. Blyth admitted that this structure was not perfect, but thought that the matter was going to be clarified on BIB's proposed move to a single building, which had not occurred by the time of the collapse. Blyth told us that he reported to Tony Hawes: "on a day-to-day basis, but my main line of reporting on credit matters was to

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Johnnie Russell and on to the Credit Committee". On Hopkins' appointment in August 1994, Blyth told us that he discussed with Hopkins: "the structure of the team, any individual credit problem that had arisen ... I do not remember a substantial amount of discussions with him".

- 6.101 Hopkins recalled that: "Iain's [Blyth] direct reporting relationship [from September 1994] was to Tony Hawes, who reported to me. He, as I say, also had the relationship with Johnnie Russell, becoming rapidly established through that time ... I suppose the best way to describe it was that it was unclear where the primary relationship, reporting line, actually went". He added: "Johnnie [Russell] became very much the controller of Iain Blyth in terms of what he was doing ... through November, December [1994] and January [1995]". Russell confirmed that he became gradually more involved in BSL's credit issues from 1992. When Russell was asked the date from which credit was managed centrally and he became the Head of Credit he said: "I do not think I would agree with that in the sense that the management of credit in Barings Securities was from a date, but I cannot remember when exactly". Subsequently he wrote to us and stated: "At no stage did Credit operations [Blyth] report to me".
- 6.102 There was general agreement that BSL credit procedures were weaker than those of BB&Co. In a memorandum to Norris dated 4 November 1994 Hopkins referred to the poor quality of the credit function and wrote: "Our efforts on credit are more form than substance. Deidre [O'Donaghue] and her group, although very energetic and well-intentioned, struggle due to inexperience. Iain Blyth has yet to establish his credentials". We asked Blyth whether he was being provided with the information that would enable him to fulfil the job for which he was appointed. His response was: "No. I think there were shortcomings in the systems generally ... There was a need for better quality management information in my view".
- 6.103 Maclean, who was chairman of the Credit Committee, wrote to us and stated: "I had discussed with Mr Russell (head of credit in Baring Brothers) the need to put [Baring Securities'] credit policies on to a basis consistent with those of [Baring Brothers] but it was clear to us both that this would only be possible over a considerable period of time. We were well short of that at the time of the collapse". Russell told us that: "We were looking to bring the credit standards of that organisation [Baring Securities] up to those of the bank". He added that: "It was not until ALCO came into being, which was in the latter part of last year [1994], when the Credit Committee began to focus much more on the credit issues which arose in Baring Securities. They were not really very satisfactory discussions because, as I say, the credit culture in that organisation was very different from [BB&Co]".
- 6.104 Credit risk on trading is the exposure which results from a counterparty failing to settle a trade as agreed. Although the Credit Units did not differentiate between the risk on agency and proprietary business, credit risk on agency trading can be mitigated if client funds are used throughout the process although it would arise if margin is paid to an exchange before it is received from a customer. The Credit Units' responsibility was to monitor all counterparties and customers to ensure credit risks were controlled and to inspect all counterparties for evidence of money laundering.
- 6.105 Granger told us that Futures and Options Settlements would verify that they had sufficient client margin on deposit on a daily basis. The 'Margin Excess Limits' report listed only those customers whose overdue margins exceeded their limits at the end of

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the previous day, but did not include the total of all margin advances. The Credit Unit reviewed this throughout the period in question but saw only those balances where limits had been exceeded. No problem with the BFS agency business was identified by the review.

- 6.106 However, this review did not address the apparent advance margins paid by BSL to BFS which management believed to have been made on behalf of clients. These amounts were included in 'advances' in the weekly solo consolidation balance sheets.
- 6.107 The BSL Credit Unit did not routinely receive a copy of the solo consolidation balance sheet and Blyth and O'Donaghue told us they were unaware of the growth of the 'K2/P4' balance in 1994 and in January and February 1995.
- 6.108 We asked Granger whether anyone from Credit in London ever asked her about the 'K2' account. Granger noted that: "Credit had asked me this before as well as the accounting people. I explained this. They would look at our debtors report and it would very clearly not equal up to the amount that we had down there. I would explain, 'well we have given a loan down to Baring Futures (Singapore)'" . Granger told us she spoke to O'Donaghue on this matter and "very seldomly" to Blyth.
- 6.109 O'Donaghue told us that she thought that the: "classification of 'client loans' was always incorrect because, again, it was the timing, so it was not a loan in the short term. Timing was the understanding that we had at the time [1993]". She went on to say: "Baring Securities is not in the business of funding any clients other than one client, which was FCT, so there would be no reason to have 'client loans' in the balance sheet".
- 6.110 The usual credit control procedures were designed only to monitor individual counterparty limits, not the overall advance margin position. We have not been provided with any explanation as to the lack of credit approval for the advance margins sent from BSL to BFS.
- 6.111 We asked Russell about the credit approval process for those advances. He stated: "To my certain knowledge, those advances escaped the credit process altogether. They were not identified ... as loans to clients". As a result, he explained that they were not picked up as credit exposures. We asked who should have been responsible for identifying that and he replied: "I think it should be the Accounts Department. As we now know, it represents unreconciled balances in respect of money remitted to Singapore, so clearly the Treasury must have known what was going on there ... I think the fault probably lies in the way in which the solo system was configured, in the sense of there not being any system to capture the individual loans within that account and include them in our exception reporting".
- 6.112 We consider the purported receivable from SLK at 31 December 1994 in Section 7. No assessment was made of the credit implications resulting from the SLK year end receivable once management believed that payment had been received. Russell told us he was not aware of the SLK receivable and that it "probably should have been" brought to the attention of the Credit Committee.

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Conflicting management policy in respect of financing client margin

- 6.113 We asked Maclean about the monies advanced to BFS and whether he would have expected to have seen credit approval for the clients if the assumption was that the funding to BFS was made for clients.
- 6.114 Maclean said: "Baring Securities had a general approval to finance client margin until it could be collected as quickly as possible from the client. In other words, they could not leave it outstanding for as long as the trade was outstanding, but because SIMEX makes its claim intra-day or pronto - makes it either at the end of the day or before it could conceivably be collected from the client - then they were allowed to put it up. Baring Securities' financing mechanism was allowed to put the money up and collect from the client immediately. That was understood. That was a general understanding, that they could finance that".
- 6.115 We asked: "So they had a free rein on that one without any limit per se?"
- 6.116 Maclean replied: "As long as they could collect overnight, yes. As long as they could collect as quickly as possible. I would have to say that once the two businesses had been fully merged and brought together, and the credit process had been fully merged, we would not be happy with that. No, we would not have allowed that in the bank [BB&Co], but this is how it had worked for years and we were told to keep the business going. You had to allow them to do that. We certainly would not do that in the bank [BB&Co]".
- 6.117 He went on to explain that: "Our assumption was that they were very, very small amounts and very widespread amongst some good clients of long standing of Baring Securities. It was not something that we thought about. It did not seem to me to be a major issue".
- 6.118 We asked Norris whether: "short term - or long term even - funding of client margin positions was not something that went through the Credit Committee". When we mentioned Maclean's comments in paragraph 6.114, Norris replied: "That is simply not true. The whole rationale for the solo consolidation exercise was to bring all of these financial exposures and the prudential management to the balance sheet into one place".
- 6.119 He went on to say that: "There was no remit within the Barings world for the agency equity broking side to advance the bank's [BB&Co] funds to customers".
- 6.120 We asked Russell whether there was any general permission or credit approval for Baring Securities to advance money to customers in respect of margins. He stated: "No. There was no consent for them to do that". He explained that there was a specific case, FCT, where facilities were put in place but: "To my memory, that was the only occasion on which that happened".
- 6.121 Walz told us: "I had a view about the level of intensity of operational credit at Baring Securities, which was that it was pretty average and they were struggling".

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Allocation of funding cost

- 6.122 Allocation of the costs of funding appears to have been the subject of some attention in Barings but did not result in management identifying the house positions in account '88888'.
- 6.123 Tony Hawes told us: "I think the chronological order [in respect of allocating funding costs] ... was the run-up to the bonus calculations. The Structured Products Group were questioning the amount of funding they were being charged. It was really something between them and Financial Control but I got involved, I would perhaps describe it, as a referee ... I passed most of the comments that I got from the Structured Products Group through to David Crookston, Financial Controller, but I did talk to Geoff Broadhurst about the way the funding was calculated and said could it be due to this unexplained top up balance and the cost of funding that".
- 6.124 He told us that he briefed Jeremy Stunt (Barings Financial Control) about a two phase project to: "solve the immediate problem of coming up with a funding calculation that everybody would buy into, but, secondly, to investigate exactly what this excess funding was ... The agency derivatives team, who at this stage were separate from the Financial Products Group, were also unhappy with the amount of funding credit they received for the funds that their clients deposit with Baring Securities as margin".
- 6.125 Broadhurst recalled that in September 1993 during the annual bonus calculations Tony Hawes raised the fact that the internal funding of £3 million charged by Barings London to the exchange traded futures and options client activities might be overstated. Stunt reported back to Broadhurst within a few weeks that it had been explained by Leeson (apparently to Stunt's satisfaction) that the £3 million internal funding charged by London was offset by £3 million credited to the exchange traded futures and options client activity by Singapore and that no misallocation existed. Accordingly, Broadhurst considered that this issue was "resolved".
- 6.126 In a letter to us, Broadhurst stated: "I was also aware that Ms Walz had asked Mr David Crookston to check that the internal funding charged in the management accounts to Equity Financial Products was correctly stated. Mr Crookston delegated much of the detailed work on this to Mr Stunt. The main emphasis of this investigation revolved around the Japanese cash futures arbitrage and Hong Kong derivatives businesses and not Mr Leeson's inter-exchange arbitrage ('switching') business. Mr Crookston was managing the project and regularly gave me an overview of progress. He communicated to me on completion of the exercise that the numbers included in the management accounts did not require material adjustment. In addition Ms Walz expressed satisfaction to me as to the way in which the investigation had been carried out in such a way that my understanding was that it had been concluded to everyone's satisfaction".
- 6.127 Tony Hawes did not share Broadhurst's view that the funding cost issue had been resolved. He told us that early in 1995 the project had stalled after the first stage and that it was: "something I would have to do myself within Treasury". He considered that for most of 1994 Treasury: "did not have the resources to undertake such a project". He added: "By the start of 1995 I felt we did have the resources to look fully at what was going on with margin generally, and specifically with margin in Singapore, and it was a project I started".

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- 6.128 The specification of what he termed the 'Singapore Project', described later in paragraph 7.32, was outlined by Tony Hawes in a note to Hopkins dated 11 January 1995 as follows: "The project is to investigate the way in which margin is provided to, and used by [BFS]. Both Agency and House margin should be addressed". The project included the identification of the causes of the very large and consistent requirement for funding from London under the heading "Loans to Futures and Options Customers".
- 6.129 Tony Hawes sent the project specification to Bax for him to consider with the intention that it would be discussed jointly with the nominated project manager who decided to leave Barings before it started.
- 6.130 Tony Hawes told us: "James Bax gave this project to Nick Leeson and Simon Jones to have a look at, and promised us a response by the end of the month [January 1995] which did arrive but I thought it was a pretty worthless document ... I think you have to put it against the background that I expected this project to be addressed in the form of a three or four week project by somebody independent, dedicated to it. The fact that it was answered in a three and-a-half page memo by the two people I really wanted the enquiry to be independent of made it fairly worthless, as far as I was concerned".

Data sent to London

- 6.131 We described in paragraph 5.3 how Leeson arranged for details of account '88888' to be suppressed from all reports, except for the margin files that were sent to London. We found that information on account '88888' was, in fact, received in London as part of the daily transfer of those files via cc mail from BFS but that this information did not alert Barings to the unauthorised trading.
- 6.132 Prior to accepting data on a particular account, the First Futures system in BSL determined whether it recognised the account number by reference to a master file which contained a list of known account numbers. It appears that if the account number was not on the master file, the data were not entered into the First Futures ledger. If the account was recognised, the information was downloaded, and was used, for example, to call for margin from a BSL customer. Account '88888' was not on the master file. Therefore, information sent to BSL in relation to account '88888' was not downloaded into the First Futures system.
- 6.133 The information relating to accounts which were not loaded into the First Futures system was left in a suspense file, and no effective investigation of such items appears to have been carried out. Although reports were produced to indicate whether margin data had been downloaded to First Futures successfully, these did not detail all accounts skipped during the download because the account number was invalid. Farley explained this to us in a letter: "There are two 'margin processing' screens available to users of the First Futures system. The first screen listed all the margin balances loaded from the CONTAC system in Singapore. The second screen listed the accounts recognised by First Futures as being valid London accounts, for which the margin balances were loaded into the First Futures database. A comparison of the two screens would indicate those accounts rejected by First Futures as being not relevant". In addition, we noted there were no system based reconciliations or control totals to ensure that all data records received in London were processed (or deleted/posted to a suspense code).

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- 6.134 Gamby told us: "If it could not actually find a relevant client in the First Futures system, then in effect it would be held in suspense waiting allocation ... That [the responsibility for clearing out the suspense] would have been the responsibility of the settlements area in London, i.e. Brenda Granger's area".
- 6.135 Granger told us that she "never saw" account '88888'. We asked her whether it had come across on one of the downloads of the file. She said: "It did. I found that out in retrospect, that it was in the margin file ... I do not know how long it has been there ... There is a bunch of other accounts in there that do not belong to Barings (London)". She told us there was never any effort to print off all of the accounts from BFS and reconcile the total amounts. She stated it was not the responsibility of her department to review the accounts which were not loaded into the First Futures system. She added: "In hindsight if we had looked at this, we probably could have questioned something". It appears that the margin file was used by Futures and Options Settlements, for example when reviewing FCT's balance, but that account '88888' was not investigated.
- 6.136 The margin file could be viewed on a computer screen showing account numbers and balances in Yen. Review by us of the items held in suspense in London revealed that at 1 February 1995 account '88888' was recorded as having a balance of ¥48.2 billion (£320 million). This is a material amount, as would be expected given the balance (or loss) on BFS's account '88888', as may be seen in Figure 4.2.
- 6.137 On 21 February 1995 Hassan sent to Futures and Options Settlements in London by cc mail a list of account numbers, including account '88888', with amounts in Yen, presumed to be margins. It is not clear what was done with this information, although it was only received in the week leading up to the collapse.
- 6.138 The absence of any systematic analysis of items in suspense or the lack of effective exception reporting helped ensure that account '88888' was not identified and investigated by Barings' London staff.

Funding to BFS

- 6.139 In Section 4 the unauthorised trading activity is described based on an analysis of account '88888' and available SIMEX statements. We have not had access to BFS accounting records and we are therefore unable to reconcile the cash sent to BFS against the margins placed at SIMEX by BFS.
- 6.140 The funding from BSL was thought by management to represent advances to clients although, in fact, it was for unauthorised house positions at SIMEX. Almost all of the funding described as advances to clients in BSL was used to fund the unauthorised trading in BFS. The majority of funding from BSL was considered to be in respect of reported proprietary positions although only a proportion may have been required to support reported positions. It appears that funds remitted by BSJ to BFS were in respect of reported positions. However, due to the apparent profitability of the reported positions, BSJ understood that excess margins returned by SIMEX to BFS were not similarly returned to BSJ. There was no apparent attempt by Barings in London or Tokyo to consider the Group's overall funding of BFS in respect of known positions on SIMEX. Finally, in Section 5 we have described how non-market

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transactions were booked to account '88888' and account '92000' which enabled the funding requirement to be reduced.

- 6.141 The funding provided to BFS by BSL, BSLI and BSJ was extremely high. The funds were transferred, at least in part, on the basis of unsupported requests from BFS for which there was no reconciliation to underlying records. The failure to investigate thoroughly these transfers of funds played a major part in the collapse of Barings.

7. INTERNAL CONTROLS

Introduction

- 7.1 A material failure in the management, financial and operating controls of Barings enabled massive unauthorised positions on exchanges to be established without detection until 24 February 1995, by which time it was too late to save Barings plc from administration.
- 7.2 These control failings were in the Singapore, London and Tokyo offices of Barings and ranged from the failure of high level Group management controls at the BIB level, through several organisational units and business functions, to day-to-day operating controls, such as those over the disbursement of funds. In this report, we have commented on the details of these failures in controls in the section where the underlying organisational unit or business function is covered. In this section, we summarise the failures in controls and include cross references to the sections and paragraphs where these failings are covered in detail.
- 7.3 We have described in paragraph 2.33 the important role of MANCO and ALCO in the management control of BIB. During the period 24 January to 23 February 1995, ALCO in particular had frequent discussions about several issues related to the 'switching' business. The second part of this section (paragraphs 7.29 to 7.53) describes those discussions and the degree of management concern that was emerging during late January and February 1995. We also describe within this section the purported receivable from SLK (paragraphs 7.54 to 7.99) and the market concerns that became known to Barings during that period (paragraphs 7.100 to 7.118). Throughout this section we refer to MANCO and ALCO and occasionally to 'management' collectively. Specific criticism of individual members of these committees is reserved to Section 13.
- 7.4 Dare told us that he believed that Barings' controls and systems reflected Barings' basic philosophy of conservatism. He said: "I always assumed - I had no reason to doubt - that our controls were in good shape and reflected management's desire to run a very tight ship". However in respect of BSL he continued: "they [BSL] were usually in a bit of a catching-up position because their business had gone through a few periods of quite rapid growth, when it is challenging, to say the least, to keep your controls on top of a business that is growing rapidly. There were times when I was aware that this was a strain; that the front office were marching faster than the back office".
- 7.5 Following well publicised losses at Kidder Peabody, a US investment bank, in early 1994, an internal review of the risk controls in BB&Co and BSL was commissioned by the Board. The results of that review were presented to the Board in June 1994 by Hopkins, for BB&Co, and Katz, for BSL. The minutes of that Board meeting stated that: "It is not possible to confirm that our controls are typical of other dealing operations ... Collusion is the most serious threat to our control system. We are however protected by a strong and independent back office. It is impossible to tell whether the Kidder Peabody episode could take place here". In respect of BSL's risk management system the Board noted: "[BSL] have to deal with a trading business that operates in five main locations and a primary objective is to introduce systems which will enable all positions to be accessible from all locations. Such a system is in the

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process of being developed". The minutes do not record whether any specific action was requested or taken by the Board following the findings of this review, nor do they record whether the matter was ever referred to again by the Board.

- 7.6 Hopkins was concerned by the increasing significance and complexity of the trading business. In a memorandum to Norris dated 25 November 1994 he wrote: "it is becoming very clear that our systems and control culture are distinctly flaky".

FAILURES IN INTERNAL CONTROLS

Absence of management supervision over Leeson's activities

- 7.7 The internal control environment in the years and months leading up to the collapse was in a state of considerable change as Barings Group management tried to combine the entrepreneurial, and somewhat loosely managed business of BSL with the relatively conservative, tightly managed business of BB&Co.
- 7.8 From 1992 to 1994 there were a number of reorganisations and the evidence given to us indicates that reporting lines were not always clear in the minds of individual managers, although Norris maintains: "There was absolutely no ambiguity in the reporting lines" (paragraphs 2.23 and 2.26).
- 7.9 The lack of clear understanding appears most pronounced in respect of the management control of BFS and the activities of Leeson. The consequent lack of management supervision had a grave impact on Barings. No one in management accepts responsibility for Leeson's activities between October 1993 and 1 January 1995, from which date Ron Baker acknowledges that he was responsible (paragraph 2.27).
- 7.10 The lack of clarity in Leeson's reporting lines stems from two aspects of the matrix structure introduced by Norris, with the approval of Tuckey, in late 1992. First, Leeson performed two types of activities for Barings: managing the proprietary 'switching' business that was booked in the accounts of BSJ and BSLL; and executing trades on SIMEX on behalf of both Barings companies and third party customers. Ron Baker acknowledged that when he took on management responsibility for the equity derivatives business at 1 January 1994, he assumed responsibility for the revenue and profit of Leeson's 'switching' business, but said that in a product sense Leeson reported to Killian as Head of Global Futures and Options Sales. However, Killian told us: "I do not believe that Nick [Leeson] ever thought I was his boss".
- 7.11 Secondly, under the matrix structure, the integrity of each local office operation was intended to be preserved by local office management. Bax was the Head of the Singapore office and of the Asia region and was also chairman of the Asian Management Committee. Norris thought Bax was one of his strongest managers. Jones was Regional Operations Manager for South East Asia, and was also a member of the Asian Management Committee. However, BFS was not included on the agenda of the Asian Management Committee. Mr Jeremy Palmer, Head of BSHK and Director of BSL, cannot recall BFS ever being mentioned at the Asian Management Committee. It appears that Bax and Jones were preoccupied with the Baring Securities businesses in Asia and South East Asia in particular. Tony Hawes told us: "[Jones] took a complete back seat as far as futures were concerned and he will maintain that he was under instructions that, although he was a director of the futures company, it was no

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concern of his and he was responsible only for the monthly management accounts" (paragraph 2.64).

- 7.12 Evidence was given to the inquiry which indicated that Leeson was, in view of his high levels of reported profitability, considered to be a 'star performer': and that there was a concern not to do anything which might upset him. Hopkins told us: "Leeson was his [Ron Baker's] star trader; he did not want him roughed up". Fraser told us: "in so far as one had a feeling about him [it was] 'for God's sake don't interfere'". Ron Baker told us: "I thought Nick [Leeson] was a lone star and did his own thing at the time". Ron Baker told us that Bax indicated that if there were issues to be taken up further with Leeson, Bax would take them up himself. Gueler told us: "Because he [Leeson] was so trusted, he was regarded as almost a miracle worker. He had a lot of free rein to do what he had to do".
- 7.13 This lack of management supervision, alone, may not have enabled Leeson to establish the large unauthorised positions which caused the collapse of Barings. However, there were several other significant control failures which, taken together, meant that these unauthorised positions went undetected, until it was too late to save Barings.

Lack of segregation of duties in Singapore

- 7.14 Leeson had responsibility for both the front office and back office so that all reconciliations and other detailed control procedures in BFS were rendered ineffective. The internal audit report of 1994 recommended that the back office be reorganised so that Leeson was no longer directly responsible for it (paragraph 9.23). Tuckey told us that this recommendation was: "very important [and seemed] to me to be fundamental". In a letter to us, Norris stated that: "I accept that the combination of Leeson's positions in front and back offices constituted a most serious failing, in the context of the failure to implement the recommendations of the internal audit report to segregate front and back office duties and to reinforce the independent supervision in Singapore of BFS's activities. The intent of the recommendations of the report (which recognised the need for the General Manager to retain involvement in both front and back office matters), as I understood them, was to preserve the interface necessary between front and back offices which, in general, maximises the efficiency of securities operations, while introducing the necessary checks and balances in terms of independent supervision".

Insufficient action taken in response to warning signals

- 7.15 Management was aware of a number of warning signals concerning the activities of BFS. Management did not act in a timely or vigorous enough manner to investigate these activities and the role of relevant members of management involved is described in paragraphs 7.29 to 7.53.

No risk management function in Singapore

- 7.16 During 1994, the risk management process received increased management attention with the appointment of risk controllers in London, Tokyo and Hong Kong, but not in Singapore. In November 1994 it was agreed that the financial controller of BFS would perform this function. Yong had not started in this role by the time of the collapse (paragraph 2.71).

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Weak financial and operational control over the activities and funding of BFS at group level

- 7.17 There were several weaknesses in Barings' financial and operational controls over the activities and funding of BFS.
- 7.18 An important element in the matrix reporting structure was the dialogue between chief operating officers and financial controllers in each region and the Group Financial Controller in London. From May 1994 such a dialogue between Jones in Singapore and Broadhurst in London hardly existed owing to a breakdown in their relationship. As a result, little effective financial control over BFS was exerted from London (paragraphs 2.74 to 2.80).
- 7.19 The results for 1994 showed that the operating profit before tax of the Bank Group (£37 million) was contributed by SPG (£40.6 million) of which at least £28.5 million was contributed by Leeson's 'switching' activities. No sustained attempt was made by management or financial control to determine the reasons for the very high level of profitability of, what they considered to be, a 'risk free' business (paragraphs 3.56 to 3.66).
- 7.20 Following the introduction of solo consolidation at the end of 1993 (paragraphs 11.21 to 11.29), the accounting system produced a 'difference' which represented margins paid to exchanges on behalf of clients, and which had not been recovered from clients. This difference, which in fact substantially represented the funding, in part at least, of account '88888', was included in the solo consolidation balance sheet as loans to clients, and no attempt was made to reconcile the amount to underlying client receivables (paragraphs 6.81 to 6.95).
- 7.21 The daily margin file sent by BFS to the Futures and Options Settlements Department in London explicitly included the balance on account '88888'. Since no such account number existed in the First Futures master file the balance was left in a suspense file rather than being posted to the First Futures Ledger. No procedures or controls were in place to review, analyse or evaluate items in the suspense file (paragraph 6.131 to 6.138).
- 7.22 A further significant control failure was over the arrangement of funding by Group Treasury and the disbursement of funds by Futures and Options Settlements in Barings London to BFS. Substantial sums of money were paid to BFS in accordance with Barings' authority mandate, but without the necessary reconciliations or checks being performed, notwithstanding that Granger and Tony Hawes were aware that there was inadequate support for US Dollar advance margin calls (paragraphs 6.81 to 6.95).

No system of credit control to identify margin advanced on behalf of clients

- 7.23 The credit control process of IBG and later BIB evolved from the process followed by BB&Co. The process was deficient in that it failed to review what were erroneously thought to be exposures to clients where Barings had advanced margin monies via BFS to SIMEX on behalf of clients. Also, once the purported SLK receivable was discovered, it was not brought to the attention of the Credit Unit. This purported

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exposure was not subsequently investigated by the Credit Unit, nor reported to the Bank as a large exposure (paragraphs 6.96 to 6.112).

Inadequate follow up of key internal audit recommendations

- 7.24 The planning of the July/ August 1994 internal audit of BFS identified that some senior managers had material concerns about the controls and activities relating to BFS. The audit report produced in October 1994 reported several significant control weaknesses, including the unacceptable position of Leeson having entire responsibility for both front and back offices. Management's response (mainly local Singapore management in the form of Jones) noted that this, and other significant weaknesses, would be addressed. In fact, by the time of the collapse, these weaknesses had not been resolved. There had been no follow up by London management to ensure the actions promised by local management had been effected (Section 9). Furthermore, it is apparent that there was an awareness, on the part of some, that the segregation of duties in BFS had not been effected. This was demonstrated, for example, by a telephone conversation recorded between Ron Baker and Walz on 26 January 1995. Walz said to Ron Baker: "He [Leeson] is in an unfortunate position, though, because he is settlements [and] he is cash management and he is the trader and it's a problem because there's nobody else to call but him about it".

Ineffective compliance function of BFS

- 7.25 There was no separate compliance function in BFS (paragraph 11.148) although the arrangements for risk and compliance monitoring were the subject of an internal audit recommendation (paragraph 9.24).
- 7.26 Overseas compliance arrangements did not appear to receive significant attention in London. Thomas was the BIB Compliance Officer, reporting to Norris. Although she had a global role (paragraph 11.142), this did not include monitoring the effectiveness of overseas compliance arrangements. There was, in effect, a decentralised approach to compliance within the Barings Group.

Inaccurate reporting to regulators

- 7.27 Regulatory reports by Barings contained certain information relevant to the collapse but did not include material information which could have alerted regulators to the existence of the unauthorised positions. The relevant reports included consolidated large exposures to exchanges in Japan and Singapore reported to the Bank, which showed excesses over 25% but were subject to errors, and BB&Co's solo consolidated large exposure returns which did not include material amounts of 'top up' on connected lending (paragraphs 11.30 to 11.40). At the same time, client money returns reported to the SFA failed to include the BSINGCOLL account (which substantially reflected the 'top up') until the return of 31 January 1995 which was received by the SFA on 22 February 1995 (paragraphs 11.86 to 11.88).

Reaction to SIMEX letters

- 7.28 There were letters from SIMEX referring to account '88888' and Barings' ability to pay margins which were not adequately followed up by management (paragraphs 11.97 to 11.118).

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THE ROLE OF MANCO AND ALCO

- 7.29 An important part of the management controls in Barings was the oversight role of MANCO and ALCO, (formerly the Risk Committee of BSL and the Treasury Committee of BB&Co), including, in particular, those members involved in BIB. During 1994 and 1995 these committees discussed a number of issues relevant to BFS and the 'switching' activity booked in BSJ.
- 7.30 The discussions suggest that prior to 24 January 1995 the committees were generally comfortable with the 'switching' activity, although concerns were beginning to surface about the funding it was consuming. From 24 January 1995, ALCO appear to have had increasing concern about the 'switching' activity in a number of respects: level of gross positions, inaccuracy of information about margin calls, risk profile, market rumour relating to the size of open interest on OSE, and the level of funding. Also during this period questions were beginning to surface at MANCO about the profitability and funding of the 'switching' business. However, relevant members of management failed to pursue their concerns in a sufficiently rigorous and rapid manner so that the identification of the unauthorised activities came too late to prevent the collapse.
- 7.31 We describe below the relevant MANCO and ALCO discussions since 24 January 1995 in order to provide an understanding of the issues management were dealing with and the actions they were taking in the weeks leading up to the collapse.
- 7.32 On 24 January 1995 Tony Hawes reported to ALCO that without a booking error, BFS would have broken its daylight margin call limit with Citibank. This was reported to Walz who confirmed that Leeson had been instructed to reduce the size of his positions. The committee went on to discuss the inaccuracy of margin calls received from Singapore and the absence of supporting information, but deferred the discussion on who should be responsible for such issues until 25 January 1995. Smith was asked to ensure Norris was aware of the discussion. A memorandum from Tony Hawes to Hopkins, dated 11 January 1995, was included with the reporting package. The memorandum detailed the remit of a project initiated by Tony Hawes to investigate the way in which margin was provided to, and used by, BFS in the so-called 'Singapore Project'. The memorandum did not include a timetable for the completion of this project.
- 7.33 On 25 January 1995 MANCO discussed the profits and losses experienced in the Far Eastern markets: a short position in Japanese equities on 23 January 1995 had cost US\$1 million, and a high level of business had been executed on SIMEX earning a profit of US\$9 million. There is no record of the reasons for the high level of profitability being questioned at the meeting, or the large profits earned from the 'switching' book during the next week being discussed at the following week's meeting.
- 7.34 ALCO also met on 25 January 1995, although Broadhurst, Tony Hawes and Katz were the only committee members who attended. Smith and Blyth were present. Tony Hawes indicated that the daylight limit available to BFS with Citibank had been increased to US\$100 million, although the committee remained concerned that this might still prove inadequate in adverse market conditions. The discussion on the inaccuracy of margin calls received from Singapore and absence of supporting

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information was deferred to 26 January 1995. The results of this discussion were not minuted.

- 7.35 The meeting on 26 January 1995 was very much focused on 'switching' and was attended in person by Norris, Maclean, Barnett, Broadhurst, Tony Hawes and Katz with Blyth, Smith and Walz present. Ron Baker was on the telephone from New York. At this meeting Maclean made some handwritten notes indicating total margin at SIMEX and OSE of £1 billion. Tony Hawes told us that this may have been overstated, but confirmed that the margins at exchanges were discussed.
- 7.36 The Daily Commentary highlighted a £2.1 million profit from equity derivative trading. The Daily Income Report showed that £4.7 million of the week to date profit of £5.6 million from Structured Products, Japan, was attributable to Nikkei exchange arbitrage. There were no minutes of any discussion on the level of profitability of this activity.
- 7.37 The discussions at the meetings on 26 January 1995 and 27 January 1995 centred on the SIMEX/OSE positions and covered the following issues based on a paper presented by Norris: event risk/market risk, funding risk, credit risk, public relations and operating risks. He also mentioned "house/client trade off".
- 7.38 On 26 January 1995 Norris reported that several people in Barings had been called about the level of positions held on OSE and SIMEX. Maclean told us that: "We were obsessed not with positions but with the market's perception of us, because there had been gossip about Barings somehow having massive positions or having a customer who could not meet a margin call and we were worried about the public affairs aspect". The committee was concerned that because a number of different people were responding to the queries regarding the SIMEX/OSE positions, contradictions might arise. It was therefore discussed who should be the point of contact with the market to ensure a consistent message was transmitted, but responsibility for this was not decided on. It was decided the following day that Norris would be responsible for contacting Mr William Daniel, Branch Manager, BSJ, and Bax was to ensure that all enquiries were handled consistently. Market concerns are considered below (paragraphs 7.100 to 7.118). ALCO agreed that: "Nick Leeson be advised that positions should not be increased from current levels and when possible reduced pending further instructions from ALCO".
- 7.39 The meeting the following day, 27 January 1995, was attended in person by the same members as on the previous day, (Ron Baker was not present or on the telephone). ALCO agreed the following dealing strategy for Monday 30 January 1995:
- (a) There should be no increase in the Nikkei position;
 - (b) If the market rises the position should be cut;
 - (c) May increase the JGB/Euroyen position up to the agreed amount of available initial margin;
 - (d) Intra-day delta limit increased to 500 OSE lots;
 - (e) If the market falls Leeson is authorised to leave the position to expiry in March.
- 7.40 Walz reported the open positions in Nikkei and JGB futures contracts on SIMEX. It was decided that: "The major cause of rumours about our open positions is that open

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interest on OSE is given by member, which does not happen on SIMEX leading people to assume we have a significant long position”.

- 7.41 On 27 January 1995 the BIS in Basle contacted Barings saying that they had heard rumours in the Far East that Barings could not make a margin call. Norris telephoned Walz in response to this to confirm the current positions and funding.
- 7.42 In referring to the Nikkei position and the agreed action should the market rise or fall, Tony Hawes told us that the particular concern was to control funding in that if the Nikkei 225 rose, BFS would have to pay variation margin to SIMEX on its short position before it could collect variation margin on the long position on OSE (under Exchange rules). ALCO was aware of the apparent profitability of the ‘switching’ book but noted the funding constraint. Walz reported Barings’ share of open interest on OSE Nikkei as 29% and on TSE JGB as 26%.
- 7.43 Although ALCO agreed at these meetings on 26 and 27 January 1995 that there should be no increase in the Nikkei position, the summary sheets presented at ALCO meetings showed the position to have increased during February, contrary to the instruction of ALCO. The reporting package showed an increase of 1,000 lots on 7 February 1995, an increase of 1,200 lots on 16 February 1995 and an increase of 2,000 lots on 17 February 1995. The minutes do not contain an explanation of what, if any, action was taken in respect of these apparent breaches of ALCO strategy.
- 7.44 Ron Baker and Walz were responsible for communicating to Leeson the decision taken by ALCO at its meetings of 26 and 27 January 1995 not to increase positions. Records of telephone conversations between Walz and Gueler on those dates show they had a number of discussions about the size of the positions. On 27 January 1995 Walz is recorded as telling Gueler that Leeson should not increase his position at all, and if he can, reduce it. Walz is recorded as telling Gueler that there was a question concerning funding from MANCO, which had arisen as a result of a fax from Ron Baker. Gueler replied that he had spoken to Ron Baker. The telephone records indicate that Gueler spoke to Ron Baker about the positions and funding. Leeson’s telephone records show that he attempted to call Ron Baker five times on 30 January 1995. However, Ron Baker did speak directly to Leeson on Sunday 19 February 1995, after he had told ALCO on 17 February 1995 that he would instruct Leeson to reduce the positions. When Ron Baker spoke to Leeson it seems he instructed him to reduce the position to 10,000 contracts and required that this be done by 2 March 1995. Leeson was not in the office on 20 and 21 February 1995 although the Nikkei arbitrage position reduced.
- 7.45 It should be pointed out that, given the techniques of concealment being employed at the time by Leeson, it is likely that if the ALCO directive had been implemented a significant margin call from SIMEX would have been made. This is because Leeson was netting out the long Nikkei position in account ‘88888’ against the short position in the BSJ ‘switching’ account ‘92000’ and reporting the net position to SIMEX for the purposes of margin calculation. Had he reduced significantly the size of the short position reported as one side of the matched book, the amount of margin due to the exchange would have increased.
- 7.46 The issue of why the BSJ account was classified as a ‘client’ and not a ‘house’ account was raised at the ALCO meeting on 27 January 1995. The reason for the question being asked was not minuted but we assume it was a reference to BSJ’s account with

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SIMEX. We consider this issue in the context of large exposure reporting to the Bank in paragraph 11.63.

- 7.47 On 31 January 1995 Maclean reported to ALCO that he had received a copy of a letter from SIMEX to BFS requiring a reply within two weeks and that ALCO (Tony Hawes and Maclean) would draft a reply. This is the letter dated 27 January 1995 (paragraphs 11.112 to 11.118), which referred to the Exchange member's ability to fund future margin calls. At MANCO on 6 February 1995 there was discussion of the Bank's requirement for Barings to treat margin deposited with OSE as a large exposure, as required by a European Union directive, limiting the maximum margin with OSE to approximately £105 million. MANCO decided to look at alternative funding mechanisms. The issue of funding was further discussed at MANCO on 13 February 1995 when it was reported that the cash facilities in Singapore were being reviewed with the objective of increasing the capacity to make margin payments.
- 7.48 On 8 February 1995 the ALCO discussion centred around the ¥7.778 billion (£50 million) error arising from what ALCO understood to be an incorrect payment made by BFS on 3 December 1994 to BNP Japan, relating to an OTC option trade arranged by BFS between SLK and BNP Japan. In his weekly report dated 10 February 1995, given to MANCO on 13 February 1995, Hopkins recorded the explanation that he had given to ALCO. He noted: "The annual audit of Baring Futures Singapore brought to light a ¥7.7 billion (c. US\$80 million) error arising from an incorrect payment made by us on 3 December to BNP Singapore relating to an OTC option trade brokered by us between BNP and Spear Leeds Kellogg, a futures broker for whom we provide clearing on SIMEX. The trade expired on 30 December, but the amount was not recovered until 5 February. We have yet to claim interest. Although our principal was probably never at serious risk, the episode has brought to a head the need to build a proper operational infrastructure in the Singapore futures operation, and particularly to devolve settlement responsibility from Nick Leeson. Tony Railton, deputy head of futures settlements in London, has gone out to Singapore to cover in the short term, and will hopefully be a permanent secondment. Tony will report to Simon Jones, the local COO, who has to date distanced himself from the futures company". We consider the SLK receivable in paragraphs 7.54 to 7.99.
- 7.49 In addition, SIMEX margining was discussed. It was noted that rumours had existed that one of the smaller houses was having difficulty meeting advance margin calls which were being made due to high volatility on the Nikkei. ALCO acknowledged the large positions held by Barings on the Nikkei and therefore spoke about the need to negotiate additional funding lines in Singapore.
- 7.50 At the meeting on 16 February 1995, when Norris was in Singapore (for a previously arranged meeting unrelated to BFS) and therefore absent, ALCO agreed in principle that the arbitrage activity between OSE and SIMEX should be given maximum long/short gross limits by contract. Tony Hawes and Smith were to collate the required information to allow ALCO to set appropriate limits. In the interim, Leeson would be advised that the positions should not be increased above current levels.
- 7.51 On 20 February 1995, further rumours were circulating in the market about Barings' positions in Nikkei futures contracts. On this date MANCO discussed a rumour, reported to them by Schrodgers, that Barings' gross position at the end of the previous week was equivalent to US\$3.1 billion and that they were experiencing problems with

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a counterparty. The committee's main concern was to ensure that the company should maintain a high level of liquidity. It considered a short term floating rate note issue to improve the situation. The committee reinforced ALCO's decision to reduce the size of the positions, but indicated: "that it is preferable for us to be able to take on new transactions rather than retain existing positions to maturity". The ALCO minutes of 20 February 1995 state: "No specific issues discussed".

7.52 On 21 February 1995 the morning after the MANCO meeting, Hopkins has told us he was removed from MANCO by Tuckey and Norris to be replaced by Ron Baker. Hopkins would have reported to MANCO through Maclean. He told us he was given no reason for his removal. Norris told us that he considered Hopkins ineffective on MANCO. We asked Ron Baker about this and he said: "He [Norris] also told Ian Hopkins on 21 February, together with Andrew Tuckey, that from that day on Ian Hopkins would go off the Management Committee and I would come on the Management Committee ... It seems to me that a decision was taken at some time in January or February that my ascension to the Management Committee should be accelerated and that Hopkins should be taken off".

7.53 The last ALCO meeting was on 23 February 1995 when Hopkins reported a US\$100 million margin requirement from BFS. Details of the reason for the requirement were due to be presented at the next meeting, which was overtaken by the collapse.

SLK

7.54 We have explained in Section 5 (paragraphs 5.53 to 5.62) how the purported receivable of ¥7.778 billion (£50 million) from SLK at 31 December 1994 was used as part of the concealment in Singapore. In this section we bring together the information that we have about the SLK receivable. The aspects relevant to the audit of the 1994 consolidated financial statements are described in Section 10 (paragraphs 10.39 to 10.57) and the large exposure reporting implications in Section 11 (paragraphs 11.71 to 11.74).

7.55 There was extreme confusion in London as to precisely what had happened in respect of the SLK transaction. The various explanations or impressions were as follows:

- a) BFS had traded or broked an OTC option between SLK and BNP (which, if so, would have been unauthorised and represented an exceptionally large transaction in terms of underlying value);
- b) an unauthorised payment had been made, said to be due to an apparent 'operational error', whereby BFS had advanced money to one counterparty and had a receivable from the other counterparty;
- c) another version of the 'operational error' was that BSL was a counterparty to the transaction, as was apparently described to C&L Singapore.

7.56 As indicated below, the potential implications of the various explanations were that Leeson had involved himself in an unauthorised activity, namely the broking or trading of an OTC option or an erroneous payment had been made to a third party. It was not clear whether the payment or subsequent repayment had involved BFS or

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BSL. There were obvious credit and risk implications and large exposure reporting issues but these were not adequately considered by management.

7.57 The chronology of events described below is based on the dates recalled by the various participants. In certain instances, we have been provided with inconsistent dates.

7.58 On Friday 27 January 1995 C&L Singapore sent a status report to C&L London (referred to in paragraph 10.41) which contained the following:

“There is a ¥7.7 billion (S\$ equivalent 115 million) trade receivable from a third party Spear, Leeds & Kellogg (‘SLG’) [*sic*]. This represents refund of margin deposited with SLG for an over-the-counter [OTC] Nikkei option which expired on 30 December 1994. The amount is still outstanding. We are awaiting the audit confirmation of the year end balance.

We are informed by BFS that collectability of the said ¥7.7 billion is not envisaged to be a problem. Also, the contracting party with SLG is Baring Securities Limited (‘BSL’) and that SLG’s credit worthiness has been discussed with BSL. Could you confirm with BSL that SLG is an on-going customer and is credit worthy”.

7.59 According to Mr Duncan Fitzgerald, C&L London audit manager responsible for BSL, he saw the report from C&L Singapore on, as he recollected, Wednesday 1 February 1995 and he showed it to Broadhurst that evening. According to Broadhurst and consistent with dates of the cc mails described below, this conversation took place on the evening of Monday 30 January 1995. Broadhurst told us: “I was clearly very concerned about it. It was, to me, totally irregular because the business that Nick Leeson was meant to be doing, executing on behalf of the Group company, did not include any OTC business. I either phoned or walked round to Peter Norris’s office”.

7.60 Norris was not in Barings’ office at the time, but Broadhurst told us he spoke to Sacranie, Gamby and Tony Hawes, none of whom knew about the transaction. He also called Walz, but she was out and so he left her a message.

7.61 Broadhurst also told us he checked with the Credit Unit to find out: “What sort of substance the company Spear Leeds had ... I think they established that Spear Leeds had minimal substance, a net worth \$2 [million] or \$3 million. It raised my concerns higher”. (We have ascertained that, contrary to the information available to Broadhurst, SLK had net worth at 30 September 1994 of US\$268 million.) The Credit Unit established that on 11 June 1993 a counterparty review had been prepared for SLK and a limit of US\$5 million was granted, noting: “The F&O [Futures & Options] limit is a guidance limit only, not a credit facility”. We have not seen an update of this review. Tony Hawes told us: “We knew we had not signed off on the credit limit for SLK other than for exchange trading derivatives”.

7.62 According to Broadhurst, on Tuesday 31 January 1995 he spoke to Norris. He told us that: “I spoke to Peter [Norris] about it and mentioned to Peter whether it should be brought up at the ALCO meeting. I also voiced my concerns that I was confused about it and there were half a dozen other people who were confused about it. His view was that it would be premature until we actually better understood whether it was a problem”.

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- 7.63 Tony Hawes sent a cc mail to Leeson and Jones in the morning of Tuesday 31 January 1995, including the section of the status report (paragraph 7.58) concerning the SLK receivable. He queried the facts and requested the matter to be clarified. Leeson replied that it was Chinese New Year and he would deal with it the following day. Tony Hawes told us: "None of us understood it [the nature of the SLK transaction]. I think I did show the audit comment to Mary [Walz] and said: "This is what we have to talk about" .
- 7.64 Tony Hawes has told us that Walz challenged his sending of this cc mail: "She talked about me being the instrument that was going to ask these time consuming or difficult questions ... I mentioned to her that if one took it at face value, it could mean that there was a £50 million hole in the balance sheet. I think she appreciated the potential seriousness of it". Walz told us the SLK: "story ... remains a great mystery". She received a call from Broadhurst who told her C&L Singapore had raised an audit point and that Tony Hawes was looking into it.
- 7.65 Granger told us she was asked by Broadhurst and Gamby about an OTC trade with SLK. She found no records of it but sent a cc mail to Leeson asking him about it. She also told us: "When I came in the morning, Tony Gamby called me into his office and told me to lay off at Nick [Leeson] about the OTC. They had found out what it was. It was an unauthorised trade, that Nick [Leeson] had done an unauthorised trade with SLK. That was it. I walked away from it".
- 7.66 Leeson was explaining SLK to Jones and C&L in Singapore. Jones stated in a letter to us that he was first told about the unauthorised nature of the purported transaction in a note which he received from Leeson on 1 February 1995 and gave to Bax and Yong.
- 7.67 The two page handwritten note, which was signed "Nick", is reproduced in Appendix XII and stated the following:

"Large option trade put through the system between SLK and BNP. Booked via the system between SLK and BNP with premium to hit at maturity. At this stage no impact on system. Customer side to hit at maturity. Broker side: no movement because holding both sides (Dr + Cr) impact zero - BFS were not to be involved at all. Payment would be between SLK and BNP.

ERROR in input of maturity dates. True maturity = 30/12, maturity for BNP Leg 03/12. Subsequently BNP have received value for the funds 3/12 and funds have been effectively returned to them over a period during the normal course of business i.e. error not picked up. Therefore reversal of entries 30/12 has left us with a receivable of JPY 7,778,000.

As the trade was to have no impact, referral was not made - so blame me!

Subsequently received verbal communication that fund will be paid 2.2.95. Expecting written confirmation this evening circa 10pm.

There are obviously a lot of errors that I can be hung on, to which I will take full responsibility but suggest that we tackle the matter with the auditor, show him receipt of funds value 2.2.95 and confirmations that we will receive this evening of balances and hopefully then he will make London happy.

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See you at 7.30[pm].

Nick".

- 7.68 The note also has written on it, possibly in two different scripts: "Credit Risk - what approval - Nil credit risk"; "Profit to BFS ??? - Nil"; and "BFS out of pocket SGD [Singapore Dollars] 115 million for 2 months!!" This note appears to raise more questions than answers.
- 7.69 Jones further stated that he was very concerned about collectability and voiced his concerns to Leeson. Jones met Leeson and C&L Singapore on Thursday 2 February 1995. In an affidavit sworn in Singapore, Bax said the following:
- "Simon [Jones] queried Leeson in this regard. Leeson told him that it arose from a married deal between SLK and Banque Nationale de Paris (the Company's only direct customer account). Leeson also gave a handwritten note to such effect. Leeson said that because of a booking error by the company's settlement section in Singapore, Barings had settled this trade on behalf of Banque Nationale de Paris before receiving settlement from SLK. Leeson told Simon he would provide the auditors with all the information they required in this regard and in particular with the confirmations that the Financial Products Group in London to whom Leeson reported had approved of the trade and that SLK acknowledged the amount of the receivable as being payable by them. Simon also told me that Barings in London had been informed by Coopers of this matter. I later spoke to Peter Norris, Barings Group CEO, to update him on these details".
- 7.70 The reference to: "Barings had settled this trade" in Bax's affidavit does not specify whether it was BFS or BSL. Bax told us in a letter that he was: "Surprised that such a payment mistake had been made because all funding for payments by BFS was provided for and monitored by Treasury/Settlements in London. No payment by BFS should have been possible unless London had passed it. This was a very significant safety feature". He continued that he believed that BFS could only make payments to SIMEX or other Barings companies and that the apparent payment by BFS to BNP showed that this belief was wrong.
- 7.71 In Singapore, C&L had requested support from Leeson for the SLK receivable. As described in paragraphs 5.57 to 5.60, Leeson provided three pieces of apparent evidence: the approval fax from Ron Baker, the balance confirmation from SLK, and the Citibank transaction statements. This evidence and explanations given presumably were considered sufficient by C&L Singapore to enable them to issue an unqualified report on the consolidation schedules of BFS on Friday 3 February 1995 (paragraph 10.49). Bax's affidavit referred to above says: "The auditors also appeared to have found the explanations satisfactory as they cleared the company's accounts".
- 7.72 Jones stated in a letter to us that: "Since audit clearance was due that same day [Friday 3 February 1995], [Jones] decided to call Richard Stanley, Vice President of Citibank Singapore to seek written confirmation that the funds had been received from SLK. However, when Rachel Yong heard [Jones] directing his secretary to place the call, she interrupted him and said that this was unnecessary because the auditors had already obtained written confirmation and were satisfied that the funds had been received".

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- 7.73 Norris told us that in his conversation with Bax, Bax stated that: "There had been a mis-booking of a transaction which had gone through Baring Futures' books which should not have done over the year end". Bax told us in a letter that Norris was already aware of the SLK matter when he called him and that Bax explained the transaction as a payment in error to BNP due to a mistake from an input error by the settlements staff.
- 7.74 Norris called Ron Baker to find out what he knew about SLK. This took place on or about Wednesday 1 February 1995. Ron Baker told us Norris asked him: "Was I aware that we had lent some money to a ... broker in Singapore ... and what was happening? I had no idea what to say ... I was just shocked by it". He went to find Walz who was reported to know of the issue and they called Norris back together. There is some doubt in Norris' recollection as to whether he: "ever hoisted on board the fact that this was meant to be a transaction that we had written". He told us he probably should have done more to inform himself. Ron Baker told us: "I got angry because I just could not believe it [the above story]". Walz told us she spoke to Leeson about SLK who told her: "It is just an accounting screw up. Tony [Hawes] is all over me on it". She also recalled that it was unusual and that: "Somebody mentioned something about an OTC. There is no OTC business in Singapore". Walz confirmed to us that she and Ron Baker called Norris to tell him Broadhurst and Tony Hawes were: "checking this thing out". She told us she was irritated because one person should have dealt with it in a clearly defined matter.
- 7.75 Ron Baker told us that, in a subsequent call, Bax described it as: "Just a non-transaction. It is an error. It is a back office glitch. Do not worry about it". Bax told us in a letter that he had: "the distinct impression that Mr Ron Baker was aware of the details of the SLK matter and blamed Settlements/Treasury in that the mistaken payments of the 7.7 billion yen and the failure to recognise and recover it earlier should never had occurred if they had been doing their job properly".
- 7.76 Maclean first remembers hearing about the SLK matter around the end of January 1995. He told us: "That [SLK incident] did suddenly loom over the horizon as a major problem. We were told there was a receivable of a major amount between US\$75 million and US\$80 million owed by somebody I had never heard of ... In a day or two everybody was talking about it".
- 7.77 Fitzgerald sent a fax to Singapore on Wednesday 1 February 1995 (as described in paragraphs 10.44 to 10.46). He told us he sent it in error to D&T, the former auditors, but followed it up with a telephone conversation with Khoo Kum Wing, C&L Singapore audit partner, on 2 February 1995. Fitzgerald's handwritten notes of the telephone conversation record the conversation at 11.00am and he was informed that the money due from SLK had been received. This is consistent with Leeson producing the purported record of Citibank transactions at close of business Singapore time on Thursday 2 February 1995. Fitzgerald told us he then informed Broadhurst and Tony Hawes that the money had been received.
- 7.78 In his affidavit referred to in paragraph 7.69 Bax says: "Whilst I had no reason to nor did I think that the transaction was in any way fraudulent, I was disturbed that a booking error could result in Barings mistakenly allowing such a large receivable to arise. I believed this could have been avoided if Leeson's trading and settlements role within the Company were split, a view I had expressed several times before. Apart

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from such a split being desirable from a control point of view, it now also appeared that Leeson was not able to function effectively if he was to continue to be responsible for both these functions”.

- 7.79 On Friday 3 February 1995 Bax sent a memorandum to Norris, Broadhurst, Ron Baker, Hopkins and Gamby in which he referred to the ‘recent incidents’ and ‘operational weaknesses’ in Singapore and concluded that Leeson’s responsibilities for front and back offices had to be split. Bax has confirmed he was referring to SLK as well as to funding issues. We are unable to determine whether this memorandum was tabled at the ALCO meeting on 8 February 1995 referred to below.
- 7.80 Both Bax’s memorandum and the C&L Singapore audit clearance were received in London, by management and C&L respectively, on Monday 6 February 1995. The clearance was accompanied by a memo from Khoo Kum Wing explaining the SLK transaction in detail from C&L Singapore’s viewpoint, including that BSL had made the payment (paragraph 10.50). Broadhurst told us that: “The concern was diluted by receiving an audit report from [C&L], I think on 3rd February, which was a matter of days after I received the original query, saying that they were happy. They had signed an audit report [3 February 1995 report on consolidation schedules] saying in their view, that Barings Futures Singapore was okay and the inter-company balances were reconciled”.
- 7.81 Also on Monday 6 February 1995 Tony Hawes and Railton arrived at BFS. Tony Hawes went to look into, amongst other things, the specific problems of funding and SLK, already described in paragraph 1.51. Railton was to spend three to five weeks at BFS learning about the back office procedures.
- 7.82 Tony Hawes intended to talk to Leeson about SLK. He told us: “I talked to James Bax and Simon Jones first. They said Nick [Leeson] had confessed to them what had gone wrong, and they knew in broad terms what the story was. James said ‘Nick [Leeson] is under a lot of strain at the moment. Perhaps it would be better if I questioned Nick [Leeson] in more detail rather than you, as a semi-outsider, to play the thing down”.
- 7.83 Tony Hawes therefore produced a list of questions for Leeson and faxed a copy to Hopkins in London for review. Hopkins then sent a copy to Ron Baker and discussed the questions with him. These questions were sent to Bax on 7 February 1995, including questions with reference to the facts that the contracting party was BSL, that SLK had been funded by borrowing from BSL, and that OTC trades were not within BFS’s mandate. Ron Baker did not want Tony Hawes to talk to Leeson about SLK as he still felt it was an operational issue and that Bax was handling it. Ron Baker told us that: “I think I was protecting Leeson. I think that is a fair comment. I think I was protecting him from a situation that I felt was premature and ill-considered”.
- 7.84 Hopkins had returned from holiday on Monday 6 February 1995 and heard about SLK. He told us he immediately went to see Broadhurst who told him that there had been a problem but it was no longer a problem as the money had been repaid. However, Hopkins told us he raised it at ALCO.
- 7.85 From what Norris told us, it appears that Bax did not want the SLK problem to appear in the C&L management letter due to the regulatory problems it would cause in Singapore: “[Bax] then expressed his wish to try and have the thing dealt with in a

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way which would not give him problems with the local regulator, SIMEX ... which was the issue of that year's audit report or management letter. I agreed to see if we could put that in train ... I did so only on the basis that the transaction had been reversed, there was not an issue of exposure and also on the basis, as he told me, that the auditors were fully aware of it". Bax told us in a letter that the auditors were asked if they had to refer to the SLK matter in a management letter.

- 7.86 Norris passed the request on to Broadhurst who remembers Norris saying to him: "I do not want it included in the internal management letter". Broadhurst was not suspicious. He said: "I felt it was a very sensitive area". He said: "I interpreted that potentially the internal management letter might be misinterpreted by someone else who had access to it". When asked who might misinterpret the letter, he replied: "I never asked the question [of Norris] but intuitively, in my bones, I felt that it was both the regulators (SIMEX), and the sensitivity of the issue, which could have led to disciplinary action". He told us: "I did not question it and I relayed that to the auditors [C&L London] saying that I would prefer it not to be in the internal management letter [from C&L Singapore]".
- 7.87 At the ALCO meeting on Wednesday 8 February 1995, attended by regular ALCO members Ron Baker, Barnett, Broadhurst, Hopkins, Maclean and Norris (plus for that meeting Blyth, Walz and Smith), the SLK matter was discussed. This was a week after it was first notified to London. The minutes of that meeting record: "PN [Norris] highlighted a recent operational error in Singapore due to a trade mis-posting which took several weeks to come to light. A full report will be produced by James Bax at a later stage".
- 7.88 Ron Baker told us that: "Norris re-affirmed the operational error story in the ALCO and we were waiting for Bax's response ... I think the word OTC might have been used along the way somewhere but no one ever described it to me".
- 7.89 Barnett told us that he first heard of the SLK issue at this ALCO meeting, but that it was reported that it had been resolved. He told us he thought that Norris described the transaction, that it was a booking error and Barnett told us: "My recollection is that this was a large transaction that had been effectively broked by Nick Leeson between BNP and SLK".
- 7.90 By this time, Wednesday 8 February 1995, there still appears to have been considerable confusion as to whether management in London knew that Leeson had been involved in an unauthorised trade or that there had been an operational error.
- 7.91 On Thursday 9 February 1995, Tony Hawes saw Leeson. He and Jones were given Leeson's explanation of the SLK transaction by Leeson (which is not recorded). Tony Hawes was unsure about it and told us: "It was quite an extraordinary story that I did not really believe". He also told us that he had asked for support for Leeson's claims recalling his request to: "see the entries that it created in the system. So he [Leeson] went to get it and did not come back". Tony Hawes had to leave a list of unanswered questions for Leeson with Jones. This list was dated 10 February 1995 and asked for full documentation of the transaction.
- 7.92 In his affidavit to the Court referred to in paragraph 7.69 Bax has a different recollection of Tony Hawes' visit. He says: "He [Tony Hawes] also had a list of

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queries (he showed me the list) which he had for Leeson in relation to the SLK receivable and I know he met with Leeson with regard thereto. He told me after the meeting that Leeson's replies had been satisfactory. The following day Hawes told me that he had spoken to Ian Hopkins, Head of the Risk Department in London and wanted to clarify some further points with Leeson. However, I think he returned to London without having a further meeting with Leeson on these further points". Jones told us in a letter that the meeting on 9 February 1995 was followed by a meeting on 10 February 1995 between him, Hawes and C&L where there was no mention of SLK by Hawes or C&L.

- 7.93 As described in paragraphs 10.52 to 10.54, C&L London held an audit issues meeting with Broadhurst and Seal on 9 February 1995. According to Fitzgerald: "Geoff [Broadhurst] was very categoric during the meeting that the issue had been resolved". This was when they were also asked about excluding the matter from the management letter.
- 7.94 Hopkins wrote a memorandum for consideration at MANCO, summarising ALCO discussions for the week. This memorandum was dated 10 February 1995 and was circulated to MANCO members prior to or at their meeting on 13 February 1995. It stated: "The annual audit of Baring Futures Singapore brought to light a ¥7.7 billion (c. US\$80 million) error arising from an incorrect payment made by us on 3rd December to BNP Singapore relating to an OTC option trade broked by us between BNP and Spear Leeds Kellogg, a futures broker for whom we provide clearing on Simex. The trade expired on 30th December, but the amount was [not] recovered until 5th February. We have yet to claim interest".
- 7.95 Discussion of Hopkins' memorandum was not minuted. Hopkins told us that: "Peter [Norris] made a passing reference to it ... I was amazed that it did not cause more discussion ... Because \$80 million-worth of the Bank's money had gone walkabout for two months without anyone noticing".
- 7.96 Tony Hawes told us in a letter: "On my return to London on 13 February, I discussed with Mr Hopkins his note to the Management Committee on the matter. I also reported Mr Leeson's explanations to ALCO, about which I registered my own doubts, and circulated my list of follow-up questions. It is my belief that my imminent arrival in Singapore requiring answers to these questions (and the implementation of the significant changes to the BFS book-keeping system which I had commissioned) was the major cause of Mr Leeson's disappearance on 23 February".
- 7.97 Norris visited Singapore on Thursday 16 February 1995 and had a meeting with Leeson. When we asked Norris whether he and Leeson discussed any matters relating to SLK or the so-called 'operational errors' he replied: "No, we did not". Jones told us in a letter that he met Norris prior to Norris seeing Leeson and discussed BFS operations. On 20 February 1995 Leeson sent a cc mail to Tony Hawes saying: "Following my conversation with Peter Norris, James Bax and Simon Jones. I will await the finalisation of the accounts before following up with your audit request".
- 7.98 There is no evidence that SLK was considered further. We consider that the failure of management vigorously and promptly to address the clear problems thrown up by the SLK transaction to be unsatisfactory. As noted above, whatever version of events had been put forward to management, the potential implications were that, if the SLK

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receivable existed, either Leeson had either involved himself in an unauthorised broking activity or there had been an erroneous payment of an extremely large amount of money.

7.99 The matter had been drawn to the attention of management in London by either 30 January or 1 February 1995. Because of the obvious seriousness of the matter, we consider that the confused and unsatisfactory information available in London at the time required an urgent and detailed investigation to ascertain precisely what had happened. We also consider that more prompt and effective steps should have been taken in Singapore to ascertain the precise circumstances of the transaction. We further consider, given the circumstances and uncertainties as to the nature of the transaction, that the obligation to probe into the matter was not lessened by the (apparent) fact that the money had been received or by the receipt of an audit report from C&L Singapore.

Market concerns

7.100 In this section we review the market concerns and rumours known to Barings' management in the months leading up to the collapse. Between December 1994 and February 1995, Barings became aware of information from reputable sources and a number of market rumours about their positions in Asia. These rumours concerned Barings' margin requirements and its ability to meet margin calls and also the very large position on OSE.

7.101 A member's net open interest on OSE is made publicly available on a weekly basis. The open interest reported for BSJ's Nikkei 225 contracts for each week in January and February 1995 is shown in Appendix XIII. For example, on 17 February 1995, the following was reported in respect of BSJ's Nikkei 225 contracts (total 'house' and 'client'):

| | |
|------------------------------------|---------|
| Net position (number of contracts) | 20,076 |
| Total number of open contracts | 128,749 |

7.102 As there is no similar disclosure on SIMEX, the fact that the position could be matched by a short position on SIMEX would not be apparent.

7.103 At the ALCO meeting on 26 January 1995, Norris reported that several people in Barings had been called about the level of positions held on OSE and SIMEX. Maclean told us that: "We were obsessed not with positions but with the market's perception of us, because there had been gossip about Barings somehow having massive positions or having a customer who could not meet a margin call and we were worried about the public affairs aspect".

7.104 ALCO was concerned that because a number of different people were responding to the queries regarding the SIMEX/OSE positions, contradictions might arise. Therefore it discussed who should be the point of contact with the market to ensure a consistent message was transmitted, but responsibility for this was not decided on. It was decided at ALCO the following day (27 January 1995) that Norris would be responsible for contacting Daniel and Bax to ensure all enquiries would be handled consistently. ALCO agreed that: "Nick Leeson be advised that positions should not be

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increased from current levels and when possible reduced pending further instructions from ALCO”.

- 7.105 Peter Baring said that: “The first time that concern was expressed in my hearing about the size of the positions was well into 1995. I cannot remember the circumstances but I remember somebody saying - I think it was probably at the Executive Committee - that we were getting comment in the market that our positions were very large and that we planned to reduce them because of the reputational risk in generating that comment”.
- 7.106 Tuckey also remembers the discussion. He told us: “It did not have extensive discussion in the Management Committee, and it was only in January and February that one or two specific points in relation to it were raised in the Management Committee, in relation to market comments for example on the extent to which Barings were thought to have a large position in the Osaka Exchange”.
- 7.107 Also on 27 January 1995, the BIS in Basle contacted the FX department in Barings saying that they had heard rumours in Asia that Barings could not meet a margin call. Norris telephoned Walz in response to this to discuss the current positions and funding. According to a tape of the telephone call, Norris told Walz that: “For the BIS to call up was a bit unpleasant”. We consider a direct contact to an institution by the BIS in response to a rumour to be an important occurrence with implications for the reputation of Barings which should have been of concern to management.
- 7.108 On the same day Gueler received a call from the information service, Bloomberg, which said: “What’s going on? Everyone’s talking that you guys have some very long positions”. Gueler explained this by saying that they had a lot of customers and were well diversified. He told Bloomberg: “People are looking at the open interest number and drawing all sorts of conclusions”.
- 7.109 Two hours later on 27 January 1995, Walz called Gueler. She told him: “I’ve just been talking to Nick [Leeson]. No one in your team should talk to the press”. She had also received a call asking about rumours circulating in Asia including one that they could not meet margin calls. Walz and Gueler agreed that it was their 16,700 contract long ‘house’ position on the OSE that was causing the enquiries.
- 7.110 Management did not investigate these rumours to the extent of checking that the positions were, in fact, matched. The perception was that the positions at BFS were fully matched and hence the rumours were incorrect. In a letter to us Norris stated: “Discussion of the matter (as with all substantive discussions of the ‘switching’ business in which I participated) started with a reconfirmation that all our positions were fully matched. That premise was never doubted, either by FPG management or by GTR”. We asked Norris about the reconfirmation and he told us that primarily it consisted of verbal assurances given at ALCO. He continued in the letter: “Given that the axiom of our holding fully matched positions was not challenged, it became an accepted tenet of ALCO thinking, in which I shared, that the rumours could be rationalised by the contrast of the relative transparency of OSE, which published details of members’ activity, and SIMEX, which did not. It was the failure of the basic market-risk control discipline, rather than the failure of senior management to react to rumours which was to blame for this misconception which meant that the rumours were not associated in our minds with other issues and did not suggest a need to re-appraise the basis for the switching activities”.

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- 7.111 At the ALCO meeting on 31 January 1995, Maclean presented the letter from SIMEX dated 27 January 1995, which showed 'house' and customer positions and indicated that SIMEX was seeking reassurance on BFS's ability to fund margin calls at short notice (paragraph 11.113). Hawes indicated that this was in the nature of a routine enquiry by SIMEX. The reply by Jones showed the same positions for the 'house' but different ones for customers.
- 7.112 We believe at this point there was sufficient cause to warrant investigation of the market concerns and to verify that the positions were matched. As Tony Hawes and Railton were going to Singapore the following week, there was every opportunity for them to check whether there was any foundation for the market concerns and whether the position on OSE was indeed fully matched.
- 7.113 Concurrent with the discussion of these market concerns there was a flurry of activity concerning the emergence of the purported receivable from SLK (paragraphs 5.53 to 5.62 and 7.54 to 7.99) and Bax wrote his memorandum of 3 February 1995 to Norris and others (paragraph 7.79).
- 7.114 We asked members of EXCO whether the market rumours had been raised at an EXCO meeting. Miles said: "No, not at the Executive Committee". He added that the rumours were discussed on a more informal basis: "When people [members of EXCO] gathered together after an investment bank meeting". Dare recalled rumours being discussed at the EXCO meeting of 1 February 1995 and told us: "Mr Peter Norris reported to us that the volume of our trading in SIMEX and Osaka had risen to quite substantial heights. He reported that, and simultaneously informed us that a decision had been taken to reduce the volume of the business ... because there were some comments in the marketplace about the substantial positions we might be running in Tokyo, which were large and which were felt to be not understood by people because they did not know that we had completely hedged and matched those large positions in Tokyo by similar offsetting positions in Singapore ... It was decided to reduce this business even though ... [it] was described as completely matched and risk-free. It was still thought prudent ... just to turn it down". Dare continued: "Norris confirmed, that the people in Tokyo were seeing only half of our position because of the transparency of the Osaka Stock Exchange, where the positions of the participants are disclosed".
- 7.115 More specific rumours emerged in mid-February. On 16 February 1995, Peers told us he was called by a senior executive of Schrodgers. Peers was told by Schrodgers that they had had a conversation with an American bank who were about to terminate their lines with Barings because they had heard of Barings' open position on OSE of 20,000 contracts and that their counterparty had failed. This would have exposed Barings to the whole position. We consider it to be significant for another bank to telephone and advise of such market concerns and that it related to a possible customer problem.
- 7.116 Diarmid Kelly heard similar concerns were being expressed in the Japanese market. People were asking him and his team what Barings was doing; what was their big futures position. He was also told that a couple of American banks were saying Barings was a counterparty risk. He called Ron Baker on 17 February 1995 for reassurance that there was not a problem. Ron Baker was surprised to be called directly by Diarmid Kelly and was reluctant to give details of their trading strategy. Instead, he told Diarmid Kelly that the positions were for clients. Ron Baker explained

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to us that he gave Diarmid Kelly this explanation because he did not want the proprietary arbitrage positions of Barings to be leaked to the market.

- 7.117 At the MANCO meeting on 20 February 1995, the call from Schroders was discussed, but the main concern was to ensure the company should maintain a high level of liquidity. It was still management's view that the rumours were unfounded, the positions were matched, and that there was no large counterparty exposure. It was decided, however, that the size of the positions should be reduced. Peers attended the meeting and has told us that there was no question of the rumours being true, just that they were a nuisance and a disadvantage to the business. Given the seriousness of receiving a call from Schroders and the volume of rumour in the market place, we consider that more should have been done to investigate the information provided.
- 7.118 Management of BIB may initially have been justified in taking no steps with regard to these market concerns, given their perception that the positions in respect of the 'switching' activities were fully matched; nevertheless we consider that at the beginning of February 1995, when other operational issues relating to BFS had also arisen, it would have been appropriate for urgent steps to have been taken to investigate the foundation for these market concerns and to ensure that the positions were fully matched.

8. IMPACT OF UNAUTHORISED TRADING ACTIVITIES ON FINANCIAL REPORTING OF BARINGS PLC

Impact of unreported losses on financial statements

- 8.1 The structure and organisation of the Barings Group makes it difficult to review precisely the effect of trading losses on the financial accounts of companies below the level of the consolidated financial statements of Barings plc. The summary Barings Group results for each of the years ended 31 December 1992, 1993 and 1994, together with the half year ended 30 June 1994, have been restated to show the estimated effect of unreported losses in BFS's account '88888', and are shown in Figure 8.1.
- 8.2 The 'Assumed bonus' highlighted in Line B of the table in Figure 8.1 is based on the Barings Group's policy that approximately 50% of profit before bonus and tax was set aside to provide the bonus pool for employees and directors. This approximate calculation is illustrative only and may not equate precisely to the total bonuses as reflected in the financial statements. However, we do not consider that the differences involved are significant in the context of this inquiry. The 'Assumed bonus' is used in the table to calculate a 'Notional profit before bonus and tax'.
- 8.3 The adjustments made in Line F of the table in Figure 8.1 are based on our analysis of account '88888', as set out in Section 4, and are subject to the limitations in the information received, described in that section. The adjustments include provisions for unrealised losses after applying mark-to-market accounting policies, consistent with those of the Barings Group.

8. Impact of unauthorised trading activities

Figure: 8.1

| | Unaudited | | Audited | |
|---|---|---|--|--|
| | Year ended 31 December 1994 £'000 | Half year ended 30 June 1994 £'000 | Year ended 31 December 1993 £'000 | Year ended 31 December 1992 £'000 |
| A | 204,762 | 109,528 | 200,206 | 42,528 |
| B | (102,381) | (54,764) | (100,103) | (21,264) |
| C | 102,381 | 54,764 | 100,103 | 21,264 |
| D | (39,410) | (18,459) | (31,800) | (8,916) |
| E | 62,971 | 36,305 | 68,303 | 12,348 |
| | Reported shareholders' funds | 354,371 | 336,037 | 308,814 |
| F | <u>Unreported loss in Account '88888'</u> | (185,000) | (93,000) | (21,000) |
| | <u>Adjusted for loss in Account '88888'</u> | | | (2,000) |
| G | 19,762 | 16,528 | 179,206 | 40,528 |
| H | (9,881) | (8,264) | (89,603) | (20,264) |
| I | 9,881 | 8,264 | 89,603 | 20,264 |
| J | (39,410) | (18,459) | (31,800) | (8,916) |
| K | (29,529) | (10,195) | 57,803 | 11,348 |
| | Adjusted shareholders' funds | 250,371 | 278,037 | 297,314 |
| | | | | 252,895 |

Source: 1992 and 1993 - published annual reports
1994 half year - published interim announcement
1994 year end - draft annual report
Account '88888' loss analysis (Section 4).

Note: *denotes no tax relief assumed for the unreported losses in account '88888', since they arise in BFS where the original tax charge was not material in the context of the Barings Group.

9. INTERNAL AUDIT

Introduction

- 9.1 BFS was the subject of an audit by BSL's Internal Audit Department in July and August 1994. It was performed in Singapore alongside an audit of BSS; for both companies it was the first, and up to the time of Barings' collapse, the only occasion on which such an internal audit visit took place.

Planning

- 9.2 An Internal Audit Department had been established for BB&Co in the mid 1980s; its head in 1994, Lewis, had a team of around twelve staff and reported to Barnett. However, an Internal Audit Department was not formed for BSL until the end of 1992; at the time of the Singapore visit it consisted of three personnel, including its head, Mr Ian Manson (who reported directly to Norris) and James Baker who was to conduct this particular audit of BFS. James Baker qualified as a chartered accountant in 1990 and was recruited by Manson for his team in September 1993. Manson had himself joined BSL in June 1993, from an internal audit background in other banks, and had been promoted to department head almost immediately as a result of the reassignment of other personnel.
- 9.3 In spring 1994, a few months before the BFS audit, Lewis had accompanied Ron Baker (unrelated to James Baker) on a quick tour of the part of his new FPG operations in Tokyo, Hong Kong and Singapore. Lewis had learnt shortly beforehand that she, rather than Manson, would be taking over responsibility for the whole of the internal audit function when BB&Co and BSL merged under the umbrella of BIB. The trip therefore gave her the opportunity to meet BSL people who would soon come under her purview. She described her 1½ days in Singapore to us as a planning visit, not an audit. She met Leeson and got the feeling that he was probably doing some back office work, but told us she had no idea that he was actually responsible for the back office.
- 9.4 Speaking to us about the trip, Ron Baker said: "I then invited Ash Lewis to go down with me to Singapore. She had done internal audit reports on my business in London on the debt side. I felt that she and her team were one of the highest quality groups of people in Barings".
- 9.5 He went on to say: "This was the first time I had been to see the thing in Singapore. I think it was the second time I had met Nick [Leeson]. I spent a day with him on the SIMEX pit, and I spent another day with him discussing the business and ... going through a diagrammatic presentation from him of what he was doing and the like. It was clear to me from the minute I walked on to the SIMEX pit that it was going to be very hard for anyone, let alone me, to really make much of a value judgement about what was happening ... or what the flow of information is. You are reliant on people who are in it and doing it".
- 9.6 "It also seemed to me, talking the thing through and going through it with Ash [Lewis], that the key thing to do was to get the control part of it sorted out. If you had that sorted out and if you had proper cash flow reconciliation and proper dissection of responsibilities the thing was pretty simple. It was a one customer business on the

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trading side. The issue for me was how politically to get those things done. It seemed to me that the best way of doing it was to have a full scale audit that went into things. Ash [Lewis] and I could see the potential fault lines on the control side”.

- 9.7 On returning to London, Lewis arranged for audit visits to several overseas units of FPG, but found that Manson’s BSL audit team had already planned to visit Singapore as part of their scheduled programme of routine audit visits arranged before the merger of the two Internal Audit Departments of BB&Co and BSL. Their intention was to start in early 1994, but the visit was later delayed until July 1994 at Jones’ request. The audit of the South Asia business units was planned as the last audit visit of BSL’s Internal Audit Department, which disbanded upon the team’s return to London. Subsequently, Lewis took over the records of and responsibility for BSL’s Internal Audit Department within the merged department.
- 9.8 As part of the pre-planning for the visit James Baker asked a number of financial and operational managers in London whether they knew of any issues in Singapore which might be relevant to the audit. Among those James Baker spoke to were Bowser and Tony Hawes, and their responses in Figure 9.1 provide an insight into the concerns recognised at the time (June 1994).

Figure: 9.1

| Date | Person interviewed | Key points as written by James Baker |
|------------|--|--|
| 7 June 94 | Bowser, former Head of Futures and Options Settlements | There is some concern that Nick [Leeson’s] combined agency and trading role results in practices which may break local rules (e.g. front running, not best execution) and also that Nick [Leeson] has too much power and influence. |
| 22 June 94 | Tony Hawes, BSL Treasurer | A major concern is the Futures company. Nick Leeson has too dominant a role looking after both trading (agency and proprietary) and settlements aspects of the business; there is no deputy to challenge him. The amounts of money involved are vast and this is a very fast-moving and complex market. TH [Tony Hawes] believes that SJ [Simon Jones] basically leaves NL [Nick Leeson] to his own devices. While he has no evidence to suggest that NL has indeed abused his position, the potential for his doing so needs examining. One specific concern in the futures area is the level of margin calls paid by BSL London without knowing precisely on who’s [sic] behalf the cash is being paid. Citibank are our SIMEX clearing bank. A margin variation payment is made from |

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| Date | Person interviewed | Key points as written by James Baker |
|------|--------------------|---|
| | | our account each day. If our account in Singapore does not carry sufficient funds for a margin call, BSL London pays the difference (could be as much as \$10m). Tony simply receives a request for US\$ to make up the shortfall and has to satisfy the demand at very short notice, sometimes even during SIMEX trading hours. The request is in a lump sum form and the payment is debited to a 'Loans to Customers' account. Tony would at least like to know how much of the payment is for house positions and how much is for customers. |

Source: Planning memoranda prepared by James Baker following discussions with various London personnel.

- 9.9 Tony Hawes confirmed to us that James Baker's note was a correct reflection of his comments at the time.
- 9.10 During his pre-planning discussions James Baker was briefed by Broadhurst who told us: "I briefed him [James Baker] informally, saying that Simon Jones was a very parochial individual and had discouraged any constructive communication or working relationship between London and Singapore". James Baker formed the impression from talking to Bowser and Tony Hawes that Leeson was the key figure in BFS and he put in his audit planning that: "We had to consider the segregation of duties there, look for ourselves and draw our own conclusions. I was left in no doubt that that was an issue". On arrival in Singapore James Baker held many discussions with Leeson and observed exchange activity and back office routines: "My only real source of enquiries with respect to the profitability review and much of the audit review was discussions with ... Nick Leeson. He made time available, much as his work allowed. Simon Jones as well in fact proved to be pretty helpful and not quite the awkward customer we had been led to expect".

Initial draft of the internal audit report on BFS

- 9.11 There were several early drafts of the BFS internal audit report. These drafts were not fundamentally different from the final version with the exception of the earliest draft known to be available. In this earliest draft report, most of the key recommendations which appear in the final report are the same in principle; however, an additional recommendation was made in respect of margin reconciliations. This recommendation was removed from later drafts and from the final report. The background to this recommendation was noted in the report as follows:

"BFS must deposit both initial margin and, if appropriate, variation margin on all contracts open with SIMEX on behalf of clients, which are mainly Baring Securities offices. BFS in turn requests margin deposits from the clients.

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Leaving aside certain timing differences and other minor exceptions, all figures should agree. If they do not it is possible that either SIMEX or BFS are calling incorrect margin amounts ... there is no check to ensure that the amounts called by SIMEX [on BFS] and BFS [on Barings London] are, leaving aside known reconciling differences, the same.

BFS's margin call is calculated by their own computer system: a reconciliation of margins called by BFS to margins called from BFS would ensure that discrepancies between SIMEX and BFS are identified. As an additional by-product, the reconciliation would check that all trades on BFS's system and input to other offices' systems are genuine. At present it is theoretically possible for fictitious house trades (clients would pick up false client trades) to be booked to BFS's system and extra margin called".

9.12 A draft recommendation was made: "We recognise that a daily reconciliation of margin called by BFS to margin called from BFS would be onerous and thus recommend that a weekly reconciliation procedure be introduced as soon as possible".

9.13 As noted above, the point was removed and never appeared in subsequent drafts that we have been able to obtain or in the final report. No management comment appeared in this draft for this point or any other point.

9.14 James Baker told us that:

"I raised the point, say, about half way through the audit with Nick Leeson and discussed its merits. He was very much against completing the control and implementing that point. He was of the view that the control was unnecessary and that it would involve too much work and would be unduly burdensome.

I did not back down immediately but I did back down after a couple of days. Geoff Broadhurst joined the audit for a day or so ... and he joined me in my argument against Nick Leeson, essentially supporting the need for this control, whereas Nick Leeson was saying it would be too much work and we do not really need it.

I think I suggested that it did not have to be daily, that it could be done on a monthly basis, and even a control that takes a clerk two days to produce would not be unduly burdensome if it was completed just once a month. But still he argued against the point.

I can only say that I took the point out of the report because I could not out-argue Nick [Leeson] on this point ... Eventually I was out-argued and I believe Geoff Broadhurst, who was joining the fray, if you like, concurred with me that we should take it out of the report".

9.15 Broadhurst was in Singapore at the time this draft was being discussed and he participated in the debate. His recollection is different. He told us: "My recollection of that discussion is that we had a brief discussion as to what the reconciliation procedure should be and there was a compromise. Instead of doing it on a daily basis, it would be done on a weekly or monthly basis, and that is the bit I cannot remember. But from my own perspective it was clearly a very important reconciliation issue and from James Baker's perspective it was. I left Singapore on the understanding that

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there had been a compromise on the timing but not in the substance of the reconciliation itself”.

- 9.16 James Baker told us that Jones was not involved in discussing the point: “Not on that point. That was the one point where Nick Leeson did argue his own corner pretty strongly on his own. It never got to the stage of involving Simon Jones because it had been removed towards the end of the two weeks when we brought Simon Jones in”.
- 9.17 Other than Manson and Broadhurst, who have confirmed to us they knew of this point, James Baker told us that no-one else in London saw this version of the report or was involved in discussing the point.
- 9.18 In raising the point, James Baker noted that: “The main point for me was to ensure that margin was not being siphoned off by Singapore”. He continued: “I thought that reconciliation would primarily stop any danger of margin being diverted by Singapore”.
- 9.19 James Baker has told us that he had not decided prior to arriving in Singapore that the margin reconciliation was something that he would need to review.

The final internal audit report on BFS

- 9.20 James Baker drafted his report during his two week review of BFS in Singapore. He recommended that the BFS back office should be reorganised so that the General Manager (Leeson) was no longer directly responsible for the back office as well as the front office. James Baker also recommended that the growth in size and complexity of the business made it now appropriate for BFS trading to be subject to the scrutiny of an independent risk management and compliance officer.
- 9.21 The executive summary of the report began: “The audit found that while the individual controls over BFS’s system and operations are satisfactory, there is a significant general risk that the controls could be overridden by the General Manager. He is the key manager in the front and the back office and can thus initiate transactions on the Group’s behalf and then ensure that they are settled and recorded according to his own instructions”.
- 9.22 It continued: “In practice the General Manager’s powers are limited by external constraints such as customer statement reconciliations in London and SIMEX audits. Nevertheless two of our recommendations seek the addition of further checks and balances:
- Key accounting and settlements controls should either be performed or reviewed outside BFS’s back office area; and
 - BFS’s trading activities should be independently reviewed to ensure that regulations are followed and risk limits observed. A suitably experienced manager should be appointed to review the records, perform some tests of detail and discuss activity with BFS’s traders”.
- 9.23 The recommendations were set out in more detail later in the report. Under the concentration of responsibilities point it was stated that:

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“Concentration of Responsibilities in the role of General Manager

Despite the significant turnover of BFS it is a relatively small company with straightforward systems. Perhaps as a consequence of this both the front and back office operations are managed and controlled by the General Manager, Nick Leeson.

This represents an excessive concentration of powers; companies commonly divide responsibility for initiating, settling and recording transactions among different areas to reduce the possibility of error and fraud.

The back office has functioned efficiently under the current arrangements. The General Manager likes to be involved in the back office and does not regard it as an undue burden. There are also mitigating factors which serve to reduce the concentration of power in the General Manager's role:

- With a single exception, BFS do not settle with clients directly but with other Baring Securities offices, primarily London. Transactions between these offices and BFS are subject to reconciliation controls.
- BFS's management and statutory accounts are produced by the accounts department of Baring Securities (Singapore) who receive a monthly trial balance from BFS.
- BFS's systems and records are subject to detailed regulatory audits.

In normal circumstances it would not be desirable for one individual to combine the roles of dealing and trading manager with those of settlements and accounting manager. Given the lack of experienced and senior staff in the back office, we recognise that the General Manager must continue to take an active role in the detailed operations of both the front and the back office.

Recommendation

BFS's back office should be reorganised so that the General Manager is no longer directly responsible for the back office. Specifically the General Manager should not: retain sole responsibility for the supervision of BFS's back office team; retain cheque signing or journal-passing powers; review and sign off SIMEX deposit, variation margin and collateral reconciliations; and review and sign off bank reconciliations.

Besides the General Manager, BFS's back office staff are relatively junior and inexperienced; it will thus be necessary for him to retain some involvement in the control areas. For example, he should continue to double-check the back office's output as often as he deems appropriate and be available to assist with reconciliation problems. He would of course continue to fulfil back office roles which do not involve the settlement and recording of transactions such as liaison with the SIMEX authorities and the arrangement of funding in conjunction with Group Treasury. We envisage the General Manager's current powers with respect to personnel matters such as recruitment and remuneration remaining unchanged.

The responsibility for performing daily bank reconciliations should be transferred to BSS's accounts department.

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A manager outside BFS's back office should approve and sign off all journals and new account openings as well as perform a daily review of system-generated print-outs of journal entries and standing data amendments.

Other responsibilities relinquished by the General Manager should be taken on by the BSS's Director of Finance and Operations. The main requirement is to ensure that the settlement and recording processes are adequately supervised including, for example: daily contact with the futures settlement supervisor who should refer all significant matters arising in the office for discussion; daily review and sign off of SIMEX reconciliations; occasional review of daily checks of trades recorded on the system to SIMEX reports and trade tickets; and occasional review of standards maintained over standard procedures such as journal entry, customer statement despatch, invoice despatch".

9.24 Under risk and compliance monitoring it was recommended that:

"The growth in size and complexity of the business make it now appropriate for BFS's trading to be subject to the scrutiny of an independent Risk and Compliance Officer".

9.25 James Baker told us that he believed these two recommendations to be the crucial points of the audit. He told us: "He [Jones] fought both of those strongly and I fought back strongly. Eventually, on the segregation of duties point I thought I had won the day. On the compliance officer point, I knew I had not, but I thought I would take the fight back to London". James Baker also told us that Leeson by and large did accept, or appeared to accept, the thrust of the audit points and left it to Jones to argue the case.

9.26 There was then some redrafting, assisted by Broadhurst, who happened to be on a two day visit to Singapore at the time and who suggested that James Baker should: "Beef up the segregation of duties point by listing the duties that Nick Leeson should not be allowed to do, and listing some which should definitely be taken away from him and getting a bit more specific".

9.27 The report also addressed funding arrangements, noting that BFS was often left short of funding on a day to day basis due to timing differences and a requirement to fund certain clients such as FCT, and that any deficit was made up by Group Treasury in London at very short notice. James Baker told us: "I think from the evidence of my brief conversation, I concluded that certainly in a short time it was difficult to give even a split between house and client and, thus, I had to throw it back into Treasury's court and say, effectively, 'I am sorry, I have not been able to solve this problem from my discussions'".

9.28 The report's recommendation on this subject was that: "London's Group Treasury should perform a comprehensive review of BFS's funding requirements" to which Tony Hawes' subsequent official response was: "A review of BFS's funding requirements and those of the Japanese derivatives business as a whole will be one of the tasks undertaken by the new International Treasury Department over the coming year".

9.29 Finally, the report considered gross position limits. The report identified the lack of proper limits on gross positions on SIMEX and recommended that the BSL Risk

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Committee should consider whether it was appropriate to introduce such limits. James Baker told us: "The risk of not having gross limits to me appeared that they could run into funding difficulties and the positions might be so large that when they actually came to unwind them, the lack of market risk would not necessarily mean that we could avoid any problems getting out of them".

9.30 Hopkins' subsequent response to the recommendation was: "This issue is currently on the Risk Committee's agenda and a final decision will be taken shortly". However, no record of discussion of the establishment of gross limits was found in either the Risk Committee minutes or in the minutes of ALCO until 16 February 1995 (paragraph 7.50).

9.31 The internal audit team returned to London without as yet having obtained Jones' and Leeson's agreement to the report's recommendations about back office controls and a risk and compliance officer. According to James Baker, Jones in particular continued his strong resistance to these recommendations. Eventually, several weeks later, the following responses were obtained:

Back office controls

9.32 "Management Response: Nick Leeson, Simon Jones

As agreed with Internal Audit these are not normal circumstances for BFS considering the current absence of third party customers. Should these emerge, the role of the General Manager will obviously change. However, with immediate effect, the General Manager will cease to perform the functions itemised. Bank reconciliations will be transferred to the combined BFS, BSS and BIF [Baring International Finance] Accounts Department. A Financial Manager will sign off all journals, new account openings and perform the reviews recommended. The Director of Finance [Jones] (BSS/BSF *[sic]*) will ensure the adequate supervision of all settlement and recording processes".

Risk and compliance monitoring

9.33 "Management Response: Simon Jones

As discussed with Internal Audit, current risk and compliance issues do not warrant a full time officer for BFS. Since Futures activities are relatively specialised, as agreed with the auditors, the current Risk Manager based in Hong Kong has been approached to perform independent reviews in Singapore as and when required (a quarterly time frame is anticipated). Gordon Bowser has confirmed that he is willing and able to do this". This did not occur.

9.34 "Management Response: Ian Hopkins

BIB's newly formed Group Treasury and Risk Department (GTR), which combines treasury, credit risk and market risk functions, has representatives in Tokyo and Hong Kong who combine credit and market risk control duties with other work, such as income reporting and compliance monitoring. We have considered making a similar appointment in Singapore, but are not as yet convinced that there is enough work for a full time treasury and risk manager, even if the role incorporated some compliance duties. If Singapore's business changes substantially, we will reconsider

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this decision but, for the moment at least, the arrangements Simon has suggested look to be satisfactory”.

Distribution

- 9.35 The on-site visit having ended in August 1994, the report was not completed and finally distributed by Manson until late October 1994. The report was addressed to Norris and copies of the report were distributed to: Ron Baker, Barnett, Bax, Broadhurst, Fraser, Gamby, Farley, Tony Hawes, Hopkins, Jones, Lewis, Sacranie, Thomas and Walz.
- 9.36 It was not seen by MANCO, or sent to the external auditors in London.

Follow up to the final BFS internal audit report

- 9.37 It appears that there was little by way of formal follow up on the points raised in the BFS internal audit report. Norris told us that by the time the report was issued the BB&Co and BSL internal audit functions had merged and that he was consequently no longer directly responsible for the latter although he continued to take an interest in the report. Recipients of the report previously concerned about the need for segregation of Leeson’s duties assumed that it had happened, on the strength of Jones’ and Leeson’s management response. For example, Ron Baker told us: “If I was struck by anything in the report it was that any doubts that I had about aspects of it seemed completely to be set aside by the affirmation that the report gave and went through all the compliance and risk issues ... It gave dates at which the particular fault line of the front and back office thing had been fixed - that had been fixed since August 1994. To me it was a specific and conclusive gold stamp on the strategy in the business, and it also talked about the fact that the compliance and risk and settlement issues had all been resolved”. The report did include an assessment of the profitability, the mitigating individual controls (paragraphs 9.21 and 9.22) and stated: “Much of the year to date [profit and loss] has been earned using arbitrage strategies which call for hedged positions” and “Risk control in London and Toyko review and follow up exceptional profits and losses in a single day.” However, Jones told us in a letter, in respect of the segregation of duties issue: “At the time the response was made, [Jones] did not feel that he was committing himself to immediately becoming responsible for the BFS back office”. Jones seems to have taken no significant steps to give effect to the report in this regard.
- 9.38 Of the recommendation for a review by London Treasury into BFS funding, Tony Hawes told us the: “Report made no mention at all of what I saw as the excess margin there ... It moved my anxiety down a couple of notches”.
- 9.39 The appointment of an independent risk and compliance monitor did receive some attention in London. Norris recalled a discussion he had with Hopkins on this point and that a derivatives trader, Mr Gerald Ashley, had been offered the post but had declined. Tony Hawes noted that there were officially no risks being run in BFS, so it was difficult to interest someone of the right quality.
- 9.40 In Singapore, Jones responded to the need for an independent risk and compliance officer by suggesting that Yong - who had indicated that she no longer wished to remain in her post of Financial Controller - assume this role. Yong was to take up her

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new position (which was approved by London, according to Jones) with effect from 1 March 1995, when her replacement as Financial Controller was due to start at BFS. In a letter to us Jones said: "By agreeing to, and approving the appointment of Rachel Yong to be the Risk and Treasury representative in BFS, London understood and concurred with [Jones'] approach to the Singapore operations, which would address the points raised in the Internal Audit Report".

- 9.41 It appears that Hopkins discussed the findings of the report with BFS management. In a letter to us Hopkins stated that he: "visited Singapore for 2 days at the end of September, 1994, primarily to meet the people who ran the Singapore businesses. He continued that he took with him a draft of the internal audit report prepared by James Baker of Baring Securities Internal Audit department, the recommendations of which were discussed with local management. SIMEX was undertaking an audit at that time".
- 9.42 The scope of James Baker's audit took the form of a review of the designated areas mentioned and was not designed to provide a searching in-depth examination of BFS's controls and financial records. The internal audit did not uncover account '88888'. It did nevertheless address important control issues and made important recommendations. These were not followed up. If after the audit occurred the failure to segregate Leeson's duties, despite the undertakings of local management, had been recognised and corrected, then it is likely that the unauthorised trading of Leeson would have been uncovered. Alternatively, if, after the audit occurred, gross trading limits had been imposed, or an independent risk and compliance officer had been introduced, or the intended comprehensive review of BFS's funding requirement had taken place earlier, then Leeson's unauthorised trading could have been uncovered. Detection could also have occurred if the draft recommendation for a reconciliation of margin accounts had been developed and retained in the final report.

10. EXTERNAL AUDIT

Introduction

- 10.1 This section relates to the work of the external auditors of Barings in London and Singapore. The section includes a summary of the role and responsibilities of auditors, our comments on the effect of Leeson's activities on the 1993 financial statements and mentions the extent to which the 1994 audit had been completed. The section then considers the external auditors' work relating to the relevant key indicators identified in paragraph 1.70.
- 10.2 C&L and their predecessor firms in London had been the auditors of Barings plc for many years prior to 31 December 1994. The Singapore firm of C&L, a separate partnership, was appointed to audit the financial statements of BFS for the first time in respect of the year ended 31 December 1994. In 1992 and 1993 the audit of BFS was performed by the Singapore firm of D&T who reported to C&L London for the purposes of its audit of the consolidated financial statements of Barings plc. C&L audited all other relevant subsidiaries of Barings in 1992, 1993 and 1994, through its London office or other offices of C&L.
- 10.3 The following three paragraphs are included to assist in an understanding of the remainder of this section.
- 10.4 An audit of the financial statements of a company incorporated in the United Kingdom is required under the Companies Act. The auditor is required to give a report to shareholders on whether the financial statements give a true and fair view of the company's state of affairs as at the date of its balance sheet, and of its result for the period ended on that date.
- 10.5 Auditors have a professional requirement to comply with Auditing Standards and to consider Auditing Guidelines issued by the Auditing Practices Board. These standards state, amongst other things, that an auditor should assess a company's system of recording and processing transactions as a basis for the preparation of financial statements. If an auditor then wishes to place reliance on the operation of internal controls in the conduct of his audit he should ascertain and evaluate these controls and perform compliance tests on their operation to obtain reasonable assurance that the controls on which he wishes to rely were functioning both properly and throughout the period.
- 10.6 Auditing Guidelines state that auditors should plan their audit so that they have a reasonable expectation of detecting material misstatements in financial statements or accounting records resulting from irregularities or fraud.

1993 audit

- 10.7 D&T reported to C&L London on the financial statements of BFS for the 15 month period ended 31 December 1993, produced for the purpose of preparing the consolidated financial statements of Barings plc, on 28 January 1994. D&T's audit was stated to be conducted in accordance with UK Auditing Standards. Their report was unqualified apart from an outstanding matter relating to outstanding bank

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confirmations. C&L London have no recollection of receiving any subsequent modification of this report. BFS reported a profit for the period of S\$20 million (£9 million). It is now apparent from our analysis of Leeson's trading activities that the profits arising from the activities within BFS must have been materially overstated for this accounting period as there were concealed realised and unrealised losses for that period of about £19 million to be offset against the reported profit.

- 10.8 C&L London placed reliance on D&T's opinion in their audit of Barings' consolidated financial statements. The financial statements of BFS were consolidated into the Barings Group financial statements for the year ended 31 December 1993. As a consequence of including what can now be seen to have been these misstated results, it is now apparent that the consolidated profit of Barings plc for the year ended 31 December 1993 was also overstated.
- 10.9 We have not been permitted either access to the working papers of D&T or the opportunity to interview any of their personnel who performed the audit. We do not know what records and explanations were provided by BFS personnel to them.

Status of the 1994 audit

- 10.10 At the date of the collapse C&L London had not completed its audit of the consolidated financial statements of Barings plc. Davies told the inquiry: "No external opinions had been expressed. We had received clearances in line with the audit instructions that had been issued from the various entities around the Group ... we were still two weeks away from the statutory accounts".
- 10.11 In a letter to us C&L London have told us that there were outstanding audit items at 25 February 1995, namely:
- "(a) The preliminary announcement of results was planned for Monday 13 March. At the time of the collapse, the subsidiaries' financial statements had not been agreed and the signing by us of a working copy of the group financial statements was planned for 10 March. Furthermore, we only received a first, incomplete draft of the group financial statements on the afternoon of Friday 25 February.
 - (b) We had not started our subsequent events review in London. This is clearly a vital part of the audit and it would be wrong ... to conclude that these enquiries would not have led to the identification and questioning of the significantly increased funding requests from Singapore that we now understand to have arisen post 31 December 1994.
 - (c) At the time of the collapse both our management letters and work relating to regulatory reporting were outstanding".
- 10.12 C&L London had met Barnett and Broadhurst on 21 February 1995 to discuss audit issues arising from the Barings Group. C&L's minutes of that meeting record that: "It was noted that C&L were still auditing the consolidation journals, but would be in a position to clear the group PBT [profit before tax] on 23 February [1995]".
- 10.13 C&L London told us they were aware the Board had met to approve the accounts on 22 February 1995 although they did not attend the Board meeting. At that meeting it

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was reported to the Board that the preparation of the financial statements would be concluded with C&L on the following day, Thursday 23 February 1995. The profit for the year before tax would have been £102.3 million although a further provision of £1 million was being considered. It was resolved at that meeting that a committee of any two members of the Board was authorised to approve any necessary amendments to the draft financial statements provided at the meeting and to convene the Annual General Meeting to approve them.

- 10.14 The recollections of the Barings plc directors we have interviewed differ as to the state of the 1994 accounts as at 22 February 1995. Peter Baring told us that prior to the Board meeting Barnett had taken him through the draft accounts and had identified two outstanding matters, one of which was the SLK receivable. He told us: "It was my impression that it remained outstanding at the time of the Board meeting". However, Tuckey told us: "I recall Geoffrey Barnett saying - as the plc Board approved these accounts the day before the collapse occurred - there were one or two audit issues which were still in discussion but they were minor and they would be resolved the next day. These accounts were approved by the plc Board at that time the day before. It could be ... that one of those issues was ... something about Spear Leeds Kellogg as an unreconciled client account. Maybe that was one of those points that was raised, but I certainly did not know about it".
- 10.15 Peers has told us that there was no discussion of any unresolved matters relating to the audit at the Board meeting. He was unaware of any material outstanding issues. He told us: "There was an indication, which, I think came from Geoffrey Barnett, who was in attendance, that he expected the accounts to be signed the following day".
- 10.16 We understand that BB&Co staff were to be informed of their bonuses for 1994 on 24 February 1995. It was unlikely that this date could have been met if there had been any significant unresolved audit issues at the Board meeting which might have materially affected the profit available to distribute as bonuses. If C&L London had any significant unresolved matters which might have affected the amount available for distribution as bonus, we would have expected them to be communicated in advance of this Board meeting.
- 10.17 Davies has told us that he had met Norris to discuss matters relating to the audit at 2.00pm on Thursday 23 February 1995. Davies told us that at this meeting he had asked: "Is there anything that you [Norris] know of that you think would have a bearing on our audit that we have not discussed in this meeting?" Davies continued: "He [Norris] said 'No, nothing'".
- 10.18 Norris has given us his account of this meeting saying: "I only met the auditors once in the context of the 1994 audit which was, ironically enough, on 23 February [1995] when Gareth Davies (who was the audit partner) arranged to see me to give me his debrief". We asked Norris whether the SLK receivable (paragraphs 10.39 to 10.57) was discussed specifically. Norris replied: "No. In fact very little was. I can remember thinking that the previous year we had spent two and a half hours going through various things and this was literally half an hour of tea and biscuits really".

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The internal audit report on BFS

10.19 C&L London have told us that they had not arranged to receive copies of reports produced by the Internal Audit Department of BSL although they did receive the reports of the Internal Audit Department of BB&Co regularly. Davies, Mr Andrew Turner, a partner in C&L London, and Fitzgerald have all told us that no one from C&L London saw the internal audit report on BFS prior to the collapse. Fitzgerald told us he was not aware of any concerns over the segregation of duties in BFS prior to 1 February 1995 when Broadhurst mentioned it in the context of the SLK receivable (paragraph 10.44).

10.20 The Audit Strategy Memorandum prepared by C&L Singapore in November 1994 contains the following observation:

“Internal Audit Review

No major issues were raised by the Corporate Internal Auditors from London during their visit in August 1994”.

10.21 As we have not been able to interview C&L Singapore representatives, we have not been able to determine whether the report was made available to them and on what basis they drew this conclusion. Manson has told us that C&L Singapore had asked to see a copy of the report but he does not believe he sent one to them. The inquiry has not been able to determine whether C&L Singapore received a copy of the report from another source.

C&L assessment of the internal control environment

BFS

10.22 C&L London did not receive copies of planning documentation from D&T, the auditors of BFS in 1992 and 1993. As part of the 1993 audit, D&T completed a check list at the request of C&L London in order to provide the parent company auditor with a summary of the audit approach followed by D&T and their principal findings. In completing this questionnaire D&T confirmed: that they had evaluated the adequacy of controls within the accounting system and identified that reliance could be placed on these controls; that they had performed sufficient testing to provide audit evidence that internal control procedures were in place and were effective; and that there were no weaknesses in the company’s systems which were of sufficient significance to bring to C&L’s attention.

10.23 No significant matters were raised in the management letters prepared by D&T in 1992 and 1993 following their audits of BFS.

10.24 C&L Singapore performed an assessment of the BFS control environment as part of their audit planning which was completed in November 1994. The assessment stated: “We have completed our assessment and concluded that its control environment is satisfactory ... Internal control procedures in place are assessed to be adequate”. The audit strategy was described in the following terms: “Given the high volume of trades and adequate internal controls, a system-based audit would be done. Balance sheet trade items would be validated via confirmations as there are only 4 clients. Analytical

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review of P&L [profit and loss] items would be done with vouching restricted to unusual trends and items". This planning documentation was, as a matter of routine, sent to C&L London.

- 10.25 This conclusion as to internal controls is on the face of it not readily compatible with the lack of segregation of duties. We do not know the basis for this conclusion by C&L Singapore.
- 10.26 C&L Singapore had informed C&L London on 27 January 1995 of one potential point for the management letter of BFS. This related to the frequency of the calculation of Adjusted Net Capital for local regulatory purposes.

BSL

- 10.27 The planning documentation prepared for the audit of BSL in 1992, 1993 and 1994 suggests that C&L London perceived a gradual strengthening of BSL's controls.
- 10.28 C&L London in planning their 1994 audit stated that: "Prior year experience, preliminary planning and control testing to date ... indicates that the control environment is good and that good computer and application controls exist. Therefore our audit work will primarily consist of tests of application and computer controls for the systems as shown in the flow of accounting records".
- 10.29 In 1993 they concluded: "There is a good attitude to control and the general control environment can be relied upon. The environment appears to have strengthened in the year and operational controls operated more effectively as a result".
- 10.30 In 1992, the assessment was: "There is a good attitude towards control and in general the control environment can be relied upon, although the depth of this attitude is in some doubt. However, due to the increased importance of First Futures ... there is a need for good manual controls where information is moved between systems, more attention is required in this area".
- 10.31 The assessment of internal controls carried out as part of the audit would have been used as the basis for recommendations on the internal control environment contained in annual letters to management. We have been told by C&L London that no draft management letter for 1994 had been prepared at the time of the collapse.
- 10.32 The Barings Group management letter prepared after the 1993 audit observed that reconciliations of intercompany accounts were reviewed monthly but a formal review was only performed annually. This point had been made previously in 1992. The management response in 1993 was to agree that a procedure for monthly reconciliations was now Group policy and had been implemented in London in November 1993, although not yet in overseas offices.
- 10.33 The management letter in 1992 had identified control weaknesses in the area of derivatives settlement. The letter observed:
- "The areas of internal control weaknesses which we believe require immediate attention are detailed below:

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Derivatives Settlements

The Derivatives Controller has not acted in a review capacity due to high staff turnover, and lack of resources on the desk.

Since most of the derivatives business originates in the Far East the Derivatives Controller, who is London based, has found it difficult to exercise the degree of global control required”.

The audit of Futures and Options Settlements

- 10.34 In 1994, C&L London adopted an audit approach to BSL which was based on the examination and testing of the internal controls in operation. This work included an assessment of controls and an examination of the operation of the identified controls to ensure that they were operating effectively.
- 10.35 C&L London’s work in relation to margin calls included tests of the procedure used by Futures and Options Settlement staff to ensure that margin calls were reasonable and that payments were properly authorised within appropriate limits. In the performance of the reasonableness review, C&L staff noted, following a conversation with Granger, that: “For Singapore, SPAN margining is used, so only a ball park margin requirement can be calculated ... Due to BG’s [Granger] experience and other supervisors in FF [First Futures], they have a rough idea of how much the margin will be. If out of line, they will investigate, if material”. These notes were made following C&L London’s observation of the Futures and Options Settlements Staff on 20 December 1994.
- 10.36 C&L London have told us that the reference to Granger’s experience is derived from their dealings with her since 1992 and the opportunity they had to assess her experience. C&L London have told us that their staff were told by Granger that: “She and her fellow supervisors were able to judge, in general terms, whether margin calls were within the range that they would expect”. C&L London further told us that their staff accepted that Granger had the experience to be able to make this judgement.
- 10.37 No specific tests were performed in relation to margin payments to BFS, which represented the largest component of outward margin payments. The difficulty of reconciling margins paid to BFS with the margins collected from clients of BSL was not apparently explored; nor was it established whether BFS was able to provide a precise breakdown supporting the daily requests of funds. Elsewhere in the work papers, C&L London staff identified that SPAN margining software for LIFFE and Hong Kong Futures Exchange was available and was used within BSL to recompute margin requirements. The reason why BSL staff did not similarly use the specific SPAN margining software for SIMEX was not explored.
- 10.38 C&L London have also told us that they performed controls testing over the cash payments system, through which margin payments were made. Controls over the payment of cash from BIB to other Barings Group companies were audited in September 1994. The audit testing revealed a number of control weaknesses. The work papers state: “There is no evidence of strong monitoring controls by management. Therefore at the year end we will test the process over reconciliations”. The intercompany reconciliations as at 31 December 1994 were subsequently tested by C&L London and no discrepancies were found by them.

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The audit of BFS and amounts apparently receivable from SLK

- 10.39 We have not been permitted either access to the work papers of C&L Singapore or the opportunity to interview any of their personnel who performed the audit. C&L Singapore has stated that its obligations to respect its client's confidentiality prevent it assisting us. We do not know what records and explanations were provided by BFS personnel to them. We have however had access to communications from C&L Singapore to C&L London.
- 10.40 C&L Singapore planned to audit the balance sheet of BFS by confirming the trade assets with third parties. As already noted, the Audit Strategy Memorandum on BFS stated that: "Balance sheet trade items would be validated via confirmations as there are only four clients" and: "trade and bank confirmations ... would be done for year end balances".
- 10.41 A status report from C&L Singapore dated 27 January 1995 by Khoo Kum Wing to Turner set out his understanding of the debtor balance as follows:
- "There is a ¥7.7 billion (S\$ equivalent 115 million) trade receivable from a third party Spear, Leeds & Kellogg ('SLG') [*sic*]. This represents refund of margin deposited with SLG for an over-the-counter [OTC] Nikkei option which expired on 30 December 1994. The amount is still outstanding. We are awaiting the audit confirmation of the year end balance.
- We are informed by BFS that collectability of the said ¥7.7 billion is not envisaged to be a problem. Also, the contracting party with SLG is Baring Securities Limited ('BSL') and that SLG's credit worthiness has been discussed with BSL. Could you confirm with BSL that SLG is an on-going customer and is credit worthy".
- This balance represented about 20% of the gross assets of BFS and 3.3 times its net shareholders' funds as at 31 December 1994.
- 10.42 We have seen a copy of a letter on BFS's notepaper apparently sent on 1 February 1995 to SLK asking them to confirm details of this transaction directly to C&L Singapore. We do not know if any confirmation letter had been sent to SLK previously, and we do not know whether it was sent under the control of C&L Singapore personnel as would be required by UK Auditing Guidelines.
- 10.43 According to Fitzgerald's account he raised the matter of the SLK receivable with Broadhurst on 1 February 1995. Fitzgerald had not spoken to C&L Singapore and relied on the information in the status report. He told us: "Geoffrey Broadhurst expressed surprise about this matter and said that he would investigate it accordingly. He asked me to contact C&L Singapore to ensure that a rigorous audit of the balance [sheet was carried out]".
- 10.44 Fitzgerald responded to Broadhurst's request by drafting a fax to Khoo Kum Wing dated 1 February 1995 which read:
- "Thank you for your recent status report. I have discussed certain matters with Geoff Broadhurst and he is concerned about certain aspects of the audit of the above company [BFS].

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Firstly, he was not aware that BFS had a large receivable from Spear, Leeds & Kellogg. He considers that this is an issue which needs to be followed up by a suitable member of your audit team. If the option expired in December then it should have been repaid by now. He is also surprised at your comment regarding BSL being the contracting party. What does this mean? If BSL was the contracting party should the receivable balance be in the books of BSL?

BFS is largely operated by one person and therefore there will not be the same segregation of duties found in other companies. He has therefore requested me to ask you to perform a rigorous audit of the balance sheet paying particular attention to intercompany balances and receivables. There should be no material reconciling items in the intercompany accounts. Please telephone me as soon as possible to discuss the above".

- 10.45 C&L London did not believe they needed to involve themselves in this process. Fitzgerald told us: "I felt that I was acting as a messenger, as a conduit. He [Broadhurst] asked me to do this and I was thinking 'Come on, guys. These guys are about to sum up their audit opinion. Yes, I will do it if you are asking me to fax this across to you in Singapore'. I felt I was acting as messenger in that respect. They were supposed to be signing off their balance sheet within, I think, the next day. Any issues or control aspects would have been identified by the auditors before then. It did not need somebody in London to tell them about the certain situation in Singapore, but I did it because Geoff asked me to".
- 10.46 In error, Fitzgerald sent his message by fax to the office of D&T in Singapore who had audited BFS previously. Fitzgerald spoke to Khoo Kum Wing on 2 February 1995 to convey the same information. We have seen Fitzgerald's note of their telephone conversation from which it appears that Khoo Kum Wing's understanding was that BFS was acting as a principal for a customer of BSL in London. The note records that Khoo Kum Wing agreed to get his audit team to find out more details about the trade; and also records that confirmation of the balance from SLK was still outstanding. Khoo Kum Wing further reported that BFS had received the money due from SLK subsequent to the status report being sent. The note states that: "Documentation at Singapore is very scarce on this deal".
- 10.47 We have seen a copy of the confirmation purportedly received from SLK confirming the receivable, which has been extracted from the audit files of C&L Singapore. The confirmation was apparently received by fax and the incoming fax contained a header line which read: "from Nick and Lisa". We understand that SLK representatives have informed the CAD in Singapore that no such confirmation was sent by them. We have also seen from these work papers a fax message purportedly from Ron Baker confirming his approval of the transaction. Ron Baker has subsequently told us that this document was forged. We have also seen purported summaries of transactions through BFS's Citibank account. We have been unable to interview C&L Singapore representatives to ascertain what steps they took to ensure these documents were genuine and whether they were received directly at C&L's office in Singapore or provided by Leeson. These documents appear to be the same as those referred to in paragraphs 5.57 to 5.60.

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- 10.48 The terms of the OTC option contained in the original trade confirmation letter to SLK, and available to C&L Singapore, show that at the time the option was written it was out-of-the-money having no intrinsic value. The confirmation letter also indicated that the transaction was entered into on 1 October 1994, (a Saturday). Although C&L Singapore had little documentation available to them, they could have questioned the commercial rationale for the transaction on the basis of the information in the confirmation letter. We have not been able to ascertain what questions they did ask about this transaction and, in particular, whether they checked the outgoing payment or sought to obtain the contract documentation which would normally be required for an OTC option.
- 10.49 On 3 February 1995 C&L Singapore issued an unqualified report on the consolidation schedules of BFS prepared for the purposes of producing the consolidated financial statements of Barings plc. According to our analysis, at 31 December 1994, there were within BFS concealed realised and unrealised losses of £208 million for the year then ended. BFS reported a profit for the year of about £8 million. C&L Singapore stated that they had performed their audit in accordance with UK Auditing Standards.
- 10.50 In a supplementary letter to C&L London dated 3 February 1995 and received on 6 February 1995, C&L Singapore described the SLK transaction in the following terms: "This amount arose due to a right purchased on a Nikkei option by a client - Spear, Leeds & Kellogg ('SLK'). The option expired on 30 December 1994 and was not exercised by SLK. As a result premium payable by SLK which was agreed to be withheld and treated as collateral was receivable from SLK at year end. The premium of ¥7,778 million was confirmed by SLK as outstanding as at year end and has been received on 2 February 1995. An audit confirmation from Baring Securities Limited ('BSL') has been received stating knowledge and approval of the said deal. We understand that BSL is a counter party to the transaction and the payment to BSL was made by 31 December 1994 [sic]".
- 10.51 Subsequently, on 23 February 1995, C&L Singapore completed the first part of their subsequent events review according to the timetable set by C&L London. C&L Singapore reported that day to Turner that: "We confirm that no events have occurred subsequent to the year end which would affect your signing of the group accounts, subject to the finalisation of bonus provision".
- 10.52 Fitzgerald told us that he regarded the conversation with and clearance by C&L Singapore as a confirmation by them that the audit issues raised by the SLK receivable had been resolved. A further discussion took place at a meeting with Broadhurst and Seal on 9 February 1995 at which Turner and Fitzgerald were both present.
- 10.53 C&L's notes record that, at that meeting, Broadhurst described the transaction as arising from an error resulting from a trade between BNP and SLK, BSL having paid SLK rather than instructing BNP to do so. He was reported as saying that he: "was concerned that the error could occur and that it took a number of weeks to identify. The back and front office functions have since been split and extra staff employed to cope with increase in trade". Fitzgerald told us that after this meeting he believed he had received positive messages from the clean audit report on BFS and from the fact that Broadhurst had responded positively in the six days since the matter was first brought to his attention, including splitting front and back office functions in BFS. At

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the conclusion of this meeting he thought: “‘It’s a dead issue’, and I did not think any more of the matter”.

- 10.54 At the meeting, Broadhurst questioned whether reference to the SLK receivable would be made in the management letter of BFS at the conclusion of the audit and explained that it would be preferable for there to be no reference to the incident in the management letter to be issued by C&L Singapore. Turner told us: “He [Broadhurst] was concerned that there would be a management letter point in Singapore about the SLK debtor issue which he was concerned about, because he thought it might give regulatory problems with the Singapore authorities if it was reflected”. Turner told us that he informed Broadhurst that it was a matter for C&L Singapore.
- 10.55 C&L London have told us that they did not consider it necessary to investigate at that stage in London the business and control issues arising from BFS’s apparent receivable from SLK (greatly in excess of the credit limit for SLK approved by the Credit Committee) in respect of an OTC option (a business activity that BFS was not authorised to carry out); or to find out who in BSL had supplied the audit confirmation to C&L Singapore authorising the transaction (given that London-based management had told C&L London they had no knowledge of the transaction). Nor did C&L London consider that the request from Broadhurst not to include the matter in the management letter of itself warranted further investigation. C&L London have told us they relied on the explanations which C&L Singapore and Broadhurst provided, although they recognised the explanation provided by their Singapore office was inconsistent with that given by Broadhurst at their meeting on 9 February 1995. C&L London were content to rely on the work of their Singapore office which had concluded that there was no remaining question as to recoverability of the amount involved and the similar assurance of Broadhurst. The request from C&L Singapore in their status report of 27 January 1995 to C&L London to investigate the credit worthiness of SLK was not pursued.
- 10.56 The apparent receivable from SLK was in excess of 10% of Barings’ capital and should therefore have been reported by Barings to the Bank. C&L’s London work papers note that: “Barings need to confirm to C&L London audit team what effect this non-disclosure had on the recent Bank of England return as at 31 December 1994. C&L not reporting on BSD1 [a prudential return] at 31/12/94. However, BB&Co auditors should ensure client properly classifies this”.
- 10.57 From the copies of those work papers prepared by C&L Singapore in the course of their audit of BFS made available to us by C&L London, it appears that C&L Singapore did not detect that the confirmation letter from SLK, the Citibank transaction records and the post facto authorisation of the transaction by Ron Baker presented to them as purported audit evidence might not be genuine documents.

11. REPORTING BY BARINGS TO SUPERVISORS AND REGULATORS

Introduction

- 11.1 In this section of the report we review, from the viewpoint of Barings, the reporting to supervisors and regulators, including: BB&Co's supervisor and the Barings Group's lead regulator, the Bank; the SFA, which regulated BSL and BSLI (and also in certain respects BB&Co); SIMEX, which regulated BFS; and the MoF, which regulated BSJ. We also cover certain other compliance matters. Section 12 reviews the supervision and regulation of Barings from the viewpoint of the Bank and the SFA. Appendix XIV includes background information on regulatory matters.
- 11.2 We consider important background information and specific matters which are relevant to the collapse of Barings as follows:
- (a) Necessary background information on consolidated supervision, solo consolidation, the connected lending limit and treasury concessions (paragraphs 11.4 to 11.7);
 - (b) Large exposures (LEs) reported to the Bank showing maximum exposures during a particular period and exposures at the end of that period. What constitutes a LE and information on BB&Co's obligations with respect to LEs is provided in paragraphs 11.8 to 11.11. An overview of the critical considerations for LE reporting insofar as they relate to the collapse of Barings is provided in paragraphs 11.12 to 11.20;
 - (c) Solo consolidation. We consider in paragraphs 11.21 to 11.29 whether solo consolidation of BSL with BB&Co contributed in any way to the collapse (solo consolidation is explained in paragraph 11.5);
 - (d) Reporting of monies sent by BSL to BFS on the solo consolidated LE returns. Although Barings' London management believed these sums sent to BFS to fund advance margin payments (or 'top up', as described in paragraph 6.68) constituted loans to clients, the solo consolidated LE returns failed to include substantial 'top up' balances as LEs to individual clients. In fact, the advance margins did not constitute loans to clients, but funded BFS's 'house' positions and should accordingly have been reported as LEs to BFS (in breach of the connected lending limit);
 - (e) Consolidated LE returns submitted by BB&Co to the Bank. These showed exposures in excess of the 25% limit in respect of exchanges in Japan and Singapore, and, due to control failings in both BFS and BIB, contained a number of errors;
 - (f) Segregated Accounts Reporting Statements (SARS) reported to the SFA. The SARS reports, which dealt with certain aspects of client money, were included in the monthly financial reporting statements sent by Barings to the SFA in respect of BSL. On the basis that Barings' London management believed advance margin (or 'top up') to represent advances to clients, the SARS failed to identify

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the effect of 'top up' until the January 1995 return delivered to the SFA on 22 February 1995, just before the collapse;

- (g) Letters from SIMEX to BFS. SIMEX wrote to BFS on a number of occasions providing information and raising questions which could have alerted Barings' London management to the unauthorised trading activities carried on within BFS.

We have identified a number of significant regulatory reporting failings for which management at Barings are ultimately responsible. These are described below under the headings of the Bank, the SFA and SIMEX.

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Background

- 11.3 We set out below certain key matters which underlie the supervisory relationship between the Bank and Barings.

Consolidated supervision, solo consolidation, the connected lending limit and treasury concessions

- 11.4 Consolidated supervision of a group such as the Barings Group, that includes a bank, is supervision which assesses the risks to the bank (BB&Co) arising from the activities of other companies (such as BSL) in that group. In the case of Barings, this assessment was based on a number of sources of information, including consolidated returns (covering the whole Barings Group) submitted by BB&Co. The Bank authorised BB&Co and was the consolidated supervisor of the Barings Group on the basis just described. As such, it received and analysed data in prudential returns on Barings' consolidated (Group-wide) capital ratios and consolidated LEs.
- 11.5 If the linkage between an authorised institution and one of its subsidiaries is sufficiently strong, and certain other criteria are met, the Bank may permit the subsidiary to be treated effectively as a division of the institution and included in the institution's unconsolidated prudential returns filed with the Bank. This is known as 'solo consolidation'. Where this occurs the subsidiary is monitored for capital adequacy and LE reporting purposes as if it were part of the institution. Barings sought to solo consolidate BSL with BB&Co from 1992 onwards; solo consolidation was permitted, on a provisional basis, in November 1993.
- 11.6 Because the Bank views consolidated supervision as a complement to, rather than a substitute for, supervision of a bank alone (and any companies solo consolidated with it) it sets limits for the exposure of the bank (or the solo consolidated group) to the rest of the group of companies of which the bank is a member. In the absence of a higher limit (or 'treasury concession'; which is outlined in paragraph 11.7) being agreed in respect of a particular group company, the maximum exposure of the bank (or the solo consolidated group) to the rest of the group must be in aggregate no more than 25% of the bank's unconsolidated (or solo consolidated) capital base; this restriction is known as the 'connected lending limit'.
- 11.7 The Bank may permit a bank which is a member of a group of companies to become the 'treasury' for those companies, provided that the group is subject to consolidated

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supervision and certain other requirements are met. In such circumstances the Bank agrees a maximum level for the bank's exposure to a particular group company which is known as a 'treasury concession'. The group company concerned is then removed from the 25% connected lending limit. Only two of the treasury concessions which had been granted to Barings are relevant to the inquiry, namely an £85 million concession to BSL and a £150 million concession to BSL which was withdrawn (because it was redundant) when BSL was provisionally solo consolidated with BB&Co. No treasury concessions were in place in respect of Barings' overseas securities subsidiaries.

Large exposures

- 11.8 Section 38(1) of the Act (which forms the basis of the Bank's LE rules) requires any UK authorised institution to notify the Bank before incurring an exposure (for instance, a loan or other transaction by which it 'exposes' itself to loss) to a person of more than 25% of its capital base. Closely related persons are treated as one person for this purpose.
- 11.9 The Bank has supplemented Section 38 by two Notices to banks. The first such Notice was published in September 1987 and the second, which implemented the EU Large Exposure Directive (LED) and was published in 1993, superseded the first Notice on 1 January 1994. Both Notices make it clear that exposures will be measured on two bases: an unconsolidated or, where applicable, solo consolidated basis and on a consolidated basis. They also require that the Bank should be notified before a bank or a member of a banking group enters into a transaction as a result of which the bank or the group would be exposed to the risk of incurring losses in excess of 25% of its capital base.
- 11.10 The most important difference between the 1987 Notice and the 1993 Notice is that, while in the earlier Notice the Bank had a discretion to allow exposures to a counterparty or group of closely related counterparties to exceed 25% of a bank's or a group's capital base 'in the most exceptional circumstances', the later Notice, in compliance with the LED, removed this discretion at the consolidated level (although certain exposures both to private and public bodies - for example, exposures to banks and sovereign bodies - were exempted from this 'hard' limit by the LED). The imposition of the hard 25% limit at the consolidated level was pointed out by the Bank in a letter of 3 November 1993 to Maclean informing him of the publication of the 1993 Notice. The LED included transitional provisions, and the 1993 Notice provided that the Bank would discuss appropriate transitional arrangements with the banks affected by it (paragraph 12.42).
- 11.11 UK banks are required to file LE returns with the Bank on a quarterly basis showing exposures over 10% of their capital base, both as at the reporting date and with respect to their highest exposures in the period. These returns are filed on both a consolidated and an unconsolidated (or solo consolidated) basis. Prior to implementation of the LED, consolidated LE returns had only to be filed on a half yearly basis.

Overview of LE reporting at Barings

- 11.12 BB&Co submitted a number of returns to the Bank but the most relevant returns for the purposes of the report were in respect of LEs. We consider below the failure to

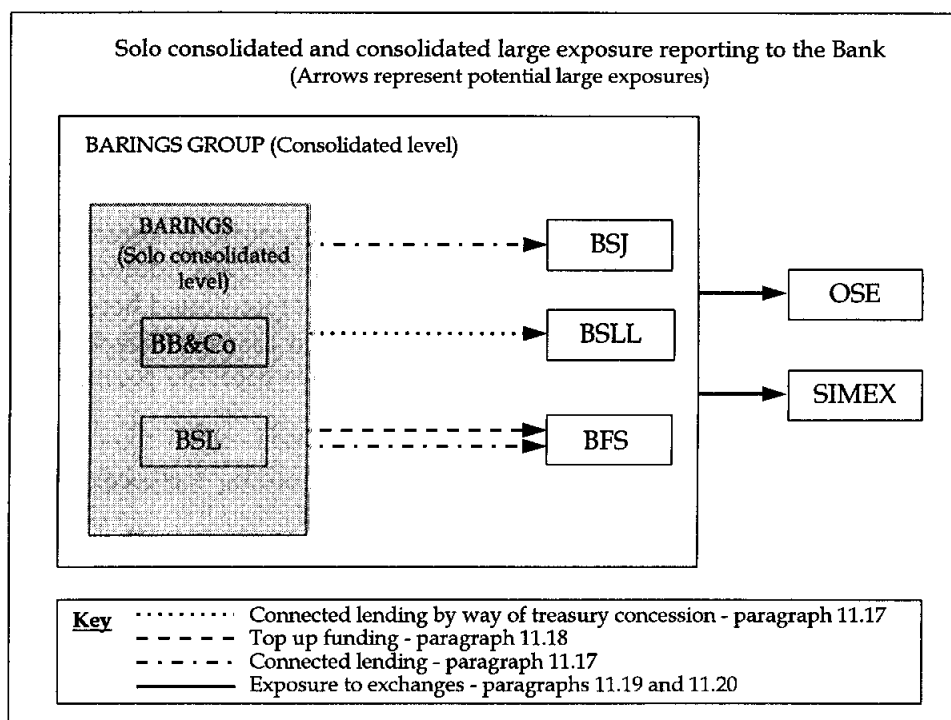
11. Reporting by Barings to supervisors and regulators

report exposures for 'top up' (paragraphs 11.30 to 11.37), the failure to report the true exposure to BFS in Group company exposures (paragraphs 11.38 to 11.40), LE reporting at the consolidated level in respect of exposures to exchanges in Japan and Singapore (paragraphs 11.41 to 11.70), the treatment of the purported SLK receivable (paragraphs 11.71 to 11.74), and responsibilities for reporting to the Bank (paragraphs 11.75 to 11.79).

- 11.13 It is important to distinguish between two levels of LE reporting, namely the solo consolidated level and the consolidated level. Under solo consolidation BB&Co, BSL and Baring Brothers BV (a funding vehicle which is not mentioned hereafter because it is not relevant to the report) reported as a single unit for LE purposes to the Bank. Until November 1993, when solo consolidation was provisionally permitted, BB&Co reported LEs on a stand alone basis.
- 11.14 At the solo consolidated level, reportable LEs were to counterparties external to the solo consolidated group. Such counterparties included other Barings Group companies, such as BFS and BSJ, as well as unconnected parties.
- 11.15 At the consolidated level, reportable LEs were to parties external to the Barings Group (for example SIMEX and OSE), intercompany lending having been eliminated.
- 11.16 Figure 11.1 illustrates, in a simplified form, the parties relevant for LE reporting after solo consolidation was granted insofar as they relate to the collapse of Barings. The diagram shows the major potential LEs, as follows:
- (a) Connected lending exposures at the solo consolidated level, including treasury concessions;
 - (b) Exposures in respect of 'top up', which are relevant in the context of connected lending at the solo consolidated level for funds provided to BFS; and
 - (c) Exposures to exchanges (SIMEX, OSE) at the consolidated level.

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Figure: 11.1



Source: Inquiry team

11.17 BSLL, which conducted proprietary trading, was partially funded by means of a treasury concession of £85 million from the solo consolidated group. BSJ, which did not have a treasury concession, was mostly funded externally (although it did also receive some funds from BSLL), so that there were no significant LEs to BSJ at the solo consolidated level. As noted in paragraph 11.6, exposures of the solo consolidated group to Barings Group companies (such as BFS) which did not have treasury concessions were subject to an aggregate limit of 25% of solo consolidated capital. Significant solo consolidated LEs to BFS were not reported by BB&Co despite the significant exposures to BFS, because of the inadequate treatment of 'top up'.

11.18 BFS's activities on SIMEX were funded by BSL, BSLL and BSJ (paragraph 6.7, Figure 6.1). The unauthorised activities concealed in account '88888' were funded in part by the 'top up' account ('K2/P4', as described in paragraphs 6.65 to 6.80) in BSL. The balance on this account was omitted by BB&Co from the solo consolidated LE returns. The 'top up' account, which was represented on both the daily solo balance sheet and the weekly solo consolidation balance sheet as advances to clients, was not reported in such returns as advances to clients (because it was assumed, without verification, to represent a number of exposures to different clients, each below the reporting threshold) nor as advances to BFS (which was in fact the case as it was funding, at least in part, unauthorised proprietary positions on SIMEX). Had its true nature been appreciated by Barings in London and reported as an exposure to BFS, it would have been materially in excess of the connected lending limit described in paragraph 11.6. Maclean told us: "Our assumption was that they were very, very, small amounts and very widespread amongst some good clients of long standing of Baring Securities".

11.19 At the consolidated level, the key LE reporting issues were in respect of exposures to exchanges in Japan (notably OSE) and Singapore (SIMEX). A number of matters arise.

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First, Barings reported as exposures to OSE only those in respect of house, non-segregated clients and local clients; it excluded exposures in respect of segregated clients. Secondly, the applicability of the 25% limit to the reported exchange exposures was contested by Barings. Thirdly, reported exposures to SIMEX and OSE exceeded the 25% limit at various times. Fourthly, there were potentially certain errors in the reporting of exposures to OSE and SIMEX in the consolidated LE returns.

11.20 At the consolidated level, the 'top up' account was mostly represented on the balance sheet as an exposure to SIMEX, as BFS had used the money advanced by BSL, BSLL and BSJ to fund margins placed with SIMEX. The consolidated LE figures in respect of SIMEX reported by Barings to the Bank were provided by BFS. It is not known how, if at all, the balances arising out of account '88888' was reported by BFS to Barings in London for LE reporting purposes. It is very likely, however, that it was not reported as a 'house' exposure because it was recorded as a segregated client account by BFS. In summary, there was, in effect, no consideration of the impact of 'top up' on LE reporting at either the solo consolidated or consolidated level.

Solo consolidation

11.21 It is necessary to describe the LE reporting framework in place for Barings to put the issues in respect of LEs into context, and because the view has been expressed to us by Maclean and Barnett that the effective solo consolidation of BSL with BB&Co for LE purposes in November 1993 may have itself contributed to the control failings in Barings that led to the collapse. Barings had been considering solo consolidation since 1992. In 1992 Barings requested and was granted by the Bank a treasury concession of £150 million in respect of exposures of BB&Co to BSL. This represented BB&Co's maximum permitted level of exposure for lending to BSL (which was therefore removed from the connected lending limit). During 1992 and 1993 the activities of Barings' securities businesses were placing considerable strain on Barings' financial resources and the Bank's restrictions on connected lending limits restraining the amounts that could be lent by BB&Co to fund these activities (paragraph 2.8). In the unconsolidated BB&Co LE returns for the quarters ended June and September 1993, the maximum in the period exposures of BB&Co to BSL were £162 million and £151 million respectively, compared to the relevant treasury concession of £150 million. This demonstrates that the concession was being fully utilised.

11.22 On 4 February 1993 Mr Christopher Thompson, Senior Manager at the Bank and Mr Philip Kelly, Bank analyst, met with Mr Andrew Jennings (former Senior Director and Head of Surveillance of the SFA) and Mr Rupert Armistead of the SFA, and Norris, Broadhurst and Mr Alexander Murray of Barings. The minutes, as recorded by Murray, state that: "The ostensible purpose of this meeting was that the Bank ... wished to discuss recent developments at Baring Securities and the outlook for the coming year. It rapidly became clear that:

1. The Bank was concerned at:
 - i) The speed of BSL's earnings collapse
 - ii) Its affect on ... [BB&Co's] earnings
 - iii) The subsidiary threatening ... [BB&Co's] very existence

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2. The Bank:

- Did not, at their own admission, really understand BSL's business
- Was worried that its jurisdiction and knowledge (and that of the SFA), did not cover the overseas operations of BSL".

The minute concluded that: "It appears that the Bank was reassured ... and now has a far better understanding of our business, our recent past and our future plans". The Bank's note of this meeting is referred to in paragraph 12.28.

- 11.23 A detailed review, commencing in mid-1993, was undertaken by Tony Hawes of the possibility of solo consolidating BSL with BB&Co so that they would report as a single unit. The main reasons for this were to allow BSL to utilise a larger capital base and to allow BB&Co to fund BSL to a greater extent than was then permitted by the £150 million treasury concession. In order to satisfy one of the criteria for solo consolidation, all external borrowings of BSL were repaid; and BSLL, which was not to be solo consolidated, was set up and BSL's proprietary trading operation transferred to it. Broadhurst told us that: "The other entity that required less capital under SFA rules was the arbitrage, the exchange trade at [traded] arbitrage business because of the risk models that the SFA had approved. The decision to exclude those businesses from BSL and therefore to solo consolidate BSL with the bank meant that there was a capital advantage. There was also a funding advantage because it meant that the bank could provide more funding".
- 11.24 Solo consolidation was discussed with the Bank on 23 September 1993 (paragraphs 12.71 to 12.73) and 22 October 1993 (paragraph 12.74). Barnett's note (copied to Peter Baring) of the meeting on 22 October 1993 with Ms Carol Sergeant (Head of Major UK Banks Supervision Division since March 1993), Thompson and Mr John Mackintosh of the Bank and Barnett, Maclean and Tuckey recorded that: "The meeting was almost entirely taken up by Carol Sergeant asking basic questions about the whole range of the group's business". Barnett's note continued in respect of: "the matter of solo consolidation ... Sergeant and Thompson acknowledged that they are in some disarray on the subject and that approval for solo consolidation on the basis discussed with the Bank of England on 23 September had been given before Sergeant herself had been satisfied with the proposal".
- 11.25 Maclean believed that the Bank granted solo consolidation: "towards the end of 1993" (but see paragraph 12.76), and at or about the same time approved revised treasury concession limits, reducing the total from £394 million to £364 million, including a new £85 million concession in respect of BSLL. The BSL concession was no longer applicable as BB&Co was not restricted in how much it could lend to BSL, since they were treated for supervisory purposes as one unit. With the exception of those companies in respect of which BB&Co had received treasury concessions, the solo consolidated group's aggregate exposure to Barings Group companies, such as BFS, outside that group was still subject to an overall limit of 25% of solo consolidated capital. Barings requested an increase in total concessions to £843 million in October 1994, but this was rejected by the Bank and the limit of £364 million remained in place at the time of the collapse.
- 11.26 Barnett told us that: "I think the consequences of the solo consolidation of [BB&Co] with [BSL] was that the movement of funds to support the worldwide securities

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business actually was not as separately and easily distinguishable as it would have been if the regulatory entity had remained just [BB&Co]”.

- 11.27 Maclean told us: “I was involved in the setting up of the process which became known as ‘solo consolidation’, which in my view, is one of the factors at the heart of this problem, this crisis”. He went on to say: “I think, then, allowing solo consolidation as a technique to be applied, when we look at numbers we see it on the outside of Baring Securities in London but without having controls inside Baring Securities but inside that net, that is the weak link that we will never forgive ourselves for”. He added: “It could not have happened without solo consolidation. That is the starting point, as far as I am concerned”.
- 11.28 We asked why solo consolidation was so fundamental. Maclean explained his view: “That amount of cash could not have got to where it did if it had only been in Baring Brothers [BB&Co]. The principle of solo consolidation is that the bridge between Baring Brothers and Baring Securities was taken away and the two were pushed together, so that any amount of cash that was agreed it could go from Baring Brothers to Baring Securities through the Baring Securities Group Treasury, which is just a branch mechanism. Forget that. It gets into Baring Securities without limit. Our money market people were told that they could fund Baring Securities without limitation. Then we designed various constraints to go round that which, I am afraid to say, the accounting system of Baring Securities completely defeated”.
- 11.29 Our conclusion is that the real fault lay in the control failings in Barings over funding described in Section 6 and summarised in Section 7. It is true that, following solo consolidation, money was allowed to pass without clear visibility from Treasury in BB&Co to BSL, which in turn funded BFS without limit, but that lack of visibility was the result of deficient management accounting and control and the way in which solo consolidation was implemented by Barings

Solo consolidated LE - failure to report exposures for ‘top up’

- 11.30 BB&Co failed to report ‘top up’ either as LEs to clients (paragraphs 11.31 to 11.37) or to BFS (paragraphs 11.38 to 11.40). When BFS posted client margins at SIMEX prior to receipt of funds from the (genuine) client, the funding of BFS’s client margin payment by BSL was referred to as ‘top up’. The debtor resulting from the ‘top up’ process would typically be very short term, say one or two days duration.
- 11.31 While ‘top up’ relating to initial margin and variation margin was properly included in client balances within the First Futures system, the systems in place did not enable ‘top up’ relating to advance margin to be broken down to individual client accounts. The unauthorised trading activities in Singapore were funded in part by sums paid by BSL to BFS in response to requests by BFS to fund advance margin calls (ostensibly on Barings’ clients); these sums ultimately formed margin payments in respect of BFS’s unauthorised positions on SIMEX. Barings’ London management thought these payments by BSL consisted of short term advances to clients of Barings. We are aware of only one occasion in January 1995 when SIMEX made a material advance margin call on BFS. The ‘top up’ stood at £306 million at 24 February 1995, having been £120 million at 30 June 1994, £144 million at 30 September 1994 and £120 million at 30 December 1994 (paragraph 6.74, Figure 6.6).

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- 11.32 The sums advanced by BSL in response to requests by BFS to fund advance margin calls were recorded as advances to clients in the solo consolidation balance sheet (paragraphs 6.65 to 6.80) which was the basis of the capital adequacy return provided to the Bank. At the consolidated level, as the 'top up' was funding margin payments to exchanges, it was mostly reflected in the balance sheet by Barings as part of the exposure to exchanges but the figures for these exposures were obtained from the relevant subsidiaries, BFS and BSJ (paragraphs 11.41 to 11.70).
- 11.33 As noted above, Barings' London management appeared to believe 'top up' consisted of short term advances to clients. However, even if all of the 'top up' had been capable of allocation to individual client accounts there was, in any event, no link from the First Futures system into the LE reporting process and therefore it would not have fed through into LE reporting to the Bank.
- 11.34 Since BSL had no procedure for allocating advance margin to clients and the First Futures system did not feed automatically into LE reporting, Barings failed to identify any large 'top up' exposures for reporting by BB&Co to the Bank. Of course, had Barings realised that the 'top up' was, in fact, for the most part financing 'house' positions and not client positions (an attempt at allocation of 'top up' to client accounts would have brought this to light), the balance should have been included in the solo consolidated LE return as an exposure to BFS. In this event an excess over the aggregate 25% limit for connected lending should have been reported (paragraph 11.39). However, because of the control failings described above 'top up' was excluded from any solo consolidated LE return. It seems that no-one within Barings considered this critical issue.
- 11.35 In a letter to the Bank dated 29 January 1993, Barnett noted: "Controls are being installed in Baring Securities to ensure that limit excesses are captured. They will be reported to a credit unit for prudential purposes and where appropriate taken into account in the calculation of future Group Large Exposures". With regard to this point, Tony Hawes told us: "It [implementation of controls] did [happen] for everything except, with hindsight, the loan contra ['top up']". This January 1993 letter is considered further in paragraphs 11.44 and 11.54. Tony Hawes told us: "I would like to add that at the time we wrote this letter, and throughout 1993, the loan contra was a relatively low figure - up to £10 million - and I was told that it was spread over a large number of clients, or even if it was concentrated on one client, would not have been significant in large exposure terms". He also told us that he noticed that the US Dollar funding requests from BFS were often split 50/50 between 'house' and 'client' but that there was no connection made to LE reporting.
- 11.36 We asked Seal, who signed the LE returns from September 1994, if there was any discussion in the Credit Unit about whether the 'top up' account was likely to lead to a LE reporting issue. She said: "Not that I am aware of". In a letter to us [Seal] stated that: "[I] did sign the BB&Co solo consolidated large exposure returns made to the Bank of England ... but did so in good faith having reasonably relied on information supplied to [me] by the BSL Finance Department, which had been reviewed by [me] and [my] staff (as far as possible) for inconsistencies and obvious errors".
- 11.37 We asked Norris whether there was ever any discussion about the effect of the transfers of funds to Singapore for margin payments on LE reporting, other than the

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question of how to interpret the nature of exposures to exchanges (paragraph 11.44). He told us: "No, I think that was the point, as far as I understood it".

Solo consolidated LE - failure to include BFS in Group company exposures

- 11.38 Excluding those Barings Group companies in respect of which treasury concessions had been given by the Bank, the solo consolidated group's exposure to all other Barings Group companies (including BFS and BSJ) was subject, as noted above, to an aggregate 25% limit. The 'top up' described above, which was in fact an exposure to BFS, was omitted from LE returns of exposures to Barings Group companies.
- 11.39 Exposures of the solo consolidated group to other Barings Group companies were communicated weekly to management in a spreadsheet entitled 'Connected Lending' (in the same format that these were reported to the Bank quarterly). The spreadsheet, which showed small balances (no larger than £18.6 million) due from BFS during 1994 and 1995 through to the collapse (because 'top up' was excluded) and BSJ (no larger than £8.6 million), formed part of a more extensive weekly management pack, which also included a weekly solo consolidation balance sheet. The weekly management pack was circulated to, among others, Peter Baring, Tuckey, Norris, Michael Baring, Maclean, Barnett, Hopkins, Russell, Broadhurst, Peers, Ron Baker, Katz, Tony Hawes, Seal and Sacranie. If the whole of the 'top up' had been included as an exposure to BFS, ('top up' was £144 million at 30 September 1994, £120 million at 30 December 1994 and £150 million at 30 January 1995), and we believe the vast majority of it should have been so included, this would have resulted in the aggregate connected lending limit of £77.35 million (25% of solo consolidated capital) being exceeded.
- 11.40 Barings' management was of course aware of the existence of the connected lending limit. BB&Co's unconsolidated and solo consolidated LE returns submitted to the Bank did not usually show significant funding to BFS or BSJ. For reasons explained earlier in the report, management did not appreciate the true purpose for which funds were being advanced to Singapore. The failure of controls in Barings meant that, following the solo consolidation of BSL with BB&Co, the connected lending limit did not provide an effective barrier between the solo consolidated group and BFS, and in practice funds, which as a matter of law constituted loans by BB&Co to BSL, were passed by BSL to BFS without limit. The solo consolidation of BSL with BB&Co need not have resulted in a reduction in control over the advance of funds to BFS; but in practice, in the case of Barings, it did. We return to consider solo consolidation more generally in paragraphs 14.40 to 14.43.

Consolidated LE - reported exposures to exchanges

- 11.41 Problems in LE reporting had been identified by C&L in their 21 April 1992 report on the Barings Group's 31 December 1991 consolidated LE return to the Bank (paragraph 12.91). Our investigation indicates that, in addition to the failure to report 'top up' described above, there were a number of breaches of LE rules and errors in LE reporting by Barings at the consolidated level in 1994.
- 11.42 The process at Barings for compiling the consolidated LE return after November 1993 was that daily advice of all exposures over £500,000 was sent by cc mail from BSL's subsidiaries worldwide to BSL Financial Control. These exposures were combined with other Barings Group exposures to produce a 'Daily Global Large Exposure

11. Reporting by Barings to supervisors and regulators

Report' which formed the basis for the consolidated LE return each quarter. In respect of BFS, the LE information was subject to the control weaknesses in Singapore described earlier in the report (paragraph 7.14) and it was not independently checked in London.

- 11.43 From the 'Daily Global Large Exposure Report' a 'Large Exposure - Excess Report' was produced. This 'Large Exposure - Excess Report' was circulated daily to, among others, Barnett, Maclean, Ron Baker, Broadhurst, Hopkins, Tony Hawes and Seal. The report contained on its cover all LEs which, on a consolidated basis, breached existing credit limits that day.
- 11.44 The key issues relevant to consolidated LE reporting discussed by Barings with the Bank were the applicability of the 25% limit to exposures to the exchanges and (in the case of OSE only) the separation of 'house' and 'client' margins. These issues were first raised by Barnett in a letter to the Bank dated 29 January 1993 in the context of OSE and TSE. Barings reported net exposures to the Japanese exchanges, that is 'house' exposures and exposures of its non-segregated and local clients, but not of its segregated clients (the issues are explained in more detail in paragraphs 11.54 to 11.56). Barings did not specifically raise the reporting of exposures to SIMEX with the Bank, apparently assuming it was covered by the discussions on OSE. We have not had access to BFS's records to determine fully the components of the amounts which were reported to London in respect of SIMEX house exposure. Accordingly, it is not possible to determine precisely the impact of account '88888' on LE reporting at the consolidated level.
- 11.45 Barings contested whether the 25% consolidated LE limit was appropriate for the Japanese exchanges (and, by implication, SIMEX). Barings' argument was that the 25% limit should not have been applicable to exposures to the exchanges because such exposures should have been treated as quasi-sovereign risk or that they were not in fact to the exchanges themselves, but to the members of the exchanges individually. If this latter argument had been correct, Barings' exposure to each member of each exchange would have been well below the 25% limit.
- 11.46 Norris told us that: "Our argument was that you should not regard the exchange as a single counterparty for large exposure purposes". He explained that it was Maclean, Hopkins and Barnett who addressed this question with the Bank.
- 11.47 Maclean told us: "Many times when we had reported in the Japanese exchanges, we had gone above 25%; so there was no embarrassment about that. They [the Bank] were aware". Tony Hawes told us: "At this time, exposure to the Exchanges was known, that the limits in the system were purely a reporting mechanism. It had been agreed with the Bank of England that until the policy on whether exposures to the Exchanges were a single exposure, joint and several on the members or whether they were sovereign risk or not, the limit was a soft limit so Credit would not have been concerned in above-limit exposures to the Exchanges".
- 11.48 Maclean recorded in a note dated 7 September 1994, copied to Barnett, Hopkins, Russell, Tony Hawes, Katz and Seal, that: "On 6.9.94 we breached our internal limit of £100m in respect of exposure to OSE and exceeded 25% of our consolidated capital base (£117m). Our exposure amounted to £127m. Accordingly, I telephoned Christopher Thompson at the Bank of England to report this fact and to enquire where

11. Reporting by Barings to supervisors and regulators

the BoE stood on exposure to the Japanese exchanges. At our last supervisory meeting in May, Thompson had said he would be writing to us on this subject having had the views of his Policy Unit. Thompson said that he was aware he owed us a response but that the matter was buried reasonably deep in his in-tray. He said, however, that he was relaxed about the exposure on the basis of our view that the exposure was in effect an exposure to all the individual members of the Exchange. I reminded him that although that was indeed our view it would be impossible for us to prove it in a legal sense. He was happy with us having reported the situation and that we should continue to exceed 25% of our capital base from time to time. He will now accelerate the drafting of a formal letter to us setting out the Bank's views". We understand that the Bank does not have a record of this telephone call.

11.49 Around 1 February 1995 (i.e. over two years after the issue was first raised by Barings in Barnett's letter of 29 January 1993) a written response was received from the Bank. The reply from Thompson entitled 'Japanese Stock Exchanges: Margin Exposures' noted that:

- "i) We have been advised by our policy area that the constraints of the Large Exposures Directive do not allow us sufficient discretion to exempt these exposures by classifying the exchanges as quasi-sovereign risks.
- ii) We are unable ... to 'look through' the exchanges to their individual members".

It concluded: "We recognise that for some time there has been uncertainty as to the applicability of our policy to these exposures, and I had hoped it would be possible to accommodate them within the rules. Assuming, however, that we are correct in our understanding of the transactions, as set out in this letter, we would have no discretion not to enforce the 25% limit. At the same time, in view of the nature of the exposure and its importance to your business activities in Japan, instead of instant compliance we would propose that you explore urgently whether it might be possible to reduce the exposure, for example, by persuading the non segregated clients to become segregated or by obtaining an authoritative legal opinion that margin provided to the exchanges to cover clients' positions was not an exposure to Barings".

11.50 Tony Hawes was working on a response (paragraph 7.47). In February 1995 he visited Tokyo to commence discussions with Japanese banks on laying off part of Barings' risk. Maclean noted (paragraph 11.70): "No sooner had the letter arrived from the Bank of England answering on the two Japanese exchanges than we popped above the limit on SIMEX. I was particularly fussed about that. I was almost poised to ring my supervisor but I thought that Tony Hawes was off to Singapore and he was going to do some exploratory work on how we could perhaps cover this credit risk on SIMEX. It was delayed for a bit. I thought that the Bank, having taken two years to reply to us on the Japanese, could wait another week on SIMEX. It very much triggered the worry in my mind about the 25% rules". We consider below the actual reporting of consolidated LEs by Barings.

11.51 It is clear from the consolidated LE returns submitted to the Bank that the Baring Group's exposure to OSE exceeded 25% of its consolidated capital base in five of the six reporting periods from January 1993 to December 1994, and to SIMEX in the quarters ended March 1994 and December 1994. As Barnett stated, Barings was exceeding the limit: "from time to time".

11. Reporting by Barings to supervisors and regulators

11.52 The maximum reported Baring Group's exposure, in each period, to OSE and SIMEX are shown in Figure 11.2 where they are greater than 10% of Barings' consolidated capital base (see paragraph 12.49, Figure 12.1).

Figure: 11.2

| Period covered by return | 25% of consolidated capital base £ millions | Maximum reported Barings' exposure | |
|--------------------------|--|------------------------------------|---------------------|
| | | OSE £ millions | SIMEX £ millions |
| Jan 93 - Jun 93 | 70.8 | 89.6* | - |
| Jul 93 - Dec 93 | 78.2 | 139.4* | - |
| Jan 94 - Mar 94 | 117.4 | 174.1* | 120.2* |
| Apr 94 - Jun 94 | 117.4 | 116.0 | 39.0 |
| Jul 94 - Sep 94 | 117.4 | 195.0* | 75.0 |
| Oct 94 - Dec 94 | 117.4 | 131.0* | 118.7* |

Source: BB&Co consolidated LE returns

Note: * denotes maximum reported exposures above 25% of consolidated capital base

11.53 BB&Co did not prenotify the Bank of LEs to exchanges in 1995 (paragraph 12.64). The first LE reports for 1995 were due to be submitted after the collapse. We reviewed the 1995 'Daily Global Large Exposure Reports' produced by the Regulatory Reporting Department in Barings through to 24 February 1995, during which period the 10% consolidated LE reporting threshold was £46.9 million and the 25% consolidated LE limit was £117.4 million. There were excesses related to both SIMEX and OSE in January 1995, including 31 January 1995 when SIMEX was 39.5% of consolidated capital base at £185.7 million (up from £73.1 million on 30 January 1995) and OSE was 40.8% of capital at £191.8 million (up from £70.6 million on 30 January 1995). On 1 February 1995 the SIMEX exposure was approximately the same as on 31 January 1995 but OSE exposure rose to 73% at £342.7 million. In February 1995 Barings' exposure to both SIMEX and OSE consistently exceeded the 25% limit according to the internal LE reports circulated. These exposures are shown in Figures 11.3 (paragraph 11.57) and 11.4 (paragraph 11.65).

Japanese exchanges

11.54 As noted above in paragraph 11.44 and in paragraph 12.44, the reporting of exposures to Japanese exchanges had been identified as problematic as early as 29 January 1993, when Barnett wrote to the Bank on the subject. The difficulties in reporting these items, as explained by Barings, arose from the fact that BSJ placed margins on these exchanges both on its own behalf and on behalf of its clients and that under Japanese exchange rules only one margin account could be held at each exchange. This therefore resulted in the co-mingling of client and house margin.

11.55 Barings' management believed that exposures of segregated clients did not require reporting to the Bank as in their view the risk was borne by the client, i.e. only margins placed in respect of the 'house' (Barings Group's own positions) and Barings Group's non-segregated and local clients' positions represented Barings' risk and therefore had to be reported. In his letter dated 29 January 1993, Barnett stated: "We have established to our satisfaction that it is correct to apportion risks connected with the

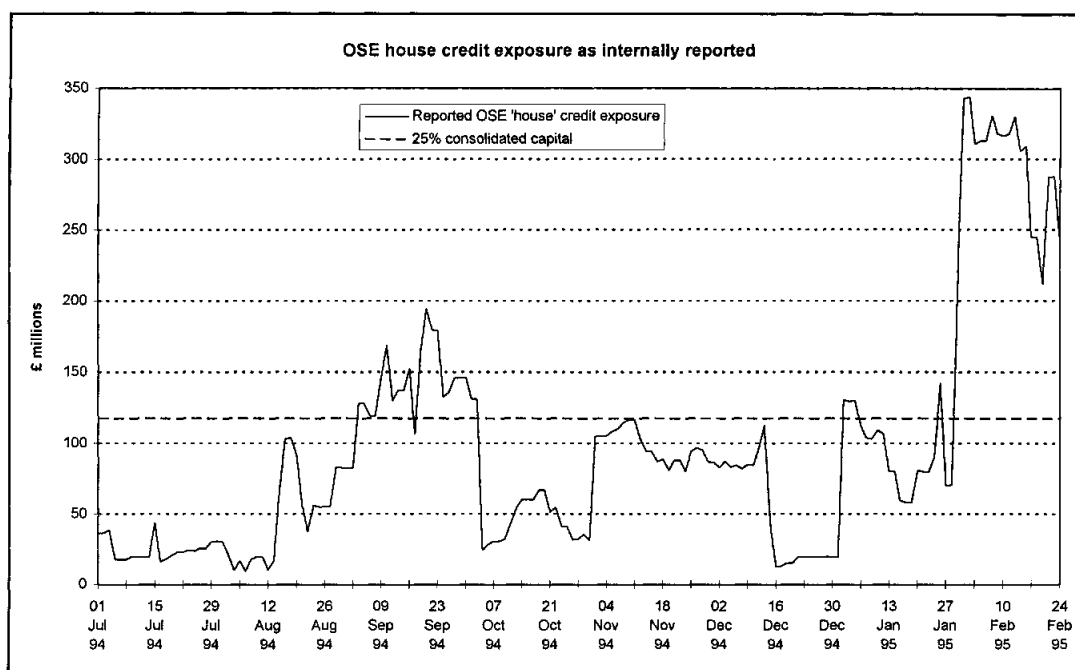
11. Reporting by Barings to supervisors and regulators

net margins provided to the exchanges by BSJ between the group and segregated clients in proportion to the gross margin attributable to each stream of business”.

11.56 According to Tony Hawes the method selected to calculate the reportable exposure to the Japanese exchanges for LE reporting purposes was to prorate the net margin held by the exchange based on the number of outstanding contracts held by the Baring Group or its non-segregated or local clients, on the one hand, and those held by its segregated clients, on the other. This reflected Barings’ view that, in the event of a default by an exchange, the loss would be apportioned on this basis.

11.57 A summary of the daily exposure to OSE, as reported on the ‘Daily Global Large Exposure Reports’, which is consistent with the consolidated LE returns to the Bank in respect of OSE (shown in paragraph 11.52, Figure 11.2) and the increase in positions on OSE from 31 January 1995 is provided in Figure 11.3 for the period 1 July 1994 to 24 February 1995.

Figure: 11.3



Source: Daily Global Large Exposure Reports

11.58 We reviewed the returns from BSJ used as a basis for these figures in the fourth quarter of 1994. These indicated that there were certain days when the ‘Daily Global Large Exposure Report’ figures produced by Barings in London for exposures to OSE did not reflect the information provided by BSJ. It has not been possible to determine why these differences arose. The ‘Daily Global Large Exposure Report’ was the basis for the consolidated LE returns to the Bank.

SIMEX

11.59 Separate ‘client’ and ‘house’ margin accounts were held by BFS at SIMEX so, in theory, overcoming the problem, described in paragraph 11.54, for Japan. However, Barings experienced difficulty in identifying the amounts of ‘house’ positions in 1994 for the purposes of reporting to the Bank the ‘house’ exposure. The reason for this was

11. Reporting by Barings to supervisors and regulators

advised to the Bank in a letter dated 29 April 1994 from Barnett (see also paragraphs 12.50 and 12.58). In this he stated (with reference to the 31 March 1994 LE return): "Our Singapore office maintains two accounts with SIMEX: a house account and a segregated client account. The house account is in respect of the local Baring Securities Singapore office trading positions, and our exposure on this account is generally below £20 million. However, trades from other Barings offices are booked as part of the client account at SIMEX rather than as house trades, so that the aggregate Group exposure to SIMEX has not been established. We are currently setting up a system to determine on a daily basis the total extent of the Group exposure to SIMEX, and this will be put in place shortly. For the purpose of this LE return, however, we have assumed that 50% of our SIMEX client account is actually Group exposure and have aggregated this within the house account to give the reported exposure to SIMEX". It appears this letter refers in error to 'Baring Securities Singapore' rather than BFS.

- 11.60 Tony Hawes told us he discussed with Barnett and Maclean this problem, which was apparently rectified by Mr Mark Cooke, former Regulatory Reporting employee, BIB, advising Leeson and Jones to book all 'house' trades, irrespective of the Baring Group company transacting them, through the 'house' account. Barnett told us his statement about a "system" was based on his understanding of continuing work as subsequently set out in a short note dated 6 May 1994 by Cooke to Tony Hawes. The method to be adopted of reporting house exposure to SIMEX was believed to be accurate at the time of the prudential meeting with the Bank on 18 May 1994 attended by Barnett, Maclean, Tuckey and Thompson and Mr Howard Walwyn of the Bank (paragraph 12.33). Barnett told us: "I assumed that the reported exposure was the correct exposure for May 1994 onwards". We asked Barnett whether he knew how the reporting system had been remedied and he replied that he did not. It is not clear whether this reporting system had, in fact, been amended despite Barnett's: "confidence that the reported SIMEX exposures were the correct ones". In a file note prepared by Barnett, copied to Peter Baring, Tuckey, Norris and Maclean, of the 18 May 1994 meeting, Barnett stated: "We confirmed that we are now monitoring daily our overall house exposure to SIMEX in Singapore".
- 11.61 The issue appeared to Barings to have been resolved until August 1994, when it was again noticed, this time both by Tony Hawes and staff in the Regulatory Reporting Department, that BFS's reported 'house' exposure to SIMEX appeared unusually low. There had been an increase in 'switching' business booked in BSLI in the period leading up to August 1994 (prior to its transfer to BSJ, paragraph 3.32) which had been reflected in the increased 'house' exposures allocated to the Japanese exchanges, but which had not flowed through in increased exposure to SIMEX as reported by BFS.
- 11.62 This was followed up by Tony Hawes via a cc mail to Leeson dated 8 September 1994, in which he reminded Leeson that all 'house' exposures must be reported as such. No significant further action was taken for four months.
- 11.63 The consolidated LE return to the Bank for the quarter ended 30 December 1994 was prepared by BB&Co in the last week of January 1995. On 27 January 1995 (paragraph 7.46), as noted in a cc mail from Tony Hawes to Jones and Leeson, Tony Hawes stated that he had discovered that: "A very large amount (around US\$300 million) was being reported in the 'customer' account with no effort to subdivide between external and house customers although the account must now contain significant cash margin posted against BS (Japan) business". He indicated that as a matter of urgency the

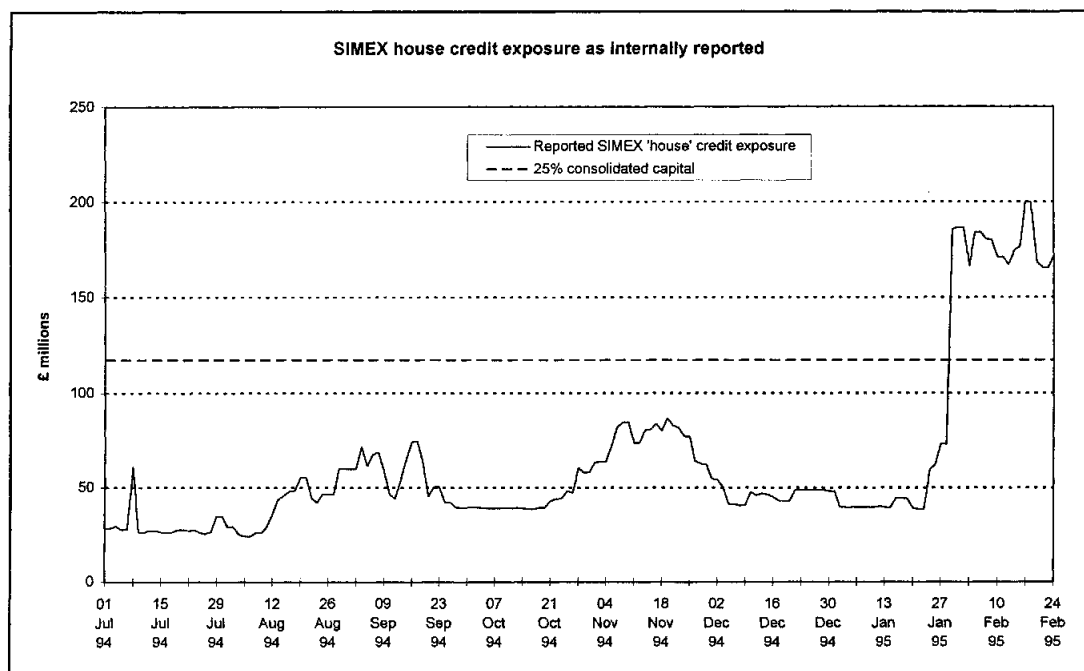
11. Reporting by Barings to supervisors and regulators

“true” ‘house’ position should be reported for the purposes of the LE return to the Bank for the fourth quarter of 1994, which was due at the end of January 1995. He also noted in the cc mail that this was a similar error to ones he had identified in April and August of 1994.

11.64 Tony Hawes told us: “For the four quarters of 1994, it was three out of four where we had had to ask for last minute verification or amendment of the figures that had been provided”. Maclean said: “The exposure to SIMEX and OSE, I now understand may well have been dramatically underreported. It is just inefficient and incompetent systems inside Baring Securities. I do not know about the front and back office in Singapore but that appears to be a shambles too”.

11.65 A summary of the daily exposure to SIMEX, as reported by BFS to Barings in London, for the period 1 July 1994 to 24 February 1995, is provided in Figure 11.4. These figures are consistent with the consolidated LE return submitted to the Bank in respect of the quarter ended on 30 September 1994 but not with the 30 December 1994 LE return (shown in paragraph 11.52, Figure 11.2), as Barings amended figures prior to submitting the return to the Bank (paragraphs 11.67 and 11.68).

Figure: 11.4



Source: Daily Global Large Exposure Reports

11.66 The ‘Daily Global Large Exposure Report’ figures for SIMEX were compiled by Barings in London from information sent by BFS. The large increase in the reported exposure at the end of January 1995 appears to result from the inclusion, possibly for the first time, of BSJ exposure to SIMEX (account ‘92000’ which BFS recorded as a client account but which was, in fact, ‘house’ exposure). Given the lack of access in Singapore we are unable to explain the fluctuation in reported ‘house’ exposure figures prior to January 1995.

11.67 Barings attempted to correct the figures for SIMEX in the preparation of the December 1994 LE return by requesting corrected information on cc mails from BFS for

11. Reporting by Barings to supervisors and regulators

9 December 1994 (on the apparent assumption that this cc mail, once amended, would give the maximum in the period exposure) and 30 December 1994 (quarter end date) with the corrections showing BSJ exposure as 'house' exposure.

- 11.68 The maximum exposure in the period in the consolidated LE return (9 December 1994) could have been incorrect. Although the cc mails were revised for 9 December 1994 (when the BSJ exposure to SIMEX was £72 million) and 30 December 1994 (when the BSJ exposure to SIMEX was £66 million), this was not apparently done for other days in the quarter. Accordingly, without access to BFS it is not possible to determine whether there were higher exposures on other days.
- 11.69 Prior to 30 January 1995, the BSJ exposure to SIMEX was apparently excluded from the consolidated SIMEX exposure figure in the 'Daily Global Large Exposure Report' and consequently the 'Large Exposure - Excess Report'. The 'house' exposure to SIMEX on the LE return for the quarter end date of 30 December 1994 was restated. However, it is possible that the SIMEX exposure in previous returns (particularly June and September 1994) was understated, but we are not able to recalculate the exposure in the absence of information from BFS.
- 11.70 Management was aware of the increase in the exposure to SIMEX, as noted by Maclean: "On that day [1 February 1995] the large exposure report shows a large jump in SIMEX ... it was a bit of a red alert to me ... I can remember him [Tony Hawes] saying something like, 'I think they were recording Barings Securities (Japan's) position, which is really house, as client' ... suddenly, large exposures became an issue for me".

Treatment of the purported receivable from SLK

- 11.71 On about 1 February 1995, the receivable of ¥7.778 billion (approximately £50 million) apparently due to BFS from a client, SLK, at 31 December 1994 was raised by C&L in a discussion with Broadhurst (paragraph 7.59). This amount had not been captured by the LE process and had been omitted from the LE return, despite purportedly being greater than 10% of Barings' consolidated capital base. Seal told us she learned about the receivable on 2 February 1995 and knew that the LE return had been submitted and that there may be a large exposure issue but that: "I got the impression that this was effectively a receivable from BNP (Japan) and not from SLK" and that BNP would already have been reported as a LE. This impression conflicts with the information received by C&L London from C&L Singapore, and given to Broadhurst, which referred to the receivable as being from SLK.
- 11.72 Broadhurst told us he would have expected the SLK balance to be treated as a LE but: "I do not know who to, whether that was to BNP (Japan) or Spear Leeds [SLK] because it was a confused explanation as to what had happened with that transaction".
- 11.73 Norris told us that Bax brought SLK to his attention: "[Bax] then expressed his wish to try and have the thing dealt with in a way which would not give him problems with the local regulator, SIMEX ... which was the issue of that year's audit report or management letter. I agreed to see if we could put that in train [i.e., excluding a reference to the SLK receivable in the C&L Singapore management letter] ... I did so only on the basis that the transaction had been reversed, there was not an issue of exposure and also on the basis, as he told me, that the auditors were fully aware of it".

11. Reporting by Barings to supervisors and regulators

He explained: "Any form of regulatory interface of that sort was always something which was very, very sensitive on the agenda of James [Bax] and Simon Jones and the other managers in the office". Communication with the auditors on this matter is considered in paragraph 10.54.

- 11.74 Norris told us: "I am not sure that my first impression of the thing was actually that the money was coming back from BNP rather than from SLK".

Responsibilities for reporting to the Bank

- 11.75 Given the failure to report exposures in respect of advance margin ('top up') in the solo consolidated LE returns, errors in the consolidated LE returns and the failure to report SLK, we have sought to ascertain who was responsible for the LE returns within Barings. The basic information was produced in the Regulatory Reporting Department which at any time consisted of two to four staff headed latterly by Seal who told us she: "signed the returns". (Before September 1994 the returns were signed by Mr Gary Dolman, Regulatory Reporting, BIB, reporting in this respect to Seal.) Seal reported to Broadhurst and Barnett.
- 11.76 Broadhurst told us: "I never reviewed a Bank of England report".
- 11.77 Seal told us: "In terms of discussions with the Bank of England, it would be ... several people ... Geoffrey Barnett, George Maclean, Johnnie Russell, if necessary Andrew Tuckey".
- 11.78 Barnett confirmed that he "with George Maclean, handled the relationship with the Bank". Barnett said that from the "end of 1992 or the beginning of 1993 the Barings team [at the Bank] on every occasion was Andrew Tuckey, George Maclean and me".
- 11.79 Norris was Chief Executive Officer of BIB, and although not directly involved in LE returns, we consider he was ultimately responsible for Barings' compliance with requirements for the accuracy of such significant returns.

THE SECURITIES AND FUTURES AUTHORITY

Overview

- 11.80 In this section we review the client money calculations relating to SARS and responsibilities for reporting to the SFA. Background on the SFA and details of the Baring Group's SFA membership is provided in paragraphs 12.104 to 12.117.
- 11.81 Errors in BSL reporting to the SFA related to the failure to identify properly the nature of a US Dollar segregated cash collateral account called 'BSINGCOLL', through which so-called advance margin payments were remitted to BFS (paragraph 6.67). Our inquiry indicates that Barings' London management was not aware of any house positions which would be funded by the BSINGCOLL account; apparently they considered it to be for clients. In this case BSL failed to include the balance on this account in either the client money calculations (until 31 January 1995), performed for the purposes of the SARS, or in the calculation of Counterparty Risk Requirement (CRR). The SARS and CRR form part of the monthly financial reporting statement sent to the SFA.

11. Reporting by Barings to supervisors and regulators

11.82 Had Barings' management been aware that the account was, in fact, funding 'house' positions, it would have been aware of the balances arising out of account '88888', and should have included such positions in the Position Risk Requirement (PRR) calculation, which forms part of the monthly financial reporting statement, to the extent that such positions were those of Barings in London.

11.83 The failure to include the BSINGCOLL balance in the client money calculation is covered further below. As far as the CRR is concerned, Barings may have viewed these amounts as outstanding for less than three days (as advance margin may be repaid within this period), and hence subject to a nil CRR. However, these amounts were cumulative, and outstanding for periods in excess of three days and should therefore have been subject to 100% CRR. In this case the CRR would have been materially understated.

Client money calculations

11.84 The client money calculations at Barings took place daily. They were used to complete the SARS section of the monthly financial reporting statement. The calculations were only relevant to BSL as BSLL only undertook proprietary business and did not hold client money or assets.

11.85 There are several sections of SARS but only that section relating to transactions which require margin payments (such as futures and options) is relevant to this report. The calculations required on the SARS are described in paragraph 12.141. Of particular significance to BSL were amounts advanced to BFS which were described by Leeson as being advance margin ('top up').

11.86 On the basis that Barings' London management thought that advance margin was on behalf of clients, the significant amounts advanced to BFS as client margin through the BSINGCOLL account should have been included in the SARS. If the amounts had been reported in this way then the SARS would have disclosed a significant excess of margin placed on behalf of clients, over the amount required. Granger produced a list of accounts which was used by the Regulatory Reporting Department for the preparation of SARS, but the BSINGCOLL account was excluded from this list. No explanation has been given to us as to why it was not on the list.

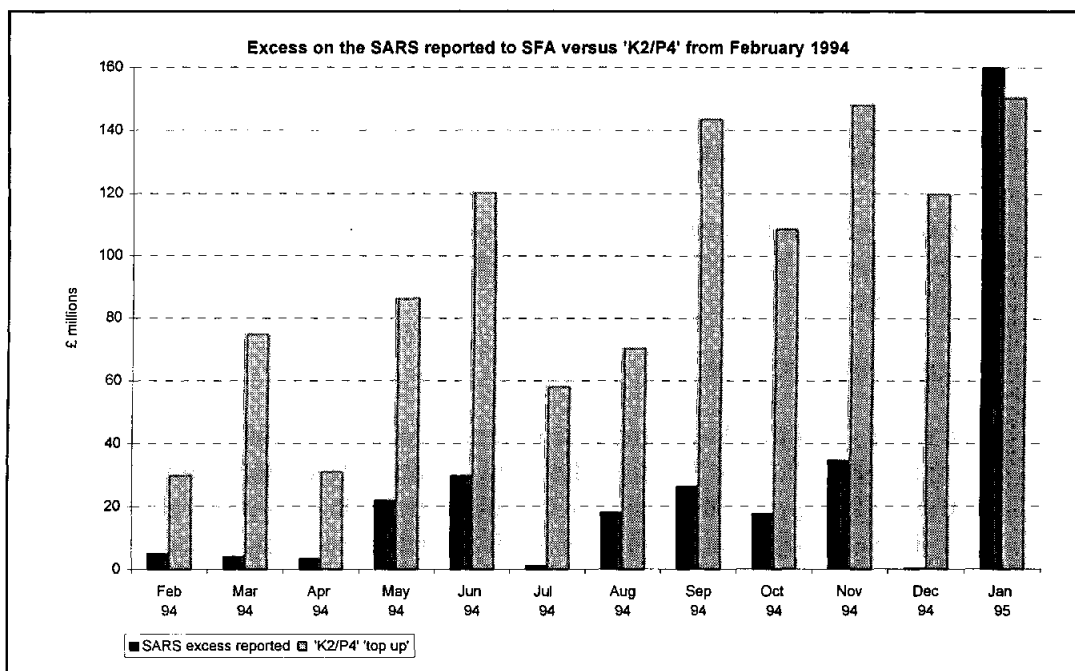
11.87 A review of SARS reported to the SFA from February 1994 to January 1995 shows that it was only in the last month of this period that the statement was 'correctly' (using Barings' assumption) calculated by including the BSINGCOLL account. At 31 January 1995 the excess, resulting from the fact that there was no corresponding required contribution included in respect of account '88888', amounted to £160 million (including the BSINGCOLL account) and this was reported to the SFA on 22 February 1995. In the first draft of the SARS for 31 January 1995, a small deficit arose and Granger was asked by Barings' Regulatory Reporting Department to investigate the reason for this deficit. It was only then that it became apparent that the BSINGCOLL account had previously been omitted. The apparent error was then rectified in the return for January 1995.

11.88 The 'K2/P4' accounts in the solo balance sheet for BSL (paragraph 6.68) should have substantially equated to the reported excesses on the SARS since both were thought to represent the funding by Barings of client margins. As Figure 11.5 shows, when the

11. Reporting by Barings to supervisors and regulators

figures were reported in January 1995 this was indeed the case, whereas the large differences between the excesses on the SARS reported to the SFA and the 'K2/P4' balances for the months prior to January 1995 demonstrate the impact of the omission of the BSINGCOLL account. Given that Barings' London management believed it was money paid for clients, we have not received a satisfactory explanation for the omission of BSINGCOLL during 1994. (SARS returns for earlier periods are shown in paragraph 12.144, Figure 12.2).

Figure: 11.5



Source: Monthly SARS reported to the SFA, and monthly BSL solo balance sheets

Responsibilities for reporting to the SFA

- 11.89 Norris was nominated as Barings' Senior Executive Officer for the purposes of SFA reporting for BSL and BSLL. Between August and November 1994 there were significant changes in the Barings department responsible for Regulatory Reporting. From November 1994 Seal reviewed the SFA returns. She told us she dealt: "with the returns" and she said: "In terms of SFA, the directors of Baring Securities were the people who effectively signed the SFA returns and that would have come under Geoff Broadhurst". Broadhurst signed off on the returns, together with one other director. Thomas did not review the returns (paragraph 11.145).

SIMEX

Overview

- 11.90 Although the MAS authorised BFS, it delegated a number of its supervisory responsibilities to SIMEX. In this section we describe the communications by Barings with SIMEX and comment on cross trades, reportable positions and open interest.
- 11.91 In 1991 BSL issued a letter of undertaking to MAS stating that BSL would ensure that BFS maintained a sound liquidity and financial position and that BSL would provide

11. Reporting by Barings to supervisors and regulators

adequate funds to make up for any liquidity shortfall. Further, in a letter dated 14 April 1992 to Citibank, BSL stated that it would ensure that BFS had sufficient funds to discharge its liabilities to Citibank as they fell due.

- 11.92 A review of letters from SIMEX suggests that SIMEX apparently identified issues which, given a thorough review by Barings' management, might well have resulted in an earlier discovery of the unauthorised trading which led to the collapse of Barings. In particular, account '88888' was mentioned and apparent inconsistencies in the margining of the account were communicated to BFS. Also, SIMEX specifically reminded BFS of the need to ensure financing arrangements which would allow them to meet margin calls which SIMEX stated might in certain circumstances be intra-day demands for settlement variation or advance margin.

Communications by Barings with SIMEX

- 11.93 The following correspondence and meetings between Barings and SIMEX are relevant to the inquiry. We are not certain whether all relevant correspondence has been made available to us.

7 September 1993 letter

- 11.94 In a letter from the Audit and Compliance Department of SIMEX to Jones, dated 7 September 1993, SIMEX noted that a recent audit had identified violations of the Rules of the Exchange and the Futures Trading Act. Attachments to this letter specify fifteen such infractions. In addition, the audit revealed five instances of weaknesses in internal controls. Also attached to the letter was a copy of a trade ticket stamped 18 February 1993 with the number '88888' written on it.
- 11.95 The reply sent to SIMEX by Jones dealt in detail with the points raised by the audit. In mitigation, SIMEX's attention was drawn to the fact that the August 1993 volume figures showed BFS to be the leading clearing member on the floor in the Nikkei 225 futures and options contracts.
- 11.96 This letter from SIMEX and Jones's reply to it were found in the files maintained by Thomas in London. No other such correspondence was found in London and Thomas appeared to have no detailed knowledge of the 7 September 1993 letter.

11 January 1995 letter

- 11.97 In a letter from the Audit and Compliance Department to Jones, dated 11 January 1995, SIMEX referred to a telephone conversation which took place between SIMEX staff and staff of BFS in relation to apparent irregularities relating to the margining of a sub-account of the BSL - 'Customer Segregated Account' (BSL-CSA, using the SIMEX description). This sub-account was specifically identified by SIMEX as: "a/c no. '88888'". It stated that: "We understand from your staff that the IM [Initial Margin] requirement was the margin requirement of the positions held by the sub-account, '88888' of BSL - CSA". It also commented that: "Based on the information provided so far, it appears to us that your company had financed the trading margin of the positions held by sub-account no '88888' of BSL - CSA. If this is really the case, your company has violated SIMEX Rule 822 which prohibits members from financing the trading margins of their customers".

11. Reporting by Barings to supervisors and regulators

- 11.98 SIMEX noted that according to the SPAN margining system the total initial margin requirement for the BSL-CSA account was in excess of US\$342 million and that it appeared that BFS might be financing the margins of customers to the extent of US\$100 million in contravention of SIMEX rules.
- 11.99 BFS was required to provide a written explanation of the margin difference on account '88888' and of its inability to account for the problem in the absence of Leeson.
- 11.100 The reply from BFS on 25 January 1995 signed by Jones (but substantially drafted by Leeson, according to Jones) did not fully address the questions raised. It stated that the margin discrepancy was due to the practice adopted of funding Group margin requirements in Asia via intercompany loans and showed an analysis of excess margin posted by BSJ which apparently covered the discrepancy identified by SIMEX. As is described in Section 5, use of excess margin posted by BSJ was one of the methods used to fund the losses incurred on the positions in account '88888'.
- 11.101 The concern expressed as to the inability of the company to provide information in Leeson's absence is met by a statement to the effect that Yong was to be appointed to: "monitor all large exposures and regulatory requirements of this nature", within the next three months.
- 11.102 The copy of the letter of 11 January 1995 we have seen is marked: "cc. N Leeson, RY" (the latter presumably refers to Yong). The comments from London management in response to our questions as to whether they had seen the 11 January 1995 SIMEX letter were as follows:
- 11.103 Maclean told us: "This is the first [time] I have ever seen this. I have not read it ... I can tell you now I have never seen this letter. I do not know what it says".
- 11.104 Norris said: "I have never seen this letter ... I think it could have been important".
- 11.105 Barnett said: "I have not seen this letter ... This strikes me as an extremely important operational matter". He added that: "I would have expected this to be dealt with through line management processes initially".
- 11.106 Tony Hawes told us: "I have not seen this one before".
- 11.107 However, Jones told us his secretary gave a copy of this letter to Tony Hawes during his visit which began on 6 February 1995. Tony Hawes told us that: "The only thing that makes me think I have heard it [the 11 January 1995 letter] referred to was a sort of throw-away remark that Jones made to me about general correspondence with SIMEX. He referred to a letter he had received previously and he said they did not know whether they were talking about [US]\$10 million or [US]\$100 million. It was in the general terms of rubbishing SIMEX's correspondence". He added that he had this conversation with Jones: "some time during the week starting 6th February". We asked if anyone else was present during that discussion. Tony Hawes told us: "I cannot honestly remember but I would be surprised. It could have happened at any time. It might just have been while we were having a drink after work. It was really in the context of the other letter, the letter of 27 January, and the fact that it talks about the Nikkei, the Eurodollar and the Euroyen contract; no mention of options and no

11. Reporting by Barings to supervisors and regulators

mention of the JGB exposures. There was rather an incomplete record of the total positions". The 27 January 1995 letter is considered in paragraphs 11.112 to 11.118.

11.108 We asked whether the letter of 11 January 1995 should have been brought to the attention of London management. Tony Hawes replied: "It certainly ought to have been. I think in the set-up there was no chance it would have been ... I think in Singapore Simon [Jones] would have regarded it purely as something for them to sort out. It refers to account titles between Singapore and London. The reason why it ought to have been referred to London is just the size of the amounts. I certainly saw a letter relating [emanating] from the SIMEX audit raising these sorts of queries but in very much smaller amounts".

11.109 Railton told us that he was given a copy of the letter of 11 January 1995 by Jones when he was in Singapore in the week beginning 13 February 1995. He told us he was given the letter whilst dealing with another inquiry by SIMEX. He saw the reference to account '88888' and also to another account ('99001') he did not recognise. Account '99001' is a summary total, according to Railton.

16 January 1995 letter

11.110 In a letter from the Audit and Compliance Department to Bax dated 16 January 1995 SIMEX noted violations of the Rules of the Exchange and the Futures Trading Act falling into five different categories.

11.111 Bax replied on 30 January 1995 that: "The underlying causes of the errors noted were largely clerical slips and typing mistakes".

27 January 1995 letter

11.112 In a letter from the Audit and Compliance Department to Jones, dated 27 January 1995, SIMEX presented a table of positions by house and customer and reminded BFS of its responsibility to ensure that: "You have at all times adequate funds including standby credit facilities in order to be able to fulfil your financial obligation to the SIMEX Clearing House at all times". This comment was made in the light of calculations performed as at 30 December 1994 on the open positions. This letter (in contrast to that of 11 January 1995) was copied to Barings in London.

11.113 The SIMEX letter of 27 January 1995 was discussed at an ALCO meeting on 31 January 1995 (paragraphs 7.47 and 7.111). Tony Hawes told us: "George Maclean ... brought it to ALCO to discuss". Tony Hawes acknowledged that the gross funding was of very substantial significance, in excess of anything he had experienced before within Barings. We asked Tony Hawes who was involved in drafting a reply. In addition to himself, he told us: "George [Maclean] saw it. Ian Hopkins saw it". He noted in respect of the positions included in the letter: "There was no check [back to Barings' own records]. We had no reason for thinking that positions were being misstated". He agreed it would have been possible to do this check and that he thought it would have identified the fact that the positions SIMEX were looking at were different from those in Barings' records.

11.114 Tony Hawes told us: "I visited SIMEX to talk about the audit, particularly about their letter of 27 January, and to explain to them the change to Group structure and explain

11. Reporting by Barings to supervisors and regulators

to them what we were doing. At the meeting, it seemed to me that they said it was a letter that had not specifically gone to Barings. It would have gone to a lot of the leading participants in the SIMEX market, just making sure that they checked their ability to meet margin calls". This meeting with SIMEX took place later in February and is described in paragraphs 11.120 to 11.122.

- 11.115 Norris told us he had not seen the 27 January 1995 letter before but: "It was tabled at an Asset and Liability Committee meeting and it was not copied round the table. It was described and a course of action was proposed ... George Maclean and Tony Hawes would reply to it".
- 11.116 Ron Baker told us: "I have seen this letter although I did not see it until after the event [collapse] ... I heard it talked about ... at [the] ALCO [meeting]". He explained that Maclean described it as a: "standard letter from the Singapore Monetary Exchange". Walz told us: "So I called Nick [Leeson] the next morning and said, 'What is the scoop with this letter from Singapore, from SIMEX?' He said, 'It is no big deal. It is a routine thing'. I remember him making some sort of disparaging remark like, 'It's the same old thing that we have been trying to get addressed for ever - the intra-day margin from Citibank'. I think at the time there was [US]\$25 million only as the line with Citibank, and there would be concern that the intra-day variation margins - or I think they call them advance margins -- would not be able to be met with the size of positions as they were and that small liquidity facility. Nick [Leeson] did not say all that to me in that conversation, but I remember there being some kind of, 'It's no big deal', and I said, 'Send me a copy of it'. He then sent me a copy and I took it down to George [Maclean]". She also spoke to Maclean and Tony Hawes. She added: "They told us it was just a routine inquiry; everything is fine; go away; stop worrying".
- 11.117 The reply to SIMEX from BFS dated 10 February 1995, signed by Jones, stated, amongst other things, that: "BFS is aware of the necessity of being able to meet its financial obligations to the SIMEX Clearing House at all times, and is confident that it is able to do so. BFS deals almost wholly as a broker on behalf of other companies in the Baring Investment Banking Group acting either as agent or principal. BFS itself has no principal positions. Margin called from these Group companies is met immediately through Group Treasury. The Group's external customer business is mainly transacted by Baring Securities Limited, minimising the exposure of BFS to customer default. BFS calls margin from Baring Securities Limited, which through Group Treasury, will always pay in full. Any shortfall in customer payments falls on Baring Securities Limited in London, not BFS.

It is the policy of the Baring Investment Banking Group to ensure that risks of all kinds, including exposure to exceptional intra-day calls for settlement variation and advance margin are managed actively. All risks are monitored daily by the Group's risk unit and reported to the Asset and Liability Committee. Immediate action is taken to correct situations where the Group is over-exposed to a particular risk. If open positions are such that an exceptional margin call by SIMEX might exceed existing overdraft facilities additional funds are made available in advance to BFS's clearing bank to ensure that the largest anticipated call can always be met. To provide additional support, funds can be made immediately available to BFS by other Baring Investment Banking Group companies in the Asian time zone....

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Their [BSLL and BSJ] concentration is on arbitrage strategies; open positions in SIMEX are almost wholly offset by positions in an equivalent future traded on another exchange, by holdings of the underlying cash instrument or by the 'delta' of over-the-counter or traded options".

The letter also referred to the close working relationship between BFS, Citibank and BIB Group Treasury.

- 11.118 The open futures client positions at 30 December 1994 reported by Jones in his reply did not agree to those noted by SIMEX in their letter of 27 January 1995 (the 'house' positions did agree) as shown in Figure 11.6.

Figure: 11.6

| Total open positions at 30 December 1994 | House positions | | Customer positions | |
|---|-----------------|---------|--------------------|----------|
| | Long | Short | Long | Short |
| Per SIMEX letter | | | | |
| Nikkei Index | 215 | (2,013) | 5,440 | (13,039) |
| Eurodollar | - | - | 429 | (186) |
| Euroyen | 665 | (5,192) | 1,434 | (12,564) |
| Per BFS reply | | | | |
| Nikkei Index | 215 | (2,013) | 3,485 | (10,624) |
| Eurodollar | - | - | 429 | (186) |
| Euroyen | 665 | (5,192) | 1,434 | (12,363) |

Source: 27 January 1995 SIMEX letter and 10 February 1995 BFS reply

3 February 1995 memorandum

- 11.119 On 3 February 1995 Bax sent a memorandum to Norris, Broadhurst, Ron Baker, Hopkins and Gamby headed up SIMEX: "As you know, recent incidents have highlighted the current operational weaknesses of our SIMEX business and an urgent need for a new approach ... The growing volumes traded on SIMEX have meant that Nick Leeson can no longer continue to run the trading and settlement roles efficiently. In any case it has long been acknowledged that there are control weaknesses in this arrangement".

8 or 9 February 1995 meeting

- 11.120 Tony Hawes and Jones had a meeting with SIMEX on 8 or 9 February 1995. Tony Hawes said: "As you can imagine, I have given quite a lot of thought to what went on at that meeting, and the one thing I probably did not mention to you before is that at one point in the meeting when I was explaining what the strategy was and how we were short in SIMEX and long in Osaka, the lady at the meeting said, 'You are long at the moment.' I said, 'No, we are not. We are short.' 'Can you check that?' 'OK, they will do that.' Later on that day, either Jones or Leeson, and I cannot honestly remember which, came up to where I was sitting and said, 'It is all right. SIMEX have 'phoned and they agree with our positions'".

11. Reporting by Barings to supervisors and regulators

11.121 Tony Hawes continued: "Leeson was due to come with us but, at the last minute, ducked out of the meeting [8 or 9 February 1995]. It was Simon [Jones] and myself plus two people from SIMEX. When I spoke to Simon [Jones], and this was only earlier on this week [3 April 1995], trying to get an answer as to whether it was him or Leeson that I got the message from, he did not even remember SIMEX questioning whether we were long or short. He certainly did not recall receiving a call from SIMEX that afternoon. On the basis of what he said, one might assume it was Leeson, but I am not absolutely certain it was Leeson". He said: "Leeson was always the major point of contact with SIMEX so it would be quite natural that they would 'phone him ... [but] I am not absolutely certain that it was not him [Jones]".

11.122 He added: "The remark that I remember being given to me, that SIMEX had 'phoned and they were in agreement with our positions ... That is what I would have expected. That is how I would have expected Leeson to phrase it".

Cross trades

11.123 Most futures and options exchanges have strict rules regarding the conduct of 'crosses'. A cross may be executed where a member has in hand simultaneous buy and sell orders for the same contract and same month from different customers.

11.124 In these circumstances SIMEX permit the trade to be 'crossed' through the floor, provided the member shows the bid and offer three times by open outcry in the pit in the presence of an exchange official. These procedures are adopted to ensure the market can participate at either the bid or the offer if it wishes and to enforce the exchange prohibition of pre-arranged trading. SIMEX rules require a record to be kept of every cross transaction entered into by a member and mandate that this record be maintained for a period of two years.

11.125 Section 5 describes in detail how in 1995 Leeson created fictitious profits in his 'switching' book by crossing trades between account '88888' and the BSJ 'switching' account '92000'. These trades were crossed on the floor, by definition at the same price, and put through the books of BFS at different prices, thereby creating false profits in account '92000' at the expense of account '88888'.

11.126 Jones told us that when SIMEX looked at the crosses they thought account '88888' was a large customer in London. He believed that SIMEX was content as long as the margin kept coming in.

11.127 Hassan told us that, during an audit carried out in August 1994, SIMEX reviewed all of the reports produced by BFS and were very curious to understand the cross trades. After trying to obtain information from the settlements staff they were referred to Leeson who at the time was on vacation.

11.128 Following this audit, we understand that SIMEX requested copies of a spreadsheet produced by BFS which showed payments and receipts for London accounts detailing the split between house, segregated and hedge accounts, the movement on each equity account, and the split between US Dollars, Yen and Deutschmarks. We understand that this spreadsheet did not include details of account '88888'. From November 1994 SIMEX requested this spreadsheet daily.

11. Reporting by Barings to supervisors and regulators

- 11.129 Mr Rob Leaning, BFS Floor Trader, stated that from the beginning of January 1995 he was conscious that SIMEX officials were watching BFS staff in the Nikkei pit very closely.
- 11.130 Leaning confirmed that a relatively high number of cross trades took place and that some of the locals had complained to SIMEX about it. He said his understanding was that Leeson was converting positions at Osaka into SIMEX positions on behalf of customers. Mr Eric Chang, BFS Floor Trader, indicated that he was aware of the crosses going on but said he was not sure what accounts were involved.
- 11.131 We have seen no evidence of a formal approach from SIMEX questioning whether the cross trades executed by BFS were within the rules. It should be pointed out that these trades were ostensibly between two accounts classified at SIMEX as customers and that it appears that some trades were struck on the floor in the manner prescribed and others were not. Nevertheless, it is a fact that some trades were unusually large and it is clear that this was a key part of the mechanisms employed by Leeson in the concealment of his positions and the reporting of fictitious arbitrage profits, at least in 1995.

Reportable positions

- 11.132 Under SIMEX Rule 816 members were required to submit to SIMEX a daily report of customers with large positions, whether assumed or entered into on SIMEX or elsewhere. For instance, any position on the Nikkei which exceeded 100 lots constituted a reportable position. This information was provided to SIMEX daily on form BC3.
- 11.133 This report contained errors as a by-product of netting out the account '88888' position against account '92000' before the report was sent to SIMEX over the modem link. This ensured that SIMEX would not see the significant percentage (by February 1995) of the open interest appearing in two BFS customer accounts.

Share of open interest

- 11.134 Section 4 of this report shows the proportion of the open interest in various SIMEX contracts accounted for by the '88888' account, although this was reduced by the techniques summarised in paragraph 11.133. Walz reported the share of open interest on OSE to ALCO on 27 January 1995 (paragraph 7.42). Many futures and options exchanges either have fixed limits on the maximum percentage of the open interest that one clearing member may have of a particular contract or have a trigger percentage, above which thorough investigations are performed by the exchange to determine the reasons for the member's open interest.
- 11.135 OSE, TSE and SIMEX do not appear to have any such limits; nor do they appear to have thought it necessary to investigate the reasons for the size of open interest in those contracts, which involved a very significant proportion of the total open interest on those exchanges.

11. Reporting by Barings to supervisors and regulators

JAPANESE MINISTRY OF FINANCE

11.136 BSJ was required to submit the following reports to the MoF:

- (a) Financial statements in a specified format at 30 September and 31 March;
- (b) Capital adequacy returns on a monthly basis.

Additional reports were submitted monthly to regulators, exchanges and bodies such as the Japanese Securities Association, mainly for statistical purposes. These included collateral, margins and trade volume of financial futures.

11.137 Our review of the monthly returns prepared for the MoF indicated that the reported capital adequacy ratio was 234.5% as at 31 December 1994, 247.9% as at 31 January 1995 but fell to 62.5% as at 28 February 1995. The MoF requires companies to explain their financial situation if their capital adequacy ratio falls below 150%. However, as monthly returns are submitted on the 15th of the following month the ratio reported for January did not raise any concerns and the February ratio was not due to be reported until after the collapse.

11.138 We have been advised by BSJ that the capital adequacy ratio as required by the MoF was only calculated on a monthly basis and so its deterioration was not monitored during February 1995.

11.139 From reviewing BSJ's regulatory correspondence files of the MoF's Securities Surveillance Commission and discussions with the MoF, Bank of Japan (BoJ) and OSE, it appears that no formal enquiries about the size of BSJ's positions or the ability to meet margin calls were made by the regulators or exchanges in Japan.

COMPLIANCE

Introduction

11.140 In this section we review the role of Barings' compliance function in respect of regulatory returns, Singapore and internal audit.

Compliance and regulatory returns

11.141 Thomas was the BIB Compliance Officer, reporting directly to Norris, with a 'dotted line' to Peers, who chaired the Group Compliance Committee. She joined Barings in July 1992 and was chiefly responsible for SFA compliance (paragraph 12.115). In a letter to us, she stated that her: "day-to-day activities centred on the provision of advice to SFA registered staff and others on the interpretation of the SFA rule book and ensuring compliance with the rules relating to membership, conduct of business, and client money and other assets". The Compliance Department consisted of Thomas and one assistant. The Group Compliance Committee comprised legal and compliance representatives from BIB and BAM. This met every two weeks and essentially provided a forum for exchanging information between different parts of the Barings Group.

11.142 Thomas assumed a global compliance role towards the end of 1993. In a letter to us, she stated: "The global responsibilities assumed ... were not set out in terms of

11. Reporting by Barings to supervisors and regulators

reference or a job description but were discussed with Peter Norris and ... [Thomas] set about the task of identifying who was in place in overseas offices with responsibility for compliance. The purpose of ... global role was not to assume a monitoring function of the management of other compliance officers, but to act as a central point for the consideration of problems which were common to offices elsewhere and to disseminate group policies in respect of such problems”.

- 11.143 Thomas received returns submitted by Barings to the SFA but latterly did not review the SARS. She said she received the returns for historical reasons more than anything else and that the effectiveness of any review diminished with time because she was less familiar with what she was looking at.
- 11.144 She told us: “In terms of what the job involved, the main thrust of it was compliance with the SFA’s rules”.
- 11.145 Thomas, the compliance officer, was not given the responsibility for reviewing the returns to the SFA, even though she received copies and these returns included certain client monies. In a letter to us Thomas stated: “It was not [my] responsibility to compile, validate or review the various financial returns made to the SFA”.

Singapore

- 11.146 During 1993 Thomas visited several overseas offices, including Tokyo and Singapore. The purpose of her visits was to meet the local BSL people, to meet local regulators and develop an understanding, as best as she could, of the local regulatory conditions.
- 11.147 In September/October 1993, she visited Singapore. She told us: “The first visit to Singapore was very much taken up with meeting the regulators. I saw the MAS, the Singapore Stock Exchange and SIMEX”. She said: “The first time was either September or October 1993, and then again in February 1994”. In September/October 1993 she met Leeson who took her to SIMEX. She remembers that: “At that time his [Leeson’s] reputation in the market seemed to be very favourable ... The SIMEX people that [we] talked to did not seem to have any problems with Barings. They seemed very positive about what we [Barings] were doing”. She also recalled that: “The balance of things in the office ... was that everything was overwhelmingly on the Securities side and everybody except Nick Leeson ... was primarily on the Securities side ... In talking to Simon [Jones] it became apparent that his knowledge was primarily on the Securities side as well”.
- 11.148 Thomas cannot recall any criticisms of the local compliance structure in Singapore, although there was no independent compliance officer in Singapore at that time. She recalls visiting BFS again in February 1994. By this time, BSS had appointed a compliance officer, although she had very little to do with BFS, concentrating on the securities business. As described generally in Section 9 (and specifically in paragraph 9.24), the internal auditors’ recommendation in August 1994 was that BFS should be subject to the scrutiny of an independent Risk and Compliance Officer.

Internal audit

- 11.149 Thomas received a copy of the internal audit report on BFS which contained matters relevant to compliance. She told us: “I did not look at this report in any detail at all

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until late in February 1995 after all the problems had occurred". Also: "I had not read all of the report. I have now but I had not at the time".

- 11.150 In a letter to us she stated that she: "accepts that the recommendation relating to the appointment of an independent risk and compliance officer would, if she had considered that part of the batch [of internal audit reports] presented to her, have been of interest to her and she would have wanted the recommendation followed up". She reiterated that: "It was not ... drawn to her attention, either by those responsible in London, or those responsible in Singapore".

12. SUPERVISORS AND REGULATORS

Introduction

- 12.1 This section of the report is primarily a review of the exercise of supervisory powers and responsibilities in respect of the Barings Group by supervisors in the United Kingdom in the period prior to the administration of various Barings Group companies on 26 February 1995. This section is based upon an investigation conducted on behalf of the independent members of BoBS only, and the conclusions expressed are those of the independent members alone. The ex-officio members of BoBS have not been involved in the compilation of this part of the report.
- 12.2 We should emphasise that while we have received certain information from the MAS, SIMEX and the MoF, which is set out or summarised below, we have not had sufficient information to express a view as to whether each of these authorities adequately discharged its regulatory responsibilities in respect of the relevant Barings entities. Thus, while this section of the report is primarily concerned with the discharge by the Bank and the SFA of their respective regulatory responsibilities, it should be borne in mind that they were not the only relevant regulatory authorities in respect of the events which happened in London, Singapore and Japan.
- 12.3 This section of the report is intended, in many respects, to be self-standing and therefore inevitably duplicates preceding sections of the report to some extent.
- 12.4 The period under review was primarily that commencing in January 1992 and ending in February 1995.
- 12.5 Appendix XIV contains relevant background information regarding the regulatory framework applicable to the Barings Group in the United Kingdom, Singapore and Japan. It describes both the responsibilities of the various regulatory authorities and the methods of regulation employed by those authorities. It also describes the mechanisms which existed to assist liaison between the various authorities with regulatory responsibilities in respect of members of the Barings Group in those jurisdictions. Section 11 of the report includes a review of the relationship between Barings and these authorities from the perspective of Barings.

BANK OF ENGLAND

Consolidated supervision and solo consolidation

- 12.6 Consolidated supervision of a group that includes a bank is supervision which assesses the risks to the bank from the activities of other companies in that group. This assessment is based on a number of sources of information, including consolidated returns (covering the whole group) submitted by the bank. The Bank is obliged to exercise consolidated supervision whenever an authorised institution is a member of a wider group.
- 12.7 The Bank authorised BB&Co and was responsible for the consolidated supervision of the Barings Group on the above basis. As such, it received and analysed data on Barings' consolidated (Group-wide) capital ratios and consolidated large exposures

12. Supervisors and Regulators

(what constitutes 'a large exposure' is explained below). However, the Bank was not responsible for the supervision of any individual Barings entities other than BB&Co and its gilt-edged market making subsidiary, Baring Sterling Bonds (BSB). The supervision of other Barings entities (including their capital adequacy and the effectiveness of their systems and controls) remained the primary responsibility of the relevant regulator in the country or business sector in which the Group company operated (including, where relevant, other UK regulators). The Bank is under no duty, indeed has no statutory power, to supervise other companies in a group to which a bank belongs. However, the Bank is required under the Act to take into account risks elsewhere in a group which might affect the authorised institution. Accordingly, Bank supervision was primarily focused on BB&Co (and BSB), but the Bank was required to take into account the activities of other parts of the Barings Group insofar as they might affect the reputation and financial soundness of BB&Co.

- 12.8 Risk analysis is undertaken by the Bank both on a consolidated basis, to capture exposures arising in subsidiaries and other connected companies as well as in the authorised institution, and on an unconsolidated basis, in order to assess the financial position of the authorised institution, taken on its own, within the group.
- 12.9 If the linkage between an authorised institution and one of its subsidiaries is sufficiently strong, and certain other criteria (in particular, as regards the relative sizes of the institution and the subsidiary in question) are met, the Bank may permit the subsidiary to be treated as effectively a division of the institution and included in the institution's unconsolidated prudential returns filed with the Bank. This is known as 'solo consolidation'. Where this occurs the subsidiary is monitored for capital adequacy and large exposure reporting purposes as if it were part of the institution. The requirements for a bank subsidiary to be solo consolidated with the parent bank are set out in a Bank Notice issued in 1993 and include requirements that management of the solo consolidated subsidiary must be under the 'effective direction' of the parent bank and that there should be no obstacle to the payment of surplus capital up to the parent bank. The intention is that the subsidiary should be sufficiently closely linked to the parent bank that it is treated as one with the bank. The intended effect of the requirements is that the linkage between the subsidiary and the bank should be such that it should be possible to wind up the subsidiary rapidly and repatriate the capital to support depositors with the bank.
- 12.10 Because the Bank views consolidated supervision as a complement to, rather than a substitute for, supervision of a bank alone (and any companies solo consolidated with it) it sets limits for the exposure of the bank (or the solo consolidated group) to the rest of the group of companies of which the bank is a member. In the absence of a higher limit (or treasury concession; the circumstances in which these are granted are described in paragraph 12.67) being agreed in respect of a particular group company, the maximum exposure of the bank (or the solo consolidated group) to the rest of the group must be in aggregate no more than 25% of the bank's unconsolidated (or solo consolidated) capital base; this restriction is known as the 'connected lending limit'.

Lead regulation by the Bank

- 12.11 Although the Act makes no explicit mention of 'lead regulation', the principle has been accepted that for each UK financial group one of the recognised regulators in the UK will play this role. The lead regulator is responsible for coordinating the various

12. Supervisors and Regulators

regulators who have responsibilities in respect of the group; the role does not result in the lead regulator incurring responsibility for the activities of the other regulators in the performance of their respective functions. The Bank acted as the lead regulator of Barings.

- 12.12 Where investment business authorised under the FSA is conducted by an institution which is also authorised under the Act, under the Bank's MoUs with the self regulating organisations (SROs) the Bank assumes primary responsibility for supervising the financial position and capital adequacy of the institution, and the relevant SRO's financial requirements are disapplied to this extent. Each MoU also contains formal arrangements for the exchange of information and cooperation in the performance of the Bank's and the relevant SRO's respective regulatory functions. The general principle enshrined in each MoU regarding the exchange of information between regulators is that of reporting by exception (i.e. matters are not reported to the other regulator unless they give rise to a concern).
- 12.13 The specific ways in which the MoUs operate vary from case to case. However, they are all based on the presumption that information must flow freely between regulators. To this end line management in the Bank is required to make contact with each relevant UK regulator before a prudential meeting with an authorised institution. In addition, there are regular College of Regulators meetings convened by the lead regulator, usually annually, although they can be called more frequently if necessary. At a College meeting, banks belonging to a pre-determined group of institutions (e.g. clearing banks) about which there are specific regulatory concerns are discussed with all relevant regulators present. It has become the practice to focus at College meetings only on those institutions about which regulators have particular concerns. The regulators included in the College of Regulators for the Barings Group were the Bank, the SFA, the Investment Management Regulatory Organisation (IMRO) and the Personal Investment Authority (PIA) (or, prior to it coming into existence, FIMBRA).

International cooperation between regulators

- 12.14 In a rather different context, the concept of 'lead regulator' is recognised internationally in the Basle Concordat, which was issued by the Basle Committee on Banking Supervision ('the Basle Committee') in 1983 and sets out internationally accepted guidelines for the regulation of international banking groups. The Basle Committee consists of the central banks and (where different) banking regulators of the G10 countries (plus Switzerland and Luxembourg). It generally meets four times a year, with those attending normally having the rank (in Bank equivalents) of Deputy Governor, Director or Deputy Director. The purpose of the Basle Committee is to foster cooperation between banking regulators and to establish agreed minimum standards for the supervision of international banking groups. Although the Basle Committee arrangements have no direct effect outside of the G10 countries, in practice many other countries adopt the arrangements agreed in Basle. The Concordat (which was supplemented in 1990 and 1992) sets out the balance of responsibility between parent and host supervisory authorities where banks establish foreign subsidiaries or branches (called 'foreign establishments').
- 12.15 Banking supervisors in other parts of the world have formed committees paralleling the functions performed by the Basle Committee and representing a particular geographic area or interest group. Singapore is represented on the Offshore Group of

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Banking Supervisors ('the Offshore Group') by the MAS. (Japan is represented on the Basle Committee.) In 1987 the Basle Committee and the Offshore Group entered into a Document of Understanding on practical aspects of international collaboration between banking supervisory authorities. This paper noted that: "there have been a number of examples of damaging losses incurred by international banks in the last few years, one material cause of which appears to have been activities undertaken by their foreign establishments with inadequate head office or parental control and without the knowledge or approval of the parent supervisor".

- 12.16 The Concordat and the Document of Understanding lay down principles for the supervision of international banking groups. Those principles which are directly relevant to the report are set out in Appendix XIV. The most material may be summarised as follows:
- (a) Effective supervision of banks' foreign establishments requires a sharing of responsibilities between host and parent authorities and contact and co-operation between them;
 - (b) Host and parent authorities should try to satisfy themselves that banks' internal controls include comprehensive and regular reporting between foreign establishments and head office;
 - (c) If a host authority has reason to suspect problems of a material nature in a foreign establishment it should take the initiative to inform the parent authority. If serious problems arise in a foreign establishment the host authority should consult with the parent authority to seek possible remedies;
 - (d) Host authorities should ensure that adequate data can flow to parent authorities, particularly in relation to large exposures;
 - (e) Where a host authority discovers an exposure which it considers should be drawn to the attention of the parent authority the host authority should take the initiative in doing so;
 - (f) Host authorities are responsible for foreign establishments operating in their territories, while parent authorities are responsible for them as part of larger banking groups. Such responsibilities are both complementary and overlapping;
 - (g) Consolidated supervision does not reduce host authorities' responsibilities for foreign establishments operating in their territories.

Background to supervision of Barings by the Bank

- 12.17 Supervision of the Barings Group was carried out by the Bank in its Financial Stability Wing. The Executive Director in charge of Regulation, Supervision and Surveillance is Quinn. The supervision was primarily carried out in the Supervision and Surveillance Division (S&S), although the Wholesale Markets Supervision Division (WMSD) supervised BSB. The relevant supervision for the purposes of the report was carried out in S&S.
- 12.18 BB&Co and (on a consolidated basis) the Barings Group were supervised in the Major UK Banks Supervision Division within S&S. Mr Michael Foot has been the Deputy

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Director in charge of S&S (or, prior to the reorganisation of the Bank in July 1994, held the relevant previous post) since September 1993; his predecessor was Mr Roger Barnes. Sergeant has been the Head of the Major UK Banks Supervision Division since March 1993; her responsibilities had previously been covered by Barnes as part of his role. The senior manager with immediate responsibility for the UK merchant banks (including BB&Co) was Thompson for the period from April 1991 to the collapse. A number of analysts assisted him on Barings matters, in particular Philip Kelly (for the period up to March 1993), Mackintosh (from March 1993 to April 1994) and Walwyn (from April 1994 to the collapse).

- 12.19 Paragraph 1.70 lists a number of 'key indicators' which together provided Barings in Singapore and London with warnings of the danger to which it was exposed. The majority of these indicators were not known to the Bank and could not have been known to it (under its existing methods of supervision) unless it had been informed by Barings or by another regulator. For instance, the Bank was unaware of the identification of the lack of segregation of duties in BFS between front and back offices and the failure to act on internal audit recommendations following the review of BFS's operations in August 1994, because the Bank does not ordinarily receive internal audit reports from the groups which it supervises and does not regularly meet with internal auditors. (We note, however, that the Major UK Banks Supervision Division is now introducing a requirement for the internal audit departments of the banks which it supervises to have regular meetings with the Bank, but that this requirement only applies to the internal audit department within a bank. Where, as was the case with Barings for most of the period under review, the securities arm of the group has a separate internal audit department from the banking arm, there is currently no proposal to establish a direct relationship between the internal audit department of the securities arm and the Bank, because the securities arm is separately regulated by the SFA. We comment further on this in Section 14.)
- 12.20 The Bank was, however, aware of three key indicators, although in some cases it was not fully apprised of all relevant facts:
- (a) it was aware that a high level of funding was required to finance Barings' Far East trading activities;
 - (b) it was aware of the reported high profitability of Barings' Far East trading activities and knew that Barings believed them to be virtually risk-free;
 - (c) it was aware of issues and questions arising out of Barings' reporting of its consolidated large exposures in respect of OSE and SIMEX to the Bank.
- 12.21 The indicators were interlinked in practice: in answer to a question concerning the October 1994 meeting during which the Bank first gained a firm appreciation of the £250 million to £300 million funding requirement of the Group in respect of its Far East securities operations (described in more detail in paragraph 12.88) Walwyn said: "It was not inconsistent with what we might have expected, I think, given that the margin exposures from the large exposures return were of the order of sometimes £100 million plus. If you have three exchanges, that is £300 million. That is from a large exposures point of view. It probably did not surprise us that the business was in the region of £250 to £300 million".

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- 12.22 The most material issues arising in the context of the supervision of Barings by the Bank identified by us are:
- (a) whether the Bank failed, given the scale of the arbitrage operation being run by Barings in Singapore and Japan, the sums involved in it and its importance to the rest of the Group, to take sufficient steps to satisfy itself that this ostensibly low risk operation did not nevertheless pose a threat to BB&Co (paragraphs 12.36 to 12.39 and 12.88);
 - (b) whether the Bank failed diligently to pursue the outstanding issues regarding Barings' large exposure to OSE, and its grant of an informal concession to Barings in respect of this exposure while the issues were being resolved (paragraphs 12.40 to 12.65);
 - (c) the solo consolidation of BSL with BB&Co and the treasury concessions which were granted to Barings (paragraphs 12.66 to 12.88).
- 12.23 We also describe certain other aspects of the Bank's supervision of Barings, including:
- (a) the subject matter and scope of the reporting accountants' reports into Barings (paragraphs 12.89 to 12.101);
 - (b) the liaison which took place between the Bank and other regulators, both in the UK and overseas, in relation to Barings (paragraphs 12.102 and 12.103).
- 12.24 In interviews with Bank staff we have discussed their general appreciation of Barings' controls. All those with whom we discussed this matter were of the view that, while its controls were informal, they were as good as those in comparable institutions and were considered effective. Walwyn characterised them as: "informal but effective", and this view was subscribed to by Quinn and, largely on the strength of his visit to Barings in 1993 (referred to below), Foot. Both Quinn and Foot referred to the continuity of Barings' management as being one of the factors which justified the informal control culture.

Development of Barings' business as seen by the Bank

- 12.25 The business of what became BSL was bought by BB&Co in 1984 from Henderson Crosthwaite. BSL had a large number of subsidiaries. BSS, BSJ and BFS were all subsidiaries of BSL (BSLL was a further subsidiary of BSL, being incorporated by it in 1993). The BSL sub-group was very successful in the late 1980s, largely as a result of the boom in the Tokyo stock market: in 1989 BSL and its subsidiaries were responsible for approximately £50 million out of the Group profit of £65 million.
- 12.26 In the early 1990s the Tokyo stock market fell considerably, as did the volume of trading on that market. This led to a substantial fall in the profits of BSL and its subsidiaries (and, as a result, those of the Barings Group). This decline in business levels and profit resulted in a period of retrenchment for the BSL sub-group. Staff levels in the BSL sub-group were cut in 1992 and management reorganised under a new Chief Executive, Norris, who was brought in from BB&Co. Whereas previously the BSL sub-group had to a large extent acted independently of the remainder of the Group, moves were begun at that time to integrate the sub-group into the remainder of the Group.

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- 12.27 The results of the Group for the 1992 financial year were substantially poorer than those for the preceding financial year, operating profits falling 28% to £36.8 million and retained profits falling 90% to £1.8 million. (This was caused in part by reorganisation costs incurred in respect of BSL.) While in the first half of 1993 the BSL sub-group reported a profit before tax of £18.6 million (an upward trend which continued throughout 1993 and 1994), the attribution of profits to the various Group companies was not straightforward.
- 12.28 At a meeting attended by Norris, Broadhurst, Thompson, Philip Kelly and Jennings and Armistead of the SFA on 4 February 1993 the Bank was informed that profits were calculated by product, as well as by country. The Bank was further informed that this resulted in BSL's accounting system being "extremely complex"; more emphasis was placed on the split by products than by originating office. This philosophy was carried through to the management committee of the BSL sub-group, which comprised worldwide product managers, rather than local office heads. Calculation of profits was further complicated by the booking of transactions offshore when the originating office had used up its available capital. (Since BSL operated in its various markets through a number of locally incorporated subsidiaries, rather than through branches of BSL itself, the amount of business which could be 'booked' to each subsidiary was limited by the size of that subsidiary's capital base; when it ran up against regulatory constraints preventing it from entering into further transactions (without first increasing its capital) another BSL subsidiary in another jurisdiction which was not utilising its capital to the fullest extent would enter into such transactions.) This resulted in the BSL sub-group instituting a system of internal allocations and transfer pricing. The Bank was informed at this meeting that the restrictions placed on BB&Co's lending to connected parties (i.e. other companies in the Group) added to the difficulty in funding the Group. (For Barings' perception of this meeting see paragraph 11.22.)
- 12.29 The Bank's understanding at that time was that the business of the BSL sub-group was primarily broking; when interviewed Thompson said: "We were assured by Norris and Tuckey that the proprietary trading was not a big activity ... they were taking modest proprietary positions and they were doing arbitrage in Singapore and Japan but our understanding from what was said at the prudential meetings was that within Baring Securities and the bank no significant positions were taken ... it was mainly a broking activity so we were told". It should be borne in mind that the assurances given to the Bank by Barings executives based in London during the period under review were made on the basis of the information which the latter had; and that they themselves were, we have been told, unaware of the actual trading activities being carried on in Singapore.
- 12.30 The description of the management of Barings as being on a product, rather than a geographical, basis was repeated in the prudential meeting on 6 May 1993 attended by Tuckey, Barnett, Maclean, Thompson and Mackintosh. The Bank was informed that there had been a convergence of management and cultures. The possibility of solo consolidating BSL with BB&Co had first been discussed in early 1992. At this meeting Barings reverted to this suggestion, on the basis that: "effectively, the companies were using the same capital and had to decide the most efficient deployment of resources". Confirmation was given that: "proprietary trading would be undertaken [by the BSL sub-group] only as part of the underlying broking business".

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- 12.31 Foot visited Barings in London on 27 and 28 July 1993, during which Norris accepted that the geographic diversity of the BSL sub-group's activity: "was bound to put strain on their human resources (and I [Foot] would have added, on their management controls); but they were determined to be among the first wherever new securities markets were likely to appear". From our interview with Foot and from comments made by Peter Baring in the meeting referred to in the following paragraph we believe that this comment was largely directed at expansion in Latin America.
- 12.32 On 13 September 1993 Peter Baring called on Quinn. The note of the meeting records Peter Baring as saying, with respect to the BSL sub-group, that: "the recovery in profitability had been amazing [following the reorganisation referred to in paragraph 12.26], leaving Barings to conclude that it was not actually terribly difficult to make money in the securities business". He told Quinn that the BSL sub-group: "would be the biggest contributor to the [Group's] profits in what was likely to be a record first half". In response to a question from Quinn, he confirmed that the bulk of the BSL sub-group's business was agency business (rather than proprietary trading).
- 12.33 By the time of the prudential meeting with BB&Co on 18 May 1994 (which was attended by Tuckey, Barnett, Maclean, Thompson and Walwyn) the 1993 Group results were available. As noted above, the BSL sub-group had had a successful 1993 financial year. The Bank was aware that much of this profit was being made in the Far East markets. At this meeting Thompson noted that, according to the March management accounts, BB&Co's commercial lending had increased to £800 million (from £400 million) since the end of the last financial year. Maclean responded that this figure included: "items such as the margin placed with overseas stock exchanges (including Osaka and SIMEX) by [the BSL sub-group]; in other words nothing could be read into a seemingly large change over any particular period". Although Thompson's recollection of this comment differs slightly from Walwyn's, they were both of the view that it referred to loans to clients by Barings Group entities to finance margin payments because, as Thompson has told us, the Bank's rules prohibited the provision of funding to the Far East companies to finance own account positions in the Far East in excess of the 25% connected lending limit.
- 12.34 At this meeting Barnett explained that the management accounts were being reorganised to reflect the increasing integration of the BB&Co and BSL businesses and that a new category, 'structured products', would be created in BB&Co's management accounts. In future, the BSL sub-group's derivative profits would be split between brokerage profits (£1.7 million in the first quarter of 1994) and proprietary profits (£9 million in the same quarter). For management accounts purposes, brokerage profits would continue to be booked to the BSL sub-group, but proprietary profits would thereafter be classified within 'structured products' in BB&Co. Barnett further explained that the £9 million proprietary profits were: "largely accounted for by a long standing arbitrage between the Nikkei and SIMEX indices, mostly intra-day ... the position had only recently become so substantially profitable". BB&Co's management accounts therefore were not prepared on a basis which would result in them reflecting BB&Co's assets, liabilities and profitability; rather (as is not uncommon in financial groups) they recorded the results (on a group-wide basis) of a number of activities which were carried on by BB&Co or its subsidiaries. As a matter of law, the party to the arbitrage activities carried on SIMEX, OSE and TSE was generally BSJ - however, the results of these activities (as reported to Barings in London) appeared in BB&Co's management accounts.

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- 12.35 Quinn and Sergeant met Tuckey and Norris on 17 November 1994. They were told that the process of bringing BSL and BB&Co together was nearly complete, and that the two companies would be located on the same premises by the summer of 1995. Despite the cultural differences between BSL (as a securities company) and BB&Co (as a bank) the combination had gone well. The business of the BSL sub-group was, they were told, virtually all international.
- 12.36 The conversion of the BSL sub-group to a brokerage-based business was confirmed in the prudential meeting held on 24 November 1994 (attended by Tuckey, Maclean, Barnett, Thompson and Walwyn), in which Tuckey said that: "only a small part" of the BSL sub-group's business was proprietary relative to its competitors: "so any large flows from Barings that did affect markets were largely generated by clients rather than by own account trades". While these statements are not necessarily inconsistent with the large exposures (of which the Bank had been informed) to OSE referred to below (since margin payments made by Barings on behalf of non-segregated clients also would have had this result), it would have been better if there had been further discussion of them, particularly in the light of the proposal to solo consolidate BSJ (which we mention below) and the significant income generated from the operations in the Far East. When asked to give a breakdown of income in the Far East between corporate finance, brokerage and position-taking income, Tuckey said he was reluctant to guess, but that it was: "predominantly brokerage". The: "apparently strong performance of 'structured products' in [the management accounts of] BB&Co" represented, the Bank was told: "'structured' (i.e. derivatives and arbitrage) debt and equity trading formerly booked in [BSL]; i.e. the larger scale set pieces in SIMEX, Osaka and Tokyo. This year [1994] those deals had been extraordinarily profitable".
- 12.37 With the exception of Thompson's letter to Barnett dated 1 February 1995 regarding Japanese large exposures, which is referred to below, there was no further relevant contact between the Bank and Barings before the collapse.
- 12.38 We asked Thompson and Walwyn whether they wondered why the arbitrage operation on SIMEX and OSE had become so profitable, and whether this profitability gave them an indication of the increasing scale of the operation. Thompson's response was that: "We knew that this arbitrage operation was pure arbitrage, so we were told, but the difference between futures prices on SIMEX, Osaka and Tokyo was quite significant ... Our understanding was that the two did not necessarily line up consistently but there were opportunities for making significant profits. [The substantial increase in profitability] could tell you that there were greater inconsistencies in price, greater inconsistencies in volume of trading that they were doing. Because we saw [margin exposures to] Osaka beginning to move towards 25 per cent [of the Group's consolidated capital base] and above 25 per cent, it did seem to us that the volume of trading was possibly increasing. How much was own account ... I do not know". Walwyn's response was: "Yes [I did wonder why Barings' position had become so substantially profitable]. Indeed, I asked questions about it periodically in briefings and things ... I was quite keen to understand the structure of the business. It was clearly profitable and they were clearly interested in it. They talked about it at both [prudential meetings] that I attended. I was quite keen to establish what kind of factors might have driven that ... I was quite keen to know how profitable it was exactly because we did not know, and some of my questions prior to the November [1994] prudential [meeting] ... are aimed at doing that. I thought about the profitability. I was pleased with it because we were keen for Barings to make

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profits given its earlier problems in Baring Securities. It was not a problem for us. The way it was explained, the dominance of Barings in the particular markets where they were taking the positions led to a unique ability to corner that particular anomaly that they were looking to corner. We thought about those kind of issues, how they generated the profit". The profitability of the operation did not "explicitly" give him an idea of its size: "until much later [in October 1994] when they sought funding under a treasury concession for it and essentially told us that the positions were in the region of £250 to £300 million (see paragraphs 12.21 and 12.88). That was the sort of funding they were looking for".

- 12.39 Sergeant has informed us that she was not aware of the significance of the arbitrage play between SIMEX and OSE until after the collapse (but see paragraph 12.53). When asked what was her view in terms of looking at items which are extremely profitable (as opposed to items which make losses), she said: "The pattern of profitability is something, I believe, that should be looked at in order to see whether anything is growing particularly rapidly or looks out of line with what we have been told in terms of budgeted figures and so on. Part of the normal analysis of the profile of the business would be to look at the profitability generally; how it was divided up, how sustainable it was, whether anything looked odd and all those sorts of things". When interviewed by us, Quinn said that a large contribution to group profits, a substantial funding requirement and the existence of comfort letters given by the relevant bank in its favour would all be factors that would go to making a subsidiary of an institution material to the institution and thereby justify particular interest being taken in it by the Bank. (We have been told by the Bank staff we have interviewed that they were not aware until after the collapse of the comfort letters referred to in paragraph 1.34 of this report. There was at that time no requirement for Barings to inform the Bank of the existence of such letters.) While, with the benefit of hindsight, it would clearly have been preferable for the Bank to have had a greater understanding of, and of the controls over, Barings' Far Eastern operations, we consider that, in the absence of any guideline to the contrary, Thompson was entitled to rely on the information and explanations given to him by Barings' London management in response to questions regarding the SIMEX/OSE arbitrage operation. We return to this issue in Section 14.

Large exposures

- 12.40 Section 38(1) of the Act (which forms the basis of the Bank's large exposures (LE) rules) requires any UK authorised institution to notify the Bank before incurring an exposure (for instance, a loan or other transaction by which it 'exposes' itself to loss) to a person of more than 25% of its capital base. Closely related persons are treated as one person for this purpose.
- 12.41 The Bank has supplemented Section 38 by two Notices to banks. The first such Notice was published in September 1987 and the second, which implemented the EU Large Exposure Directive (LED) and was published in 1993, superseded the first Notice on 1 January 1994. Both Notices make it clear that exposures will be measured on two bases: an unconsolidated or, where applicable, solo consolidated basis (i.e. they will be measured in respect of the reporting entity or, as the case may be, the solo consolidated entities alone) and on a consolidated basis (i.e. in respect of the group of companies of which the bank forms part). They also require that the Bank should be notified before a bank or a member of a banking group enters into a transaction as a

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result of which the bank or the group would be exposed to the risk of incurring losses in excess of 25% of its capital base.

12.42 The most important difference between the 1987 Notice and the 1993 Notice is that, while in the earlier Notice the Bank had a discretion to allow exposures to a counterparty or group of closely related counterparties to exceed 25% of a bank's or a group's capital base "in the most exceptional circumstances", the later Notice, in compliance with the LED, removed this discretion at the consolidated level (although certain exposures both to private and public bodies - for example, exposures to banks and sovereign bodies - were exempted from this 'hard' limit by the LED). The imposition of the hard 25% limit at the consolidated level was one of the matters pointed out by Thompson to Maclean in his letter of 3 November 1993 informing Maclean of the publication of the 1993 Notice. However, the LED contains transitional provisions. The 1993 Notice envisaged that the Bank would discuss, and the Bank's internal Guidelines for Managers gave wide discretion to its managers to agree, with institutions timetables to reduce exposures in breach of the limits in the LED which did not impose an unreasonable burden on the institution concerned. However, institutions were not to be allowed to run exposures for any longer than necessary. Increases in exposure were only permitted to the extent that they did not take the exposure above its level as at 5 February 1993 (the date of publication of the LED). The relevant Bank guideline said that this discretion was to be used sparingly.

12.43 UK banks are also required to file returns (LE returns) with the Bank on a quarterly basis showing exposures over 10% of their capital base both as at the reporting date and with respect to their highest exposures in the period. These returns are filed on both a consolidated and an unconsolidated (or solo consolidated) basis. Prior to implementation of the LED, consolidated LE returns had only to be filed on a half yearly basis.

Large exposures to OSE

12.44 On 29 January 1993 Barnett wrote to Thompson explaining the difficulties which BSJ was having in complying with the Bank's rules on consolidated LEs in the context of margin deposits placed with OSE and TSE. In the appendix to his letter Barnett explained that futures and options exchanges in Japan restrict members (BSJ was a member of both OSE and TSE) to only one account for the purposes of securing (or 'margining') open trading positions held by them, either on their own behalf or that of their clients. (This practice is unlike that of most exchanges elsewhere, which permit members to have at least two separate accounts, one for their own dealings, and another in respect of clients' transactions.) BSJ 'gross' margined its clients, but was only 'net' margined by the exchanges - that is, broadly speaking, it only had to pay margin to the exchanges on the net position which represented the combined total of its clients' and its own long and short positions.

12.45 In his letter, Barnett said that Barings believed that the correct approach was to apportion the risk of the failure of the exchanges (and their consequent failure to return the margin placed with them) between the Group and its segregated clients (i.e. those clients whose assets were held separately from Barings' own assets): "in proportion to the gross margin attributable to each stream of business". This was despite: "some doubt about the recognition of the principle of agency under Japanese law". (Barings accepted that it bore the risk on the exchanges in respect of the margin

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put up by its non-segregated clients and its local clients.) The Group's exposures to OSE and TSE (as a result of the margin accounts held by those exchanges) were reported to the Bank on this basis (i.e. after the deduction of that proportion of the margin held on each margin account which was attributable to segregated clients). Barnett attached to his letter a copy of the calculation undertaken by Barings to arrive at the figures reported to the Bank; this calculation showed that over the seven months ended on 31 December 1992 "own account" (i.e. non-client) margin placed with OSE varied between 49% and 90% of the aggregate - own account, non-segregated clients' and local clients' - margin exposure reported on the consolidated LE return. Thompson has confirmed that after 29 January 1993 the Bank did not receive a breakdown of the exposure in respect of any subsequent period: "because it was all Barings exposure, so we were informed, it did not seem to matter much what was Barings, what was local and what was non-segregated".

- 12.46 Having admitted that "some doubts remain about the treatment of funds under Japanese law in the unlikely event of [the] failure of either of the exchanges", Barnett then went on in his letter to list a number of reasons why Barings had: "exclud[ed] [and, by implication, the Bank should be prepared to exclude] this residual risk". The most material of these were that it was proper to "look through" each exchange to the individual members of that exchange as the first line of support, and that both exchanges were regulated by the MoF and were widely accepted as effectively sovereign risk.
- 12.47 While in his letter Barnett did not specifically request the Bank to view its LE rules in such a way that, as a general matter, all exposures to the Japanese exchanges fell outside the LE regime (all he explicitly sought was the Bank's agreement to exclude the "residual risk" that segregated clients' monies held in BSJ's margin accounts with the exchanges represented exposures of BSJ to the exchanges), Thompson, Mackintosh and Walwyn all believed that Barings was requesting, if not expressly then at least implicitly, to be permitted to exceed the 25% consolidated capital base limit in respect of its exposure to OSE. Thompson also recalled that in subsequent discussion with him Barings requested permission to go over the 25% limit.
- 12.48 The Bank did not finalise its view regarding this issue for two years (until shortly before the collapse) despite the introduction of the 'hard' 25% consolidated capital base limit from 1 January 1994. (Quinn thought this should have triggered: "a renewal of interest, at the very least, in the issue".) No material progress was made towards resolving the issue until the prudential meeting on 18 May 1994, prior to which the Bank had been reminded of the matter by Barings. At this meeting Thompson - following the advice of S&S Policy Group, which had been consulted two weeks earlier - advised Tuckey, Barnett and Maclean that the Bank would require the entire margin payment (i.e. the aggregate of BSJ's and segregated clients' margin payments) to be regarded as Barings' own exposure for consolidated LE reporting purposes unless Barings received a legal opinion confirming that segregated clients legally bore the risk in respect of their margin deposits and the contracts between BSJ and its clients made it explicit that the client was legally exposed in this way. Barnett confirmed that Barings had insisted on provisions being inserted in contracts with its clients along the lines suggested by Thompson, but said that Barings would be unable to obtain a legal opinion in the form requested because of the lack of recognition of agency law in Japan. It was agreed that Thompson would write to BB&Co setting out the Bank's understanding of the position, and that BB&Co would write back to confirm

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it. At this stage the Bank's attention was focused on resolving the question as to whether it was appropriate to allow Barings to report its exposure to OSE net of segregated clients' funds; it was not actively addressing the more fundamental issues (referred to in paragraphs 12.46 and 12.47) at all.

12.49 As noted above, the figures BB&Co included in its consolidated LE returns to the Bank in respect of its exposure to OSE (both before and after the 18 May 1994 prudential meeting) excluded margin placed by Barings with OSE which was attributable to segregated clients of Barings (the figures reported comprised only the margin attributable to Barings' own dealings and those on behalf of its non-segregated clients and its local clients). Even on this basis, the consolidated LE returns filed with the Bank show that the Group exceeded the 25% LE limit in respect of its exposure to OSE during almost every reporting period in 1993 and 1994, as shown in Figure 12.1.

Figure: 12.1

| Period covered by return | 25% of consolidated capital base (CCB) £ millions | OSE - Maximum exposure in period | |
|-----------------------------|---|-------------------------------------|----------|
| | | £ millions | % of CCB |
| Jan 93 - Jun 93 | 70.8 | 89.6 | 31.6 |
| Jul 93 - Dec 93 | 78.2 | 139.4 | 44.6 |
| Jan 94 - Mar 94 | 117.4 | 174.1 | 37.1 |
| Apr 94 - Jun 94 | 117.4 | 116.0 | 24.7 |
| Jul 94 - Sep 94 | 117.4 | 195.0 | 41.5 |
| Oct 94 - Dec 94 | 117.4 | 131.0 | 27.9 |

Source: BB&Co consolidated LE returns

(While Barnett's letter of 29 January 1993 discussed Barings' exposures to both OSE and TSE, between January 1993 and December 1994 the Group's exposure to TSE only exceeded the 25% LE limit in one quarter (October 1994 to December 1994), and then only marginally (25.1%.)

12.50 None of these LEs was pre-notified, as required under the terms of the Bank's 1987 and 1993 Notices, although in a letter dated 29 April 1994 Barnett did draw Thompson's attention to the exposure to OSE disclosed in the consolidated LE return in respect of the period ended on 31 March 1994. (In this respect, see also paragraph 11.59.)

12.51 Thompson has told us that his understanding (correctly) throughout was that Barings was reporting its exposure to OSE after deduction of segregated client funds. Mackintosh could not recall what his understanding was at the time. Walwyn has told us that until early 1995 he believed that the exposures which were being reported included segregated client funds; he was accordingly interpreting the consolidated LE returns filed by Barings on an incorrect basis for the period from April 1994 (when he started supervising Barings) until January 1995. His notes throughout 1994 (a number of which were copied to Thompson) reveal his misunderstanding of the basis on which Barings was reporting; we find it surprising that Thompson did not correct him. Walwyn only discovered the actual basis of reporting in January 1995 when he worked back through the correspondence on the matter and re-read Barnett's letter of 29 January 1993.

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- 12.52 We discussed with Thompson and Walwyn why Barings did not pre-notify the LE it was running to OSE. Thompson said that, while he had not explicitly waived the obligation to pre-notify, he had granted an “informal concession” allowing Barings to hold an exposure to OSE in excess of 25% of its consolidated capital base while the issues regarding the quasi-sovereign nature of the exchanges and whether it was possible to ‘look through’ the exchanges to their members were being resolved. Walwyn’s recollection was similar, although he characterised the arrangement as an “implied agreement”. Because the granting of this concession was not documented, it is not possible to state with certainty from when it took effect; however, both Thompson and Walwyn thought it was granted in 1993. Thompson was of the view that, while he had not put a limit on the exposure to OSE which Barings could run, he would have got “nervous” if the exposure exceeded half of the Group capital. Thompson also told us that Barings could not have pre-notified because non-segregated and local client margin were included in Barings’ margin exposure and Barings in London could not have been aware in advance of the decision of clients to operate on OSE through BSJ - but this would not explain why Barings did not notify the Bank as soon as it became aware of the exposure. (The 1993 LE Notice requires an institution to notify the Bank immediately upon it becoming aware that it has breached the 25% limit.) Thompson also referred to the reporting problems described in paragraphs 12.61 and 12.95 below. We believe that, at least by 1994, the reason Barings did not pre- (or post-) notify the Bank of the LE it was running to OSE was because of the informal concession referred to above.
- 12.53 The Bank’s internal Guidelines for Managers required requests for the Bank’s non-objection to a non-bank exposure exceeding 25% of a bank’s or a group’s capital base to be referred to what is now a Head of Division before a notice of non-objection was given. Thompson has stated that prior to the October 1993 prudential meeting referred to in paragraph 12.74 he went into OSE exposure with Sergeant and mentioned the excess which had been reported in the June 1993 consolidated LE return. He has also stated that he believes that at that time he mentioned the informal concession which he had granted, although he told us that he could not confirm this latter point with complete conviction. Sergeant’s recollection is that she was not told of the excess reported in the June 1993 return or, prior to the collapse, of the informal concession. Neither Barnes nor Foot (nor Quinn, although, given the Bank’s reporting structure, there was no reason why he should have been told) was aware before the collapse that the 25% limit was exceeded on a number of occasions with respect to OSE during 1993 and 1994. Sergeant has told us that she would: “have preferred to have known [of the excesses] quite strongly”. Quinn told us that when the LED (and consequently the hard 25% consolidated capital base limit) came into force: “I would have expected any concessions that were given to be looked at again to see whether those concessions were still valid”. We agree with this view.
- 12.54 Quinn, Sergeant and Foot were all of the view that, if a concession from the Bank’s LE rules was to be granted to a bank, a higher limit (which should not be exceeded without further agreement from the Bank) should be agreed with that bank. Foot said that it: “would be normal practice” for some limit to be placed on a concession, while Sergeant was of the view that “ideally” any concession which was given should have included a higher limit as part of that concession; Quinn’s view was that: “If there was a concession, particularly if there was a degree of uncertainty about whether the concession was absolutely justifiable and valid, then I would have expected the

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supervisor in those circumstances to place a limit on it". As noted above, no such limit was set in this case.

- 12.55 Thompson has told us that he did not regard the resolution of the issues regarding the exposure to OSE as a priority because he did not see the exposure as a serious risk. Instead, he saw the breaches as essentially technical breaches, for two reasons:
- (a) He considered the credit risk to be low: "Is it a real exposure? A credit risk to the exchange is pretty remote";
 - (b) He had been assured that the margin exposures were incurred in the context of a "true arbitrage operation: if it was not a true arbitrage operation then it would have been much more serious but we received those assurances".
- 12.56 No further progress appears to have been made with respect to resolving the issues relating to OSE until 18 January 1995, when Walwyn drafted a letter for Thompson to send to Barnett. At the same time Walwyn requested confirmation from S&S Policy Group that exposures to OSE and TSE could not be accepted as quasi-sovereign risks and that it was not possible to look through the exchanges to their members; this confirmation was given on 24 January 1995. Thompson sent the letter at the beginning of February 1995 (the letter was dated 1 February 1995, but Thompson told us it may have actually been sent one or two days later). The letter informed Barnett that the exposures to the exchanges could not be exempted from the application of the 25% hard limit and that the Bank had no discretion to allow Barings to exceed the hard limit. In the letter he asked Barnett, in accordance with the transitional arrangements referred to in paragraph 12.42, to "explore urgently" whether it would be possible to reduce the exposures.
- 12.57 The Bank did not inform the SFA of the LE which Barings was incurring to OSE (or that to SIMEX referred to below). Under the MoU between the Bank and the SFA the Bank was obliged to inform the SFA if it had material concerns relating to the financial soundness of BB&Co. As the Bank did not consider that this exposure would adversely affect the financial soundness of BB&Co, under the MoU it was under no obligation to inform the SFA. However, we consider that it may have been helpful if the Bank had reported this matter to the SFA, particularly since the exposure related to the BSL sub-group and (albeit indirectly) to securities activities.

Large exposures to SIMEX

- 12.58 In the letter dated 29 April 1994 from Barnett to Thompson (referred to in paragraph 12.50), Barnett also drew Thompson's attention to the Group's exposure to SIMEX reported in the consolidated LE return in respect of the three month period ended on 31 March 1994. This had reported a highest exposure in the period of £120.2 million against a 25% LE limit at that time of £117.4 million. Barnett explained that: "our Singapore office" [BFS] had two accounts with SIMEX, a 'house' account and a segregated client account. While proprietary trades carried out by BFS were booked in its house account at SIMEX, proprietary trades carried out on behalf of other Barings offices were booked to BFS's client account at SIMEX, with the result that the total Group exposure to SIMEX was spread across the house account and the client account. Barnett continued that Barings was putting in place a system to determine on a daily basis the total Group exposure to SIMEX, but that that system was not yet in place and

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therefore for the purposes of compiling the consolidated LE return BB&Co had assumed that 50% of the exposure on the client account was Group exposure: using this basis of calculation, the Group had exceeded the 25% LE limit during the period covered by the March 1994 consolidated LE return (the reported exposure was 25.6%).

- 12.59 In the prudential meeting held on 18 May 1994 Barnett stated that Barings had by that time developed a system which would enable it accurately to identify all Group (as opposed to client) margin funds held with SIMEX, and therefore it would not have to continue to estimate the Group exposure. Barnett further confirmed that the new system had revealed that Barings had been conservative in estimating the Group's exposure.
- 12.60 The Group's consolidated LE return in respect of the three months ended on 31 December 1994 (which was received by the Bank on 1 February 1995) reported that the highest exposure to SIMEX in that period was £118.7 million, which was just over the 25% LE limit of £117.4 million.
- 12.61 We have discussed with Thompson and Walwyn why the Bank did not pursue these breaches of the 25% consolidated capital base limit with Barings (we have found no letter or record on the Bank's files concerning either breach of limits). Thompson told us that there is often difficulty in pre-notifying, because the institution concerned will not necessarily know in advance that it is exceeding the limit: "In these sort of trading circumstances, where clients are coming in and requiring margin to be put up, I do not think you would have an ability to know in advance". This view was also expressed by Foot, who added: "What you look for is [the institution's] speed of picking them up; their explanation of why they occurred and what they hope to do about it in the future - those kinds of issues". Walwyn could not recall any discussion of the breach of the 25% LE limit disclosed in the March 1994 consolidated LE return; Thompson told us: "I did not pursue with Barings why they did not pre-notify because they would not have been aware at the time, for reasons I have said before [see above]. Because the trading in Osaka and SIMEX was increasing all the time, it was quite clear that they were going to go above the 25%. What we said about Osaka applied equally to SIMEX".
- 12.62 Thompson told us he was not aware of the breach which was disclosed in the December 1994 consolidated LE return until after the collapse. Walwyn was, but he believed that the issue had been effectively addressed by Thompson's letter dated 1 February 1995 (referred to in paragraph 12.56) and therefore, because the breach was again a marginal one and the exposure to SIMEX was considered low risk, took no further action.
- 12.63 Thompson and Walwyn were not entirely of the same view as to whether Barings was likely to have linked SIMEX and OSE, so that the informal concession granted in respect of the exposure to OSE would also apply to SIMEX. While Walwyn agreed that: "It was conceivable that [Barings] were linking them in their minds" he continued that: "The only thing I would say is that it was never discussed in respect of SIMEX". Thompson, on the other hand (apart from his comments in paragraph 12.61), was of the view that: "They would have implicitly, possibly, I do not know, taken the view that SIMEX had the same application as Osaka in terms of notification".

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Large exposures in January and February 1995

- 12.64 Thompson did not think that Barings would have believed that it did not have to notify the Bank of breaches of the 25% limit which occurred in February 1995: "Exposures in excess of 25% to the exchanges were permitted, but the letter [dated 1 February 1995] actually went out on 2 February or 3 February, saying 'You need to come below 25%.' If we are talking about an horrendous, massive exposure, I would have expected them to talk to us immediately. We had an ongoing dialogue about this subject. They were aware of the need to get below 25%. Barnett was in control ... I would be surprised if they did not notify us of a really serious breach". (Barings' exposures to SIMEX and OSE in January and February 1995 (as reported to Barings in London) are described in paragraph 11.53.)
- 12.65 We do not believe that the Bank was aware of the substantial transfers of funds from Barings in London to Singapore which took place in January and February 1995 and we make no criticism of the Bank for not being aware of this. The Bank would not have known of these transfers unless they were brought to its attention by Barings - which they were not. (Consolidated and solo consolidated LE returns would have been due to be filed in respect of the period 1 January 1995 to 31 March 1995 within, respectively, one month and 14 days of the end of that period.)

Solo consolidation and treasury concessions

- 12.66 Barings had the benefit of certain supervisory concessions from the Bank (and sought further concessions) in the period under review. These concessions, by creating exceptions to the 25% connected lending limit explained in paragraph 12.10, provided the Group with a certain amount of flexibility in respect of its funding arrangements.
- 12.67 Under the 1993 Bank Notice implementing the LED the Bank may permit a bank which is a member of a group of companies to become the 'treasury' for those companies, provided that the group is subject to consolidated supervision. In such circumstances the Bank agrees a maximum level for the bank's exposure to a particular group company which is known as a 'treasury concession'. The group company concerned is then removed from the 25% connected lending limit. For its internal purposes the Bank expresses total treasury concessions as a percentage of the relevant bank's unconsolidated (or solo consolidated) capital. The Bank's internal policy guidelines state that the "usual maximum" of such concessions should be, in aggregate, 100% of solo consolidated capital and that the bank should have a good case for concessions of this size. However, the Bank has informed us that for historical reasons many banks currently have concessions in excess of this amount. In order for a treasury concession to be granted the bank seeking the concession must satisfy the Bank that it has appropriate management and other group control systems in place to ensure that risk-taking in the subsidiary companies for which it performs the treasury function is properly monitored and controlled.
- 12.68 At the time of the collapse the treasury concessions granted to BB&Co totalled 117.5% of its solo consolidated capital. At the end of 1991 they had been 257%. Only two of the treasury concessions which had been granted are relevant to the inquiry, namely an £85 million concession to BSLL and a £150 million concession to BSL which was withdrawn (because it was redundant) when BSL was provisionally solo consolidated

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with BB&Co. No treasury concessions were in place in respect of Barings' overseas securities subsidiaries.

- 12.69 We have been informed by the Bank that the £85 million concession to BSL was agreed in 1993 at the time the provisional solo consolidation of BSL with BB&Co was implemented. Prior to this the only treasury concession in place for the BSL sub-group had been the £150 million concession to BSL itself referred to above (which BSL could have then on-lent to its subsidiaries). The aggregate exposure of BB&Co (or the solo consolidated group including BB&Co) to Group companies not included in the various treasury concessions should not have exceeded the 25% connected lending limit explained in paragraph 12.10; Barings' management were aware of this restriction.
- 12.70 As mentioned in paragraph 12.30, Barings had been moving towards the solo consolidation of BSL with BB&Co from 1992. As noted above, this would result in BSL being included in the unconsolidated returns submitted by BB&Co to the Bank and being monitored as if it were part of BB&Co and (among other things) would enable BB&Co to enter into transactions with BSL without regard to any LE limit. The proposed solo consolidation of BSL with BB&Co would be the first time a substantial securities company had been solo consolidated with a bank, although since at least March 1992 the Bank's internal Guidelines for Managers had allowed the possibility of solo consolidating an FSA-regulated entity with a bank if it satisfied the normal criteria.
- 12.71 When the possibility of solo consolidating BSL with BB&Co was discussed in 1992 BB&Co accepted that not all of the Bank's requirements for solo consolidation were met at that time. The matter was discussed at length again at a meeting almost a year later, on 23 September 1993, attended by Barnett, Maclean, Hopkins, Norris, Broadhurst and Tony Hawes of Barings and Thompson and Mackintosh. Norris explained the close linkage which had been established between the managements of BSL and BB&Co over the intervening period, seeking to satisfy the requirement regarding effective direction of the management of BSL by BB&Co. It was accepted by Barings that solo consolidation could not extend beyond BSL to other companies in the BSL sub-group, because most of them operated overseas and had a need for local funding and also because of possible difficulties in repatriating capital to BB&Co. The most substantial item of discussion was, however, the question of the methodology of solo consolidating BSL with BB&Co. Thompson's concern in this respect was, broadly speaking, that the Bank's capital adequacy rules were designed for banking groups rather than institutions carrying on securities businesses, as did BSL; he was generally of the view that the SFA capital adequacy rules were more appropriate to a securities trading business.
- 12.72 As a result of the discussions, it was agreed that BB&Co would submit two versions of BSD1 (the return which is concerned with the adequacy of an institution's capital to support the assets which it holds) in respect of the solo consolidated BB&Co/BSL group for each quarterly reporting period (in addition to a BSD1 in respect of the consolidated Group). One version would aggregate BSL and BB&Co (i.e. would be compiled on the basis of full solo consolidation of BSL with BB&Co) and the other would exclude BSL's assets from the calculation and deduct BSL's required regulatory capital (assessed in accordance with the SFA Rules) from BB&Co's actual capital.

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- 12.73 Sergeant expressed a number of misgivings regarding the proposal to solo consolidate BSL with BB&Co. She told us her concern: "was to basically make sure that Barings were not getting away with some kind of regulatory arbitrage and swapping somebody else's [capital] requirements for our own in any way or muddling up the regulatory divide between those two separate legal entities". She continued: "My concern was to make sure that all the angles, many of which I possibly had not thought of, had been looked at thoroughly by the policy area". On the note of the 23 September 1993 meeting she wrote: "I am not convinced that the criteria are met nor am I convinced that they are anyway appropriate for these circumstances for which they were not intended". (Solo consolidation was originally intended to facilitate the incorporation of capital-raising subsidiaries which would then on-lend the funds raised to their parent banks.) Her handwritten comments (dated 20 October 1993) on that note also included a number of questions to Thompson:
- (a) Was the Bank sure that Barings was not 'cherry picking', with only capital-rich companies going into the solo consolidation?
 - (b) Should the Bank know about the objects of the overseas subsidiaries of BSL (which were to be excluded from the solo consolidation)? The Bank had been told that the objects of these companies were separate from BSL, but those objects had not been specified.
 - (c) Did the 'group approval' which, the Bank was told, was required for significant decisions equate to effective direction of BSL by BB&Co (as required by the Bank's solo consolidation requirements)?
 - (d) Did BB&Co approve BSL's risk limits and then monitor compliance with them?
 - (e) Did the use of joint committees of BB&Co and BSL, overlaps of BB&Co and BSL staff and the use of ex-BB&Co staff in BSL equal control of BSL by BB&Co? (She expressed the view that they could simply lead to confusion about who was actually responsible for decision taking.)
- 12.74 Solo consolidation was also discussed at the prudential meeting between Sergeant, Thompson, Mackintosh, Tuckey, Barnett and Maclean on 22 October 1993. In this meeting Sergeant said that the concept of solo consolidation had developed for somewhat different purposes than that envisaged by BB&Co and that she felt the proposal merited further consideration; the changes: "created a question of management", and she felt the Bank had to look at: "the wider implications for supervision". (Barings' view of this meeting is described in paragraph 11.24.)
- 12.75 Following this meeting Mackintosh sent a note to Sergeant (which he copied to S&S Policy Group and to Thompson) on 1 November 1993 discussing whether the Bank's criteria for solo consolidation were met. The purpose of this note, the Bank has told us, was not to answer each of Sergeant's points, but to summarise the issues facing the Bank, as a basis for further discussion. On the issue of control of BSL by BB&Co, he said that the overlap of management between BSL and BB&Co was substantial and that: "at recent meetings we have been advised that for internal management purposes [BB&Co and BSL] are seen as essentially a single entity, and the 'convergence' process will continue to the point where, by the end of 1994, it appears that [BSL] will be little

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more than a trading name in specialist markets for [BB&Co]. On this basis, the criterion appears to be met”.

- 12.76 Thompson sent a letter to Maclean on 4 November 1993 setting out the Bank’s position with regard to solo consolidation. Under this letter the Bank appears to have been prepared to treat BSL as solo consolidated with BB&Co effectively on a provisional basis, pending further consideration within the Bank. The letter was largely concerned with capital adequacy issues arising from solo consolidation, but also stated that: “if the conclusion of this internal debate [within the Bank] were to be that it would be inappropriate to allow solo consolidation of substantive subsidiaries which are themselves subject to separate regulation, we would nevertheless be prepared to ‘grandfather’ any large exposures you had undertaken in the meantime” and concluded by saying: “for large exposures purposes, I confirm that the solo consolidated capital base figure as set out on the sheet provided at our meeting may be used for monitoring purposes with effect from 1 October [1993]”. These statements reflected comments made by Sergeant at the 22 October 1993 prudential meeting.
- 12.77 Mackintosh told us that by the time the 4 November 1993 letter was sent the question of whether the Bank’s criteria for solo consolidation were met had been affirmatively answered. The last record we have found of any consideration of the issues identified by Sergeant (some of which ranged more widely than whether the criteria were satisfied) is the note referred to in paragraph 12.75.
- 12.78 The position regarding the solo consolidation of BSL with BB&Co did not change after the 4 November 1993 letter. Sergeant said that she: “would have expected to have been told [if it had] because I would have wanted to know what the discussions had been with the policy area and so on. Chris [Thompson] had to satisfy himself that the criteria were met. That was his job ... my concern here was to see that the policy issue had been properly looked at from all ends”; she continued that: “it is an issue of general interest throughout my division and throughout the whole of S&S as to how that was dealt with. That was my concern”. Foot told us that he was aware of the proposal to solo consolidate BSL with BB&Co; Quinn said that at the time he was not.
- 12.79 The provisional solo consolidation of BSL with BB&Co did not, however, change the respective supervisory responsibilities of the Bank and the SFA. The SFA continued to apply its own capital requirements to BSL; it also remained responsible for the supervision of the internal systems and controls within BSL.
- 12.80 The Bank has stressed to us the importance of the 25% connected lending limit restricting exposures of BB&Co (or the solo consolidated group) to the remainder of the Group, and that no treasury concessions had been granted in respect of BFS or BSJ. Barings’ management were aware of the connected lending limit and BB&Co’s unconsolidated and solo consolidated LE returns submitted to the Bank did not show significant funding to BFS or BSJ. Until the collapse Barings’ management thought they were complying with the limit. As explained earlier in the report, they did not appreciate the true purpose for which funds were being advanced to Singapore. The failure of controls in Barings meant that, following the solo consolidation of BSL with BB&Co, the connected lending limit did not provide an effective barrier between the solo consolidated group and BFS: funds which as a matter of law constituted loans by BB&Co to BSL were passed to BFS without limit.

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- 12.81 An analysis of BB&Co's unconsolidated (or solo consolidated) LE returns in respect of the period from January 1993 to December 1994 shows that the treasury concession limits and the connected lending limit were not always complied with, and that the method of reporting BB&Co's exposure to BSL was such that the highest exposure in the period could not be ascertained; there was also a number of errors in the completion of the forms. With the exception of two breaches in respect of exposures to BSL in 1993, which were both promptly notified and explained, we have found no record of any discussion between the Bank and Barings of these lapses. Neither Walwyn nor Thompson (who has told us that these matters were not brought to his attention) raised them with Barings.
- 12.82 The statutory requirements concerning LEs (breach of which constitutes a criminal offence) are contained in Section 38(1) of the Act and only apply to authorised institutions (i.e. they do not apply on a group-wide basis; group-wide exposures are covered solely by Bank Notices). BSL was not, therefore, in the ambit of the LE reporting requirements of Section 38 at all. In the absence of solo consolidation, financial dealings between BB&Co and BSL were subject to the 25% connected lending limit imposed on BB&Co, as modified by any treasury concessions. Solo consolidation allowed BB&Co to incur exposures to BSL without limit.
- 12.83 Section 38(3) of the Act empowers the Bank to give notice in writing to an authorised institution, if it has a subsidiary which is not an authorised institution, directing that Section 38(1) will apply to the authorised institution as if the transactions and available capital resources of the subsidiary were included in those of the authorised institution. This mechanism ensures, on solo consolidation, that transactions of a solo consolidated subsidiary with parties outside the solo consolidation are covered by the statutory LE reporting regime. If such a notice had been served by the Bank in the case of Barings the transactions undertaken by BSL giving rise to large exposures at the solo consolidated level to BFS (which are described in earlier sections of the report) would have been subject to the statutory pre-notification requirements contained in Section 38(1) had Barings been aware of those exposures. However, the Bank's letter of 4 November 1993 to BB&Co did not constitute such a notice. The nearest it came was in the words quoted in paragraph 12.76, which were not sufficient to constitute a notice under Section 38(3). As a result the statutory sanction was not extended.
- 12.84 It is unlikely that a criminal offence would have been committed by Barings in London even if the statutory sanction had been extended, because it appears that Barings in London did not know the true position with regard to the funds which it was advancing to Singapore, and for an offence to be committed under Section 38 knowledge of the facts giving rise to a requirement to report is necessary. Nevertheless it is regrettable that the notice required under Section 38(3) was not served.
- 12.85 A note from Walwyn to Thompson of 10 November 1994 referred to Barings seeking to solo consolidate BSJ with BB&Co. The reason for this request was that: "solo consolidation of BSJ might be the only way for BSJ to acquire the Group funding it needs [to cover Japanese futures margin exposures]". The Bank had earlier rejected a proposal that companies within the BSL sub-group (other than BSL, which was now treated as solo consolidated) should have the benefit of unsecured treasury concessions of almost £500 million more than the existing £85 million concession to BSL; according to rough notes Walwyn made during a meeting at Barings attended

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by Barnett, Maclean, Hopkins, Tony Hawes and Thompson on 26 October 1994, this would have been used to finance BSL's and BSJ's holdings of cash stocks and also margin requirements incurred in connection with: "two arbitrage plays (cash v futures arbitrage in Japan; and futures volatility play between Osaka and Singapore) ... there would be no liquidity angle to the proposal because the assets being funded (margin payments) would all be call assets". Walwyn told us that the request for an increase in the treasury concessions was only a negotiating position and the increase Barings was actually seeking was £150 million to £250 million.

- 12.86 Solo consolidation of BSJ proved not to be possible because, according to a letter from Tony Hawes to Walwyn of 2 December 1994, BSJ and two of its intermediate parent companies were not in a position to eliminate all their external funding and therefore the Bank's requirements for solo consolidation were not met. Attention then turned to the possibility of obtaining a treasury concession on a secured basis, by BSJ creating charges in favour of BB&Co over securities owned by BSJ in return for loans from BB&Co. This proposal was still being investigated by BB&Co and BSL at the time of the collapse.
- 12.87 Walwyn was also aware that the £85 million treasury concession which BB&Co had received in respect of BSL was at least partially used by BSL for on-lending to BSJ, and also that BB&Co had lent: "around £200 million" to BSL (which was £50 million more than the £150 million treasury concession limit which, prior to the solo consolidation of BSL with BB&Co, had been granted in respect of BB&Co's exposure to BSL).
- 12.88 The requests by Barings referred to in paragraph 12.85 gave the Bank the first firm appreciation of the size of the arbitrage operation which Barings was running in Singapore and Japan. Walwyn told us: "We had an idea of the size of the activity, a tentative idea, over the course of 1994 based on the large exposures returns but it was not explicit until October 1994, at which point we took away the explicit idea that this was around £250 million to £300 million of business". Barings told the Bank that the reason for its requests was that it wished to replace funding from external banks in Japan, Singapore and elsewhere with cheaper internal funding from BB&Co rather than that it was seeking substantively to expand the business. Thompson told us: "I did not get any strong hint of the great expansion of the business. The message really was that it was a cheaper way of funding the businesses".

Reporting accountants' reports

- 12.89 Under Section 39 of the Act the Bank required BB&Co to commission annually a report from BB&Co's reporting accountants on the accuracy of a particular prudential return and a selected aspect of Barings' internal systems and controls. Reports required under Section 39, together with the accompanying correspondence, have been reviewed for the period from June 1991 to the collapse. The reporting accountants were always the auditors of BB&Co, C&L or their predecessor firm.
- 12.90 In June 1991 the Bank agreed with BB&Co that the next report on prudential returns required under Section 39 would be on the consolidated LE return for the period ended on 31 December 1991. The subject matter of this Section 39 report was agreed by Thompson with BB&Co before a formal letter was sent under Section 39, thus

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putting BB&Co on notice of the matters being reported on; neither Sergeant nor Foot thought this was usual practice.

- 12.91 The report from the reporting accountants dated 21 April 1992 listed the following material deficiencies in the preparation of the Group's consolidated LE return for the period ended on 31 December 1991:
- (a) No information on the maximum exposure in the period to counterparties was collected by BB&Co from any overseas subsidiaries of BSL, from Banque Baring Brothers Suisse S.A. or (unless agreed counterparty limits had been exceeded) from Baring Brothers (Guernsey) Limited. As a result, certain reported figures for the 'highest exposure in the period' were understated.
 - (b) BSL in London (which misunderstood the Bank's requirements) failed to supply to BB&Co, to enable BB&Co to complete the return, information regarding amounts on deposit by BSL with banks in the period covered by the return. This resulted in certain 'highest exposure in the period' figures relating to bank counterparties also being understated.
- 12.92 Tuckey responded to the criticisms in a letter to Thompson dated 15 May 1992. In that letter he said that, because corporate exposures were relatively concentrated in just a few companies within the Group and monitored on a daily basis, he believed that the Group's existing procedures were adequate to avoid any material omission, although he was aware that the approach which had been adopted could lead to some exposures to banks not being included in the 'highest exposure in the period' figure. With the exception of including Baring Brothers (Guernsey)'s counterparty limits in the 'highest exposure in the period' figures in the future he did not propose to change the existing arrangement, on the basis that the costs involved in setting up a system which would enable Barings to calculate its exposures on a daily basis would be "significant" and "disproportionate to any possible improvement in accuracy or the value of such information". (However, the subsequent work done by Barings in identifying exposures in BSL's overseas subsidiaries - including those to OSE (which were brought to the Bank's attention by Barnett's letter of 29 January 1993 referred to in paragraph 12.44) - indicates that Barings' management changed their views in this respect.)
- 12.93 Tuckey's letter did not address the possibility of margin deposits with exchanges constituting large exposures, but Philip Kelly, in an internal note to Thompson concerning the report, wrote: "we should explore to what extent there may be significant exposures (corporate or otherwise) in these offices [BSL's overseas subsidiaries, Banque Baring Brothers (Suisse) and Baring Brothers (Guernsey)] which ought to be reported. I would have expected BSL's overseas offices routinely to take significant securities positions for example". He continued that: "on the face of it [the reporting accountants'] work paints a poor picture of Barings' reporting. There seem to be serious systems weaknesses ... [and] it is surprising that [BSL] London could make such a basic mistake as to omit deposits with banks from the figures". We were told by the Bank that these weaknesses were solely in relation to Barings' reporting of its consolidated large exposures. Moreover, in his letter of 15 May 1992 Tuckey had confirmed that procedures had been amended to ensure there would be no recurrence of the failure to report BSL's exposures to banks referred to in paragraph 12.91(b).

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- 12.94 At the trilateral meeting held on 19 August 1992 to discuss the report Hopkins said that positions taken by overseas subsidiaries of BSL as principal were "relatively small". He confirmed that, because the Barings Group ran few credit risks compared to other comparable institutions, trading in BB&Co and the BSL sub-group were the areas most in need of tight controls.
- 12.95 Barnett's letter to Thompson of 29 January 1993 (referred to above in the context of large exposures to OSE) confirmed that the BSL sub-group did not at that time have information systems which enabled it to report the highest exposures of the companies within that sub-group to counterparties during any particular period, but that the sub-group was putting this right for the future by setting limits for exposures, which limits would be assumed to be fully utilised for the purposes of calculating Group LEs. However, because these limits were not at that time in place, they had been obliged, for the purposes of completing the consolidated LE return for the six month period ended on 31 December 1992, to estimate the sub-group's exposures to counterparties by establishing the highest month end exposures and then uplifting them by 20%. As a further protection, the highest exposure to each counterparty for the rest of the Group was aggregated with the highest month end exposure to that counterparty for the BSL sub-group (irrespective of whether the dates of such exposures were the same). Thompson, in his handwritten note on this letter, described this methodology as: "unacceptable even as an interim measure", but took no further action because, we were told, he understood from Barnett's letter that remedial action was being taken.
- 12.96 No further report was required by the Bank subsequently to check on whether the weaknesses identified by the first report had been addressed. Where serious weaknesses are identified by a Section 39 report into a particular return, the Bank's current policy is to require additional work to be performed under Section 39 in the following year such that the particular return would be revisited in addition to the work the Bank wished to be performed in respect of other returns. We understand that there was no such policy in 1992. While the Bank was able to select the consolidated LE return for re-examination if it was so minded, having regard to the assurances given by management at Barings that the weaknesses identified were being addressed, we do not consider it unreasonable that the Bank did not take this course of action.
- 12.97 The Bank agreed that the 1992 report on systems to be required under Section 39 should be on the credit function of the Barings Group, but that it should exclude: "those parts of the credit process which relate to the [BSL] sub-group or take place in foreign presences". The exclusion was agreed following a discussion between Barnett and Philip Kelly about the division of credit duties within the Group. The systems report revealed no serious weaknesses.
- 12.98 The systems report for 1993 was agreed between the Bank and BB&Co to be on BB&Co's internal audit function. Thompson agreed, upon the request of Barnett, to restrict it to BB&Co, rather than extend it to a Group-wide basis. The report revealed no serious weaknesses, but made it clear that BB&Co's Internal Audit Department did not have responsibility for the BSL sub-group.
- 12.99 The report for 1993 was discussed in the trilateral meeting on 15 July 1994. Barnett, in response to a question from Thompson, said that an Internal Audit Department in BSL had begun to develop from mid-1992 (prior to this time BSL had not been subject to

12. Supervisors and Regulators

internal audit review although, Barnett said, a number of issues had always been raised by external auditors). Barings now intended to create a Group-wide audit function, but the organisation of such a function was still under discussion. Given that Barings was at that time developing an audit function which covered the entire Barings Group, we think that it was acceptable for the Bank to wait for a reasonable period until the function had been properly developed before taking steps to ascertain that it was effective. Accordingly, we do not believe that any criticism attaches to the fact that the Bank did not seek to verify the efficiency of the BSL internal audit function at that time.

12.100 At this meeting discussion turned to the scope of the next Section 39 report. Thompson suggested either a report on high level controls of the Barings Group or a report on BSL. Barnett referred to the increasing integration of BB&Co and BSL, and it was agreed that the report should be on high level controls, but that the work would not be carried out until March 1995 to give Barings the opportunity to finalise organisational changes.

12.101 We noted from the Bank's files that in each of the years 1992 to 1994 one of the options for Section 39 work included in suggestions made by successive analysts was a review of BSL. In the event it was decided to scope the work as outlined above. As noted in Appendix XIV, the Bank has power under the Act to require Section 39 reports in respect of overseas branches of banks or subsidiaries of banks. However, with the exception of reports into 'high level controls' (which would look into group-wide controls), this is not usually done. Sergeant told us: "If you had a particular concern about a subsidiary then you would do whatever you could to get that concern addressed, including a Section 39 report. Routinely you would not do that".

Liaison with other regulators in the UK, Japan and Singapore

12.102 The most recent College of Regulators meeting on merchant banks was held in November 1994. The Barings Group was not discussed (which, given the principle of 'reporting by exception' at such meetings, implied that no supervisor present had concerns which it thought were required to be raised with others). However, at the meeting on 25 November 1993 the Group was discussed at some length in the light of concern regarding the problems which the BSL sub-group had experienced in 1992 (referred to in paragraph 12.26). The Bank's view, as expressed at that meeting, was that BSL had been brought under the tight management control of BB&Co, but also that Barings had acquired a reputation for being slightly cavalier in its attitude to internal controls and that, accordingly, the Bank had asked the reporting accountants to examine the quality of internal audit for the next Section 39 report (although, as noted above, the report was restricted to BB&Co, rather than the Group as a whole). The SFA representative present confirmed that the SFA capital requirement was being comfortably met, and that the SFA felt more relaxed about the position than it had in previous years.

12.103 The Bank has had frequent formal and informal contacts with the Singaporean and Japanese regulatory authorities in recent years, including visits by Sergeant and Quinn to the MAS in Singapore in March 1994 and January 1995 respectively to discuss supervisory issues. In these contacts Barings was either not mentioned, or only mentioned in passing. The Bank has told us that at no time prior to the collapse were any warnings given to the Bank by the Singaporean or Japanese regulatory authorities

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regarding potential dangers faced by any Barings Group companies or about the systems and controls in those companies.

SECURITIES AND FUTURES AUTHORITY

Introduction

- 12.104 The Barings Group companies which were members of the SFA were BSL, BSLL, BB&Co and BSB. Both BSL and BSLL were authorised by the SFA to carry out certain types of investment business (as defined by the FSA) in the United Kingdom. They were both classified as 'broadscope' firms (the widest of the SFA authorisation categories) for SFA purposes. BSB (a gilt edged market maker) has no relevance to this report. The regulation of BB&Co by the SFA is also not relevant for the purposes of this report. This is because the relevant financial regulation of BB&Co was performed by the Bank (with the exception of compliance with the SFA's own conduct of business rules, which are not material to the collapse), as agreed by the MoU between the SFA and the Bank. The Bank did not regulate BSL or BSLL although it was the lead regulator of BSL's parent company BB&Co and consolidated supervisor of the Group.
- 12.105 The SFA was the regulatory authority with responsibility for monitoring that BSL and BSLL had adequate financial resources and properly protected customer assets. The extent to which the SFA is required to concern itself with the operations in and financial affairs of subsidiaries is ill-defined by the FSA. As set out below, the SFA has rules which relate, in part, to the financial position of subsidiaries of a member firm. Nevertheless, the SFA has stated that it does not regard itself as having any obligations with regard to subsidiaries (whether UK or foreign) other than those which apply to ordinary counterparties who might expose the member firm to risk; and that it has no further powers with regard to subsidiaries other than the notification obligations expressly set out in its rules. Accordingly the SFA does not undertake consolidated supervision of a member firm and its subsidiaries in the way that the Bank does (see paragraphs 12.6 and 12.7). However, BoBS is advised that in monitoring the financial resources of BSL the SFA should have had regard to the financial soundness of BSL's subsidiaries including BSJ and BFS insofar as the operations of the subsidiaries were capable of affecting the financial integrity of BSL. That would be the case if, for example, the book value of the investment in a subsidiary was at risk of being unrealisable and the remaining assets of BSL were insufficient to meet the SFA's financial resource requirements or if there might be reputational risk to a member firm by reason of a failure or default of a subsidiary. This obligation accords with the existence of specific rules (referred to below) relating to subsidiaries and is consistent with the principles promulgated by the Securities and Investments Board (SIB), and incorporated in the SFA's rule book, one of which is that a firm should ensure that it maintains adequate financial resources to meet its investment business commitments and to withstand the risks to which its business is subject.
- 12.106 It is, however, important to stress that, in relation to subsidiaries of a member firm, the SFA is under no duty, indeed has no power, to regulate the business of such subsidiaries (unless those subsidiaries are themselves member firms). It is also important to stress that the SFA's duties and powers are in respect of the investment business of a member firm. (The FSA only regulates the carrying on of investment business in the United Kingdom.)

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- 12.107 The most material issue arising in the context of the regulation of BSL and BSLL by the SFA identified by us is whether BSL and BSLL's financial returns revealed any matter which should have led to the detection of the substantial losses arising from the unauthorised trading of BFS.
- 12.108 The following areas are covered later in this section:
- (a) the regulatory structure of the SFA and the methods of regulation employed by the SFA in relation to BSL and BSLL;
 - (b) the extent to which the key indicators identified by the inquiry were known by the SFA;
 - (c) a chronology of the regulatory issues which arose during the period from January 1992 until the collapse;
 - (d) the issues relating to the financial returns submitted by BSL and BSLL to the SFA;
 - (e) the extent to which the SFA had regard to the material effect of subsidiary companies on the financial resources of BSL.

Background to regulation by the SFA

- 12.109 Regulation of BSL and BSLL was carried out by the Surveillance Division of the SFA. The Surveillance Division has been headed by Mr David Gittings since the end of 1993. Reporting to Gittings are four deputy directors of whom two are responsible for surveillance with seven assistant directors reporting to them. The assistant director responsible for the regulation of BSL and BSLL at the time of the collapse had two team managers reporting to him, each of whom was responsible for five team members.
- 12.110 During the period from January 1992 to the collapse in February 1995 there were three successive assistant directors and one acting assistant director with responsibility for BSL and BSLL, two different team managers and a number of team members. In August 1994 team responsibilities within the SFA were changed to create specialisations within different teams. As a result, responsibility for BSL and BSLL was passed to a team dealing with corporate finance and merchant banking. The entire team changed at that point (i.e. assistant director, team manager and team members).
- 12.111 From 1992 to August 1994 the team manager who had responsibility for BSL and BSLL was Armistead. From August 1994 the team manager with responsibility for BSL and BSLL was Ms Carol Raymond. The relevant surveillance team consisted of five team members. From August 1994 it had a total of 168 firms to regulate. The team member who had most day-to-day contact with BSL and BSLL in the period since August 1994 was Ms Stephanie James, who reported to Raymond.
- 12.112 The SFA's method of regulating BSL and BSLL consisted first of monitoring the regular financial returns. The key returns were the monthly reporting statements (which included the financial resources statement, a profit and loss account, balance sheet and Segregated Accounts Reporting Statement (SARS)), the quarterly PRR

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report, and the quarterly CRR report. They are typically submitted electronically and are reviewed on personal computer screens by the relevant SFA surveillance team member. The surveillance team member looking at a return seeks to ensure report entries are internally consistent, looks for any unexpected trends and checks that they do not disclose a deficit.

- 12.113 The surveillance team also conducts inspection visits to member firms, the length of which is dependent on the size of the member and the risks associated with it. There was usually one inspection visit each year for BSL and BSLL which typically lasted three days. Inspection visits are usually planned to concentrate on certain areas, for example on areas where issues may have arisen in the past. In the case of BSL the visits in 1992, 1993 and 1994 concentrated on the treatment of customer assets, compliance with client money rules and the correct preparation of financial returns. There was an inspection visit in January 1995 which was planned as a general familiarisation visit to gain a better understanding of the sort of business undertaken by BSL and BSLL following the introduction of an entirely new team to the regulation of BSL and BSLL.
- 12.114 Visits are usually followed up with correspondence which seeks assurances that any problems identified have been, or shortly will be, remedied. During the course of a year there may also be other correspondence arising from, for instance, ad hoc inquiries from a member firm, customer complaints or matters detected or noted by the Transaction Monitoring Unit (defined in Appendix XIV) of the SFA or other regulators such as the Bank.
- 12.115 Thomas, an ex SFA employee, joined Barings in July 1992 with responsibilities for compliance. This was seen as a positive move by the SFA. According to James: "the Compliance Officer was a well-respected woman at SFA and had achieved a fairly good standing ... there was no reason to have any concerns about Barings as a whole. They were open with us. They had come from the SFA background, so they know about regulations".
- 12.116 There is also a requirement for the member firm's auditors to prepare an annual report to the SFA which states, inter alia, whether, in their opinion, the annual reporting statement has been properly reconciled with the audited annual financial statements and whether the annual statements of financial resources and financial resources requirement have been properly prepared in accordance with the SFA rules.
- 12.117 In its overall approach to the regulation of BSL and BSLL the SFA focused upon compliance with detailed rules and upon written information, with particular emphasis on financial returns. In addition the SFA placed reliance on its notification rules which required BSL and BSLL to notify SFA, within a set time-scale of certain specific events, such as the requirement for BSL to notify the SFA as soon as it became aware of any guarantee, indemnity and other such commitment it had given which could give rise to a claim in excess of £100,000.

Key indicators

- 12.118 Reference has been made in Section 1 of this report to a number of key indicators which might have raised further questions with regard to BFS. Had management of Barings appreciated the significance of the indicators the SFA could reasonably have

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expected that management would have drawn such matters to its attention. Barings' management did not draw any of these matters to the attention of the SFA.

- 12.119 In particular, the SFA did not receive items such as internal audit reports; thus it did not know of the internal audit report of James Baker on BFS or the lack of segregation of Leeson's duties. Nor was the absence of gross limits imposed on the trading activities of foreign subsidiaries known to the SFA. Audit issues are not normally discussed with the SFA and it does not routinely meet with auditors and therefore it was not aware of the SLK receivable issue. No large exposure problems or client money concerns were notified by the Bank or Barings to the SFA. The high (apparent) profitability of trading undertaken in BFS, was not known by the SFA.
- 12.120 The question of the high level of funding required to finance BFS's trading activities and the amounts transferred to BFS are dealt with below.

Brief chronology of the business of BSL and BSLL as known by the SFA

- 12.121 Until mid-1991 BSL had been profitable under the management of Heath and had operated independently of BB&Co with a culture quite different from that of BB&Co. Subsequently BSL suffered a pre-tax loss in the quarter to 31 December 1991.
- 12.122 In a report produced in January 1992 by C&L, which covered the year ended 30 September 1991, it was stated: "During the year there has been a breakdown in control procedures in the futures and options area which meant that, in this area alone, the procedures and controls for reporting the ageing and analysis of balances with counterparties was inadequate".
- 12.123 In June 1992 the SFA carried out a client money inspection visit at BSL. In its post visit letter of 7 July 1992 the SFA stated that, in its opinion, there were a number of breaches of SFA Rules including incorrect reporting of client margin. Mr Roy Johnson, Company Secretary, BSL, who at that time had responsibility for compliance in BSL, responded to the SFA with answers to some of the points raised and, in respect of others, an undertaking to develop appropriate procedures.
- 12.124 Through the course of 1992 BSL continued to incur losses, mainly as a result of its Far Eastern operation. This was widely publicised. In September 1992 the SFA was notified of redundancies in BSL and the provision of a US\$70 million subordinated loan facility by way of capital support from BB&Co.
- 12.125 At a meeting with Thompson of the Bank in November 1992 Ms Alison McMillan, then an assistant director at the SFA, Armistead and Jennings, then Senior Director and Head of Surveillance at SFA, were informed that BB&Co was, as mentioned above, seriously considering withdrawing support for BSL. Jennings noted the concern of the SFA that BSL's capital stood at only 112% of the financial resources requirement and not much above the 105% required (recently lowered from 110%). Minutes prepared by the Bank stated: "For a number of reasons, including BS [Baring Securities] actual and potential losses, the SFA are clearly very concerned about the Barings Group". They also disclosed that Jennings was very concerned to hear that the Group was seriously considering closing BSL as one option in the event of continued losses, and that he estimated that it would be lucky not to lose more than £80m of capital it already had invested if it took this course. We were told that the concern of the SFA

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representatives present was that there would be sufficient capital to facilitate an orderly and solvent wind down of BSL if this proved necessary. In the event the financial resources of BSL steadily improved in the following months to the extent that by the time of an SFA inspection in April 1993 it was being maintained at around 120%.

- 12.126 In March 1993 Heath and others left BSL. The SFA was informed that one of the reasons for the departures was a disagreement over the future direction of BSL. The SFA was told that Heath wished to pursue a strategy of proprietary trading whereas BB&Co wished BSL to concentrate on agency broking taking, less trading risk.
- 12.127 Having regard to the earlier concerns as to the financial resources of BSL, the SFA took the unusual step of requiring BSL to submit a calculation of its financial resources on a daily basis (this additional reporting requirement continued until mid 1994 when the capital position appeared to have been resolved). It also conducted an inspection visit to BSL in April 1993 in order to review the preparation of the financial returns. Only one matter was raised in the inspection follow-up letter dated 20 May 1993 which concerned the appropriate assessment of BSL's financial resources expenditure requirement. This matter was resolved to the SFA's satisfaction in subsequent correspondence.
- 12.128 In the autumn of 1993 BSLL was set up as an SFA registered company to undertake stock lending and proprietary trading in derivatives.
- 12.129 In November 1993 Barnett, Norris, Maclean and Thomas met Chris Woodburn, (Chief Operating Officer of the SFA), in order to advise him of the changes to the management structure of BB&Co and BSL. The SFA was told that the activities within each company would change and BSL would become a broker rather than a dealer, and that only a small amount of position taking would be booked in BSL. It was also mentioned that Barings had agreed with the Bank that the capital position of BB&Co would be assessed on a solo consolidated basis incorporating BSL to make more efficient use of the Group's capital. However, it was confirmed that BSL would continue to maintain regulatory capital in accordance with SFA rules.
- 12.130 In January 1994 the SFA conducted an inspection visit to BSL and BSLL which concentrated on compliance with financial resource requirements and client money rules. The SFA was informed that the principal business undertaken by BSL was agency broking and that BSLL undertook stock borrowing/lending and UK proprietary trading.
- 12.131 In January 1995 the SFA carried out a routine inspection visit to both BSL and BSLL. The surveillance team at the SFA was new to Barings. The visit was intended as a general familiarisation review. It was not specifically intended to deal with financial resources. During that visit the SFA surveillance team met Tony Hawes who outlined the BIB structure and the nature of derivatives trading undertaken by BSL and BSLL (as known to Barings in London). Follow up letters after the visit had been drafted but not sent by the time of the collapse. The draft letters to BSL and BSLL only included one minor issue in respect of the time of execution of transactions in some of the overseas markets (not Singapore) not being accurately reported.

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SFA monitoring of financial returns

- 12.132 The following paragraphs consider whether amounts included in components of the various financial returns submitted to the SFA by BSL and BSLL should have caused the SFA to make enquiries which, if pursued, might have led to the detection of the unauthorised trading of BFS.
- (a) The financial resources statement
- 12.133 The financial resources requirement laid down by the SFA's financial resources rules stipulates a required level of capital. In broad terms a member firm calculates the sum of its share capital, profit and loss account, other approved reserves and eligible capital substitutes such as subordinated loans and sets against that the SFA financial resources requirement which is the sum of a base requirement, a liquidity adjustment, charged assets, contingent liabilities (including guarantees given on behalf of subsidiaries), deficiencies in subsidiaries and the position risk requirement and counterparty risk requirement (discussed below). The financial resources must not be less than the financial resources requirement.
- 12.134 Although as noted above, the financial resources of BSL had been under significant pressure in 1992, matters thereafter steadily improved and the financial resources shown in the SFA reports of BSL (and from November 1993 BSLL) in 1993 and 1994 indicated that BSL and BSLL had become profitable and were no longer in financial difficulties; and gave no indication of any problems.
- (b) Profit and loss account and balance sheet
- 12.135 As discussed in paragraphs 12.155 to 12.158, the balance sheet included in the monthly reporting statements submitted to the SFA showed against the heading 'Trade debtors (subject to CRR)' amounts due from 'affiliates' in substantial sums relative to BSL (for example, £178 million in December 1993 and £254 million by December 1994).
- (c) Counterparty risk requirement report
- 12.136 The CRR represents the element of financial resources required by the SFA in respect of exposures to counterparties. When a counterparty has not fully met the initial or variation margin requirement a firm must calculate a CRR by multiplying the shortfall by an appropriate percentage. Where a counterparty has not been granted a credit line under an SFA approved credit management policy (for which BSL had not applied to the SFA) there is no CRR requirement against the shortfall for the first three business days but thereafter the requirement is 100% of the amount.
- 12.137 With small exceptions, CRR was not calculated by BSL against the counterparty balances in respect of margined transactions and options. The SFA was not informed of, or aware of, the substantial margin funding remitted to BFS which was apparently thought by Barings' management to constitute clients loans for margin. (As explained earlier in this report, much of this was in fact used to fund the unauthorised trading of BFS.) A large part of this funding was represented by accounts 'K2/P4' in the solo balance sheets (see paragraphs 6.68 and 6.77), which the SFA has stated it did not see prior to the collapse of Barings, and was substantially reflected in the account designated by Barings as the 'BSINGCOLL' account.

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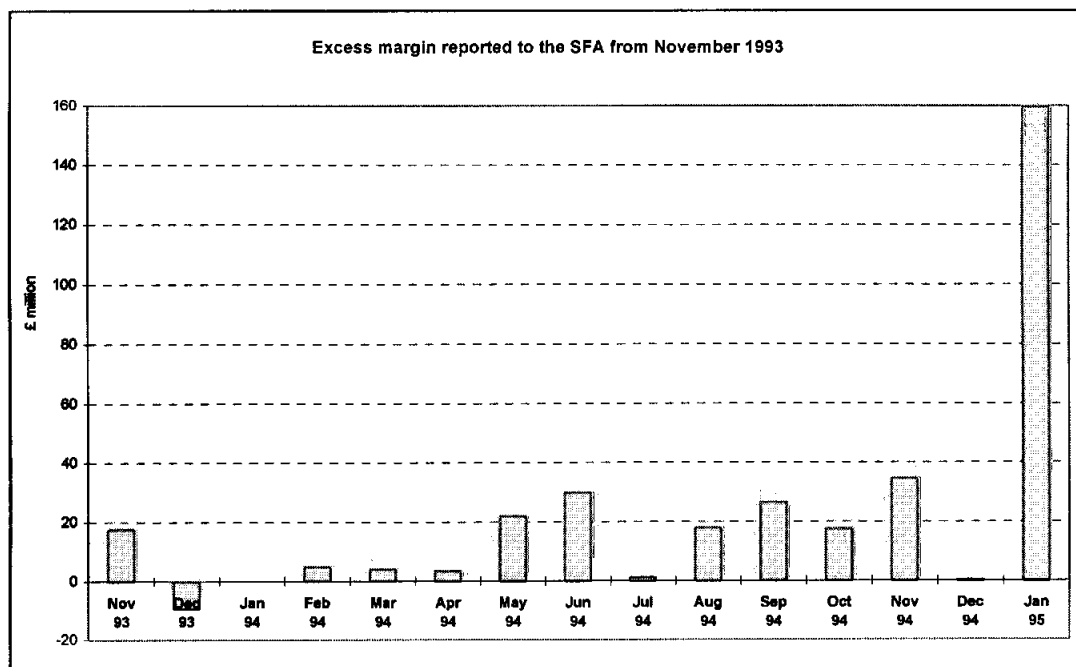
- (d) Position risk requirement report
- 12.138 PRR represents the element of the firm's financial resources required by the SFA in respect of open equity and derivatives positions. After BSL was established no PRR was reported by BSL, on the basis that it did not have any proprietary positions. The SFA had no reason to be aware from BSL's PRR reports of any proprietary trading undertaken by BFS.
- (e) The segregated accounts reporting statement
- 12.139 The SFA's conduct of business requirements regarding futures, options and contracts for differences entered into on exchanges by member firms on behalf of their clients include requirements that:
- (a) transactions should be adequately margined by the client, both at the outset ('initial margin') and to reflect subsequent movements in value ('variation margin' which would include intra-day margin which was referred to as advance margin in Barings);
- (b) loans to assist clients in making margin payments should be made in accordance with appropriate credit control procedures.
- 12.140 The Financial Services (Client Money) Supplementary Regulations also require member firms to segregate monies for clients' margined transactions. Arrangements must be in place to ensure the amount held in the segregated margined transaction bank account for clients is sufficient to meet all liabilities to clients if all clients' trading positions are unwound. Such arrangements will involve a member firm advancing its own funds to the segregated account if the amounts otherwise held are insufficient to meet such gross liabilities.
- 12.141 The only sub-section of SARS which is relevant for the purposes of this report is that relating to on-exchange margined transactions, which is designed to ensure that sufficient amounts are held to satisfy liabilities to clients. It must show that the total of assets held on trust (eg. in a client bank account) and the amount deposited as margin on behalf of clients is at least equal to the amount due to clients. BSL did not include the margin funding which was represented by a substantial part of the 'K2/P4' balance in any SARS submitted to the SFA until late February 1995 (paragraph 11.87) despite management's belief that it had been advanced on behalf of clients.
- 12.142 The objective of SARS reports is to enable the SFA to monitor protection of client monies. The monitoring by the SFA of the preparation of these reports and the information they disclosed was clearly and properly focused on this objective. Nevertheless we consider two matters which arose in relation to the SFA's monitoring of SARS because they are matters which if pursued might have led to the detection of BSL's failure to include the 'K2/P4' loan, ostensibly for client margin, in the SARS report and thereby the discovery that the 'K2/P4' funds were in fact for proprietary trading by BFS.
- 12.143 The first matter arises from the January 1994 inspection visit. The SFA noted that the figures disclosed in the SARS return at 30 November 1993 had not been calculated in accordance with client money rules; currencies other than Yen were omitted from part

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of the calculations. Also client equity balances (i.e. the amount which a client would be liable to pay to a firm, or vice versa, in respect of its margined transactions if each of its open positions were to be liquidated) had been understated because they did not take account of variation margin or option valuations. It had not proved possible to reconcile the total equity balance according to the relevant internal records to the equity balance disclosed in the SARS. Correspondence then ensued between the SFA and Norris. Norris indicated that the omission of Yen balances resulted from a change in a spreadsheet format and BSL's review process did not pick up the missing 1% which he stressed was: "purely a disclosure issue and at no point were the client segregation rules infringed". With regard to the matter of the reconciliation Norris stated that it was a complex area and that it would be a time consuming exercise to re-perform. Ms Sarah Varney, who was at that time a team member at the SFA, told us that, in her opinion, the reconciliation should not have been time consuming or complex. Varney wrote on 5 April 1994 asking for clarification as to how the variation margin and option valuations had been reflected in the SFA return since it appeared they had been omitted. Varney left the SFA on 8 April 1994. This letter was not followed up after her departure. Whether this omission by itself, had it been pursued thoroughly by the SFA and BSL, might have led to the detection of the unauthorised trading in BFS cannot be determined.

12.144 The second matter concerns the disclosure of margin requirement excesses in the SARS reports. A margin excess arises where the amount of funds put up by the member firm on behalf of clients in respect of transactions entered into by clients exceeds the amount of margin required to be maintained in respect of those transactions. Excesses constitute the member firm's own funds as at the reporting date. The excesses, reported to the SFA in the monthly SARS filed over the period commencing 30 November 1993 and ending on 31 January 1995, are shown in Figure 12.2.

Figure: 12.2



Source: Monthly Financial Reporting Statements

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- 12.145 It will be noted that the 31 January 1995 return showed a great increase in the margin excess. This was due to the fact that the BSINGCOLL account (paragraph 12.137) had been included for the first time by BSL in the SARS return as at 31 January 1995. The reason that this account was only included by BSL for the first time at this date is explained in paragraph 11.87. This return was not received by the SFA until 22 February 1995 (it was not due until 15 business days after the month end and was one day late).
- 12.146 At 31 January 1995, according to the SARS filed in respect of that date, the segregated assets held for clients (i.e. held on trust for them) totalled £420 million, whereas the amount of assets required to be segregated was only £260 million, i.e. approximately £160 million of the assets segregated were excess to requirements and therefore BSL's own funds. The excesses reported prior to 1995 were much lower than that reported at 31 January 1995, although showing high levels of excess (for example, £35 million at 30 November 1994, £26 million at 30 September 1994 as against required amounts of £282 million and £256 million respectively).
- 12.147 While a margin deficit would have been of concern to the SFA, a margin excess would not in itself be a matter about which the SFA should be concerned in relation to the protection of client assets. However, the SFA's internal guidelines (REG) provide that, to avoid pollution of the trust status of client money bank accounts, inspectors should discourage member firms from leaving huge excesses in these balances. The excesses reported for the months prior to January 1995, although large, were not so great or unusual as to attract the attention of the SFA. Had BSL included reference to the advance margin payments remitted to BFS in the SARS submitted during 1994, then the SFA could have been alerted to the existence of a significant and unusual excess. This did not happen. The report showing an excess as large as £160 million at 31 January 1995 might well have been questioned, but it was received by the SFA too late for it to have any relevance to the collapse of Barings.
- 12.148 We conclude that nothing revealed in the financial resource statements, CRR reports, PRR reports or SARS would or should have put the SFA on notice of a material risk to BSL arising from the unauthorised trading activities within BFS.

Effect of subsidiary companies on the financial resources of BSL

- 12.149 In the following paragraphs we consider whether the SFA was or should have been aware of any other information which should have put it on enquiry as to the existence of unauthorised trading within BFS, or as to the existence of the exposure of BSL in respect of BFS which led to the collapse.
- 12.150 A member firm is required to maintain adequate financial resources to withstand the risks to which its business is subject and the SFA is required to consider the financial integrity of a member firm. As noted in paragraph 12.105, BoBS considers that the SFA should have had regard to the activities and financial soundness of BSL's subsidiaries insofar as the operations of its subsidiaries were capable of materially affecting its financial integrity. These risks may include the activities of the subsidiaries, as is reflected by the specific SFA rules detailed below.

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- 12.151 SFA financial resources rules specifically require member firms to:
- (a) submit the audited accounts of each subsidiary unless the SFA otherwise permits;
 - (b) notify a deficiency of net assets in a subsidiary;
 - (c) include a deficiency of net assets in a subsidiary in the financial resources primary requirement calculation;
 - (d) include a liquidity adjustment for a liability of any subsidiary to a member firm in the financial resources requirement or include it in the counterparty risk requirement;
 - (e) notify any guarantee, indemnity or other such commitment given by the firm which could give rise to a claim exceeding £100,000 or 10% of the firm's financial resources.

In addition guidance notes to the rules issued by the SFA provide that the SFA may take into account any matter relating to any other group company in considering whether a member firm satisfies the SFA's criteria of fitness and properness, which include financial integrity.

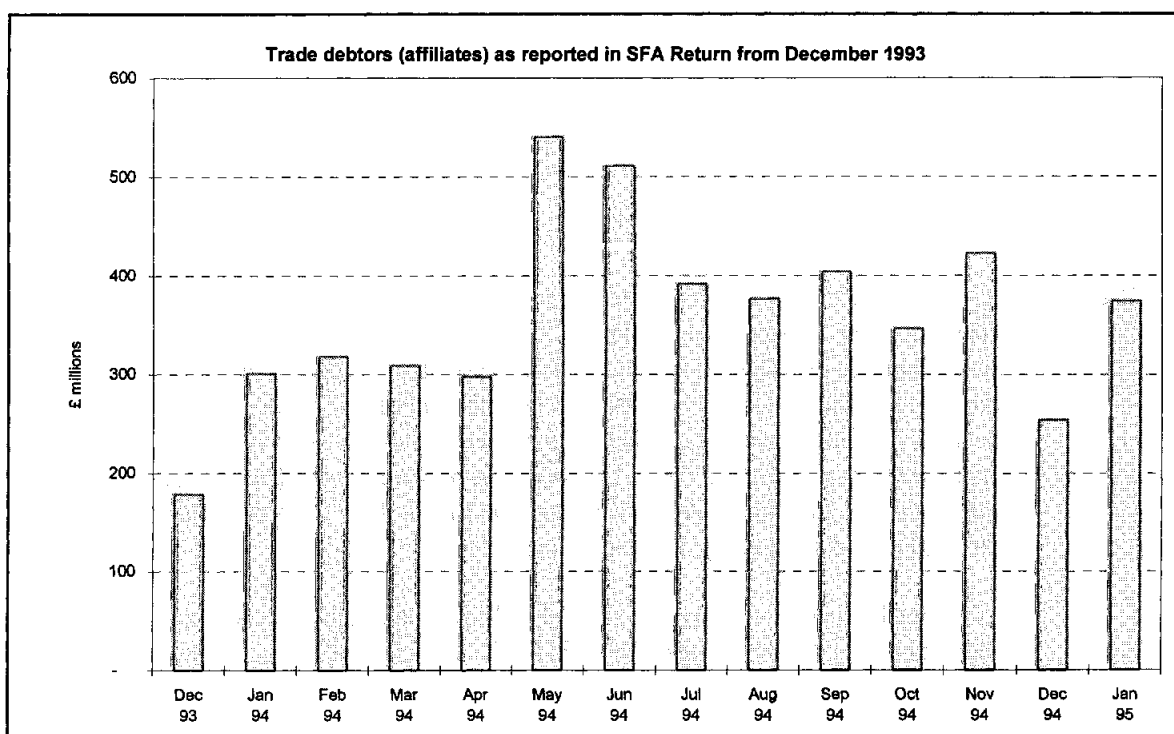
- 12.152 In relation to subsidiaries, the main matters likely to affect a member firm's financial resources are net asset deficiencies in a subsidiary, credit exposure to a subsidiary and any guarantees given in respect of subsidiaries. A failure of a subsidiary may also have an adverse reputational impact on (and hence an adverse financial impact on) the investment business of a parent. The nature and scale of, and risks inherent in, the business of a subsidiary should become matters to which regard is had by the SFA where they are capable of having a material effect upon the parent member firm.
- 12.153 As noted above in paragraph 12.105, the SFA did not regard itself as having any obligation with regard to subsidiaries other than those which apply to ordinary counterparties which might expose the member firm to risk; and the SFA considered that it had no powers with regard to subsidiaries other than the notification obligations referred to above.
- 12.154 Consistent with this view, the relevant SFA surveillance team members did not regard themselves as concerned with considering the level or nature of BSL's exposure to its overseas subsidiaries or the activities and financial standing of those subsidiaries. For example, Armistead said in response to a question as to whether the SFA would look at the controls BSL operated in relation to the overseas subsidiary, BFS: "I do not know if we would have specifically looked at Singapore as an operation ... we are looking at the one particular entity. That was the member and we were actually looking at the regulation, I guess ... As you can imagine, where you have 80 members and a team of five, you do not necessarily have the chance to sort of look at subsidiaries". James said: "BSL had a lot of subsidiaries, most of which were trading overseas in various different markets ... The assumptions would have been made at this end that those subsidiaries in those foreign countries were being looked after and regulated by another institution overseas. They are not our responsibility. Our responsibility is purely to our members". She gave BSL, in a letter dated 6 October 1994, a waiver of

12. Supervisors and Regulators

the requirement to provide accounts of overseas subsidiaries. Asked how the decision had been taken, James said: "I discussed this with the team manager [Raymond], and we agreed that it was a sensible course of action". It is fair to note that the overseas subsidiaries were very numerous although that, in itself, would not have justified the dispensing with information about a subsidiary that might have given rise to a material exposure to BSL. We also note that the accounts of BFS for 1993 did not disclose information which would have led to the detection of the unauthorised trading in BFS.

- 12.155 During the period under review substantial funding in relation to derivatives trading by BFS came from BSL (which in turn had been lent funds by BB&Co). This substantial funding was reflected in the balance sheets submitted on a monthly basis to the SFA which showed against the caption "Trade Debtors", amounts due from "affiliates" (not identifying the subsidiaries concerned) on a very large scale relative to BSL - for example £178 million in aggregate as at 31 December 1993 and £254 million in aggregate as at 31 December 1994, having risen to £540 million during the course of the year. (A significant proportion of this in fact represented funding of the unauthorised trading activities of BFS.) This is illustrated by the chart presented in Figure 12.3.

Figure: 12.3



Source: SFA monthly reporting statements

- 12.156 The operations of subsidiaries thus created a material exposure for BSL: as is underscored by the collapse of Barings itself.
- 12.157 At no time did BSL inform the SFA of any exposure that it had to BFS or BSJ or of the level and nature of BSL's funding of BFS's trading activities. The SFA team responsible for regulating BSL at the relevant times did not make enquiries as to the nature and extent of BSL's exposure to its overseas subsidiaries or to the financial position of those subsidiaries or "affiliates". The reports of BSL submitted to the SFA

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showed receivables from affiliates which on any footing amounted to large sums in relation to BSL and, if not recoverable, would result in not meeting the SFA's financial resources requirement.

- 12.158 We have considered whether the size of these amounts recorded as due from affiliates, which prevailed throughout 1994, and during the middle of 1994 was more than double the amount reported as at 31 December 1993, should have prompted the SFA to enquire precisely what these payments represented and whether any significant risk as to the recovery of these sums arose from the individual affiliates. The SFA has stated that in the context of an international securities house such as Barings it would have expected to see large amounts due from affiliates, representing transactions undertaken through such affiliates on behalf of clients. A higher debtor balance as shown in the balance sheets submitted to the SFA would be indicative of a higher level of business. We think that it would be a judgement based on hindsight to say that the SFA should have raised detailed enquiries upon receipt and appraisal of the returns during 1994.

Other matters

- 12.159 Leeson's application in March 1992 for SFA registration as a securities representative failed to mention a small unsatisfied County Court judgement debt which had recently been obtained against him. The SFA made enquiries of Barings about it, but the issue lapsed because the application was not pursued.

OTHER REGULATORS

SIMEX

- 12.160 We have not been able to interview SIMEX officials or review their correspondence files or other relevant documents. SIMEX have provided a limited amount of information, consisting of a daily listing of transactions for the account of BFS covering the period January and February 1995. SIMEX informed us that the Judicial Managers, to whom obligations of confidentiality are owed, would not consent to the release of information relating to BFS. However, a formal request for information about SIMEX's supervisory functions was submitted to MAS. In a response dated 19 May 1995, MAS provided the following information:

"Baring Futures (Singapore) Pte Ltd (BFS) was admitted as a corporate clearing member of SIMEX in June 1992. SIMEX, which is the SRO [self-regulatory organisation authorised by MAS] for futures trading firms, is responsible for ensuring that its member firms comply with prescribed rules and regulations.

MAS' supervision of ... BFS entails the review of their financial returns and audit reports, including SIMEX's ... inspection reports and the proposed disciplinary actions to be taken against member firms. MAS conducts on-site inspections of merchant banks. The on-site inspections of futures ... firms are conducted by SIMEX".

- 12.161 It described the supervision responsibilities of SIMEX as follows:

"SIMEX's supervisory responsibilities are to enforce compliance by its members with the Rules of the Exchange. These include maintenance of proper segregation of

12. Supervisors and Regulators

customer funds, and compliance with the business conduct and trade practices rules to foster customer protection.

SIMEX, as the self-regulatory organisation (SRO) for the financial futures industry in Singapore, also seeks to ensure the general well-being of its members. Officers and employees of member firms who are registered as Associated Persons or Registered Representatives are also required to comply with SIMEX Rules, and are supervised accordingly".

"The primary source of SIMEX's powers are vested in its Rules. Supplementary powers may be derived from its constitutive documents. In this connection SIMEX has, inter alia, powers of inspection and audit (Rule 907), suspension of members (Rules 911), investigation, hearing and taking of disciplinary action against members (generally Chapter 4 of the Rules). Primary responsibility for compliance rests with the member, with SIMEX exercising a primary oversight function.

As regards BFS, (as with other members of the SIMEX), SIMEX carries out:-

- on-site inspections; and
- general surveillance of BFS's activities on SIMEX.

There are two broad categories of reports submitted by members to SIMEX:-

- (i) financial reports, including quarterly and annually audited financial statements certified by the external auditor of the member; and
- (ii) position reports, including daily returns giving details of reportable positions held by customers trading through the member".

12.162 The response then specifically describes SIMEX's supervision of BFS:

"BFS was inspected by SIMEX in April 1993 and September 1994. The firm was fined S\$23,000 for violations discovered in the 1993 inspection. SIMEX was considering disciplinary action on BFS in view of the findings from its 1994 inspection when Barings collapsed.

SIMEX met BFS representatives in January 1995 to discuss areas of concerns which SIMEX had noted in its operations. This meeting is described in greater detail ... below".

"SIMEX had concerns relating to BFS from time to time. As these surfaced, they were dealt with. Either assurances were sought to allay these concerns ... or action taken [as described above in relation to inspections]. For instance:-

- SIMEX noted in December 1994 that positions of BFS' customers were building up and required BFS to submit status reports of customer positions to SIMEX on a daily basis for monitoring. Errors were noted in the reports and when BFS staff failed to explain the errors orally to SIMEX, SIMEX wrote to BFS to express concern over the operations of the firm, and to require the firm to provide a written explanation for the errors. Simon Jones subsequently replied to SIMEX to explain the errors.

12. Supervisors and Regulators

- In January 1995, SIMEX noted from its financial surveillance programme, that:-
 - (i) BFS appeared to be financing the positions of customers; and
 - (ii) Projected potential loss from any adverse price movement on the large positions held by BFS in the Eurodollar, Nikkei and Euroyen contracts as of 30 December 1994, would mean that BFS would only have \$22.9 million to cover additional adverse movements.

SIMEX required BFS to provide documentary proof that it was not financing customer positions and reminded BFS that, as a Clearing Member, it had to ensure at all time, that it had adequate funds to fulfil its obligations to the Clearing House.

BFS reacted to the concerns voiced by SIMEX in January 1995 by sending Anthony Hawes and Simon Jones to meet with SIMEX officials. The BFS representatives assured SIMEX that the Barings Group was aware of these positions and its financial commitment to SIMEX. SIMEX was also assured that BFS would be able to meet margin calls. The Barings Group Treasurer added US\$15 million to its daylight overdraft and arranged US\$75 million to be deposited with Citibank NA, Singapore, to fund margin calls on BFS'.

We have been informed by SIMEX that BFS also stated that it dealt as a trading agent for other Barings Group companies and did not deal directly with customers. Thus, SIMEX felt assured that BFS was not financing customer positions. BFS wrote to SIMEX on 10 February 1995, details of which are set out in paragraph 11.117.

Japanese Ministry of Finance

- 12.163 A licence was granted on 16 May 1986 to the Tokyo branch of BSJ and on 29 March 1990 to the Osaka branch of BSJ.
- 12.164 Subsequent to the granting of these licences, approvals were granted to BSJ regarding, among other things, changes in the name of its branch, its method of business conducted at its branch and the location of its branch. Additionally, notifications were filed regarding, among other things, changes in the name of the company, the location of its principal executive office, the amount of its capital and the amount of capital brought into the branch.
- 12.165 According to BSJ's capital adequacy reports, both the Tokyo and Osaka branches always maintained sufficient capital adequacy ratios prior to the collapse. The position lists submitted by the Tokyo and Osaka branches confirmed that their futures transactions were arbitrage transactions. No supervisory order was issued, or administrative action taken, against the Tokyo or Osaka branches of BSJ.

Other UK regulators

- 12.166 In a meeting with representatives of IMRO we were told that there had been no specific concerns raised about the IMRO authorised companies within the Barings Group in the period prior to the collapse.

12. Supervisors and Regulators

12.167 No specific concerns were referred to us by the London Stock Exchange, London Clearing House, PIA, LIFFE or the OM London Exchange in respect of Barings.

13. CONCLUSIONS

OUTLINE

- 13.1 We think it appropriate to emphasise here the caveats which we set out in the introductory section to this report. In particular, we have had very limited access to documents of BFS or SIMEX in Singapore and we have not been able to conduct formal interviews with the senior management, or more junior staff, of BFS in Singapore. Nor have we been able to see the work papers of, or interview, BFS's auditors. Further, Leeson, the General Manager and Head Trader of BFS - who, from any viewpoint, is a central figure in the events leading to the collapse of Barings - has not provided any information to this inquiry or given his own explanation of events. His response has been confined to the letter from his solicitors noted in paragraph 1.77.
- 13.2 Nevertheless, on the basis of the information provided to us we consider that a number of conclusions can be drawn.
- 13.3 The key questions are:
- (a) how were the massive losses incurred?
 - (b) why was the true position not noticed earlier?
- 13.4 Our conclusions, in summary, are:
- (a) the losses were incurred by reason of unauthorised and concealed trading activities within BFS;
 - (b) the true position was not noticed earlier by reason of a serious failure of controls and managerial confusion within Barings;
 - (c) the true position had not been detected prior to the collapse by the external auditors, supervisors or regulators of Barings.

HOW WERE THE MASSIVE LOSSES INCURRED?

The unauthorised and concealed trading

- 13.5 Leeson had no authority to maintain open positions overnight. He was given certain specific limits on intra-day trading. He had no authority to trade in options (save as execution broker on behalf of clients). In all these respects Leeson persistently acted beyond his authority.
- 13.6 Account '88888' was opened in July 1992, shortly after Leeson was posted to Singapore. Thereafter Leeson engaged, latterly on a rapidly increasing scale, in unauthorised trading in futures and options through this account. By 31 December 1994 he had accumulated losses on this account of some £208 million. Throughout he represented that he was in fact making profits. Indeed, he was perceived within Barings to be a 'star performer'. Barings understood that the profits from the trading activities within BFS were principally made from inter-exchange arbitrage activities involving 'switching' between SIMEX and Japanese exchanges, with (as they believed)

13. Conclusions

fully matched trades at no real risk to Barings. In the event, by 27 February 1995 the accumulated losses on account '88888' amounted to some £830 million.

- 13.7 This unauthorised trading was funded:
- (a) by the use of money advanced to BFS by BSJ and BSLL for what BSJ and BSLL understood to be their own account trading through BFS;
 - (b) by the use of money advanced by BSL to BFS on BFS's requests for the payment of margin to the exchanges; requests which were met without any effective query and without any adequate steps being taken by Barings in London to verify them or to reconcile the advances to the trading records of clients;
 - (c) in January and February 1995 - when the funding problems of BFS were becoming acute - by the use of artificial trades created with a view to reducing the level of margin calls from SIMEX.
- 13.8 The unauthorised trading was concealed by a number of devices. These included the suppression of account '88888' from Barings in London (which account was mentioned only in the margin files and did not attract the attention of Barings in London); the submission of falsified reports to London; the misrepresentation of the profitability of BFS's trading; and a number of false trading transactions and accounting entries.
- 13.9 The unauthorised trading activities within BFS, which intensified in January and February 1995, built up such massive losses that (when discovered on the 23 February 1995) they led to the failure of Barings.

WHY WAS THE TRUE POSITION NOT NOTICED EARLIER?

Controls

- 13.10 In 1992 Norris, as Chief Operating Officer of BSL, started to introduce additional controls into the relatively uncontrolled environment then prevailing at BSL. This process continued under his direction when BSL and BB&Co were combined to form IBG (subsequently BIB), of which he was designated Chief Executive Officer. Even so, as late as 1995, it appears that the objective of imposing a satisfactory level of controls had not been achieved within BIB. The Chairman of Barings plc, Peter Baring, described the failure of controls with regard to BFS as "absolute". We agree. It was this lack of effective controls which provided the opportunity for Leeson to undertake his unauthorised trading activities and reduced the likelihood of their detection.
- 13.11 We consider that those with direct executive responsibility for establishing effective controls must bear much of the blame. We identify below the ways in which, we have concluded, they failed to discharge this responsibility; and how others at lower levels of management were also at fault for failing to act effectively in relation to their own responsibilities.
- 13.12 As set out in paragraph 1.70, a number of warning signs were present which, had they been properly addressed, should have caused Barings to detect the unauthorised activities of Leeson and the losses that they were generating. This did not happen, mainly because individuals in a number of different departments failed to face up to,

13. Conclusions

or follow up on, identified problems; and because there was inadequate communication between departments and between individuals.

Lack of segregation of Leeson's duties

- 13.13 The fact that Leeson was permitted throughout to remain in charge of both front office and back office at BFS was a most serious failing. Witnesses whom we have interviewed on this point agreed that the need for a separation of responsibilities was fundamental. Tony Hawes, the Group Treasurer, had relatively early on (in February 1994) identified this as unsatisfactory. He subsequently made his views known to James Baker, prior to James Baker's internal audit of BFS undertaken in July/August 1994. Although the internal audit did not unearth the existence of the unauthorised activities, the internal audit report did make specific recommendations as to the separation of roles. These recommendations were never implemented.
- 13.14 At the local operational level Jones (who had responsibility for Barings' operations in Singapore and was a Director of BFS) seems to have taken no significant steps to give effect to the recommended segregation of duties; even though in his management response to the report he had stated that with immediate effect Leeson would cease to perform certain functions and that he (Jones) would ensure the adequate supervision of all settlement and recording processes. We consider that this failure to put into effect his management response to these recommendations in the internal audit report was reprehensible. Further, Bax (Director of BFS and Regional Manager of South Asian Region) failed to concern himself with, or check as to, the implementation of the internal audit report.
- 13.15 The internal audit report was circulated widely among management in London and was generally acknowledged as important. Copies were seen by (among others) Norris, Chief Executive Officer of BIB; Broadhurst, Group Finance Director of BIB, who had personally taken an active role in the drafting of the report; Hopkins, Director of Group Treasury and Risk of BIB; Barnett, Chief Operating Officer of BIB; and Ron Baker, Head of FPG. Yet by February 1995 nothing had been done to implement the recommendations of the report as to the segregation of duties. Most of those who received the report said that they considered that it was the responsibility of others (and particularly Singapore management) to implement. We consider, however, that management in London was not justified in simply assuming that these recommendations would be acted upon. The points raised by the report on segregation of duties were of such importance that we consider that it was necessary for checks to have been made to ensure that they had been implemented. But there was no internal communication in this respect, and the necessary steps to give prompt effect to the recommendations were not taken. It is significant that when Railton, Futures and Options Settlements Senior Clerk of BIB, was eventually sent out to Singapore in February 1995, the discrepancies caused by Leeson's unauthorised trading were uncovered within a relatively short space of time.

Supervision of BFS

- 13.16 Leeson was not properly supervised.
- 13.17 Leeson's back office functions were never effectively monitored; and to the extent that there were other staff in the back office in Singapore they were relatively junior and, it

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would seem, simply obeyed Leeson's instructions. The matter was compounded by the fact that Jones concerned himself primarily with the affairs of BSS and devoted little attention to BFS. Bax took no steps to ensure that the appropriate degree of supervision and internal control was in place. Thus BFS was operated almost entirely by Leeson alone.

- 13.18 This lack of supervision was reflected in the failure on the part of Jones to deal satisfactorily with the letters of SIMEX to BFS of 11 January 1995 (marked for Jones' attention) and 27 January 1995. These letters were important. The letter of 11 January 1995, which referred to account '88888', queried the accuracy of information provided by BFS relating to certain margin requirements, complained of the lack of information and explanations in the absence of Leeson and referred to a possible violation of SIMEX rules by BFS's financing the trading margins of clients; yet Jones did not send a copy of this letter to Barings in London at the time and essentially left it to Leeson to draft the response. The letter of 27 January 1995 sought an assurance of BFS's ability to fund its margin calls; and, although a copy of this was sent (by Bax) to Barings in London, it should have caused Jones to investigate why such a letter had been sent and to check that adequate answers to it were given; especially in the light of the letter of 11 January 1995 received some two weeks earlier.
- 13.19 The lack of supervision of BFS extended elsewhere. The Head of FPG in BSJ, Gueler, who was based in Tokyo and was experienced in the operation of Japanese markets, accepted that he had responsibility for analysing the risks on Leeson's intra-day trading activities from 1992 until the last quarter of 1994 (thereafter Walz had principal responsibility). He did not have a clear understanding of the extent of the supervision which he was to have over BFS's trading activities, and has disputed that he was responsible for supervising Leeson's switching activities. Whatever the precise position was as to his responsibilities in this regard, knowing as he did that BFS's trading activities were not properly supervised, he should not have allowed this lack of proper supervision to continue. We also consider that he should have questioned with management the high reported profitability of the switching activities before he actually did so in October 1994. Further, although they had responsibility for the financial products traded on a proprietary basis within BFS, neither Ron Baker nor Walz checked properly on BFS's trading activities. This unsatisfactory position was made worse by the fact that reporting lines with regard to Leeson were not clearly understood; there were no clearly laid down reporting lines for Leeson, through the management chain, to Ron Baker; and there was also uncertainty as to whether Ron Baker reported to Maclean or Norris.
- 13.20 Nor did senior management in London address the position adequately. Norris had identified Jones as being extremely difficult to manage within the matrix structure of organisation which had been introduced by 1993. Indeed, Norris had formed the view in 1993 that Jones should be replaced; although, in the event, he decided not to do so, mainly because he did not want to cause any upset for Bax. It was also the case that Broadhurst and Jones were barely on speaking terms. We express no criticism in principle of a matrix structure; but such a structure can only work effectively, especially in a global operation, with tight controls, with a clear understanding of individual responsibilities and with managers at the 'hubs' communicating effectively. This did not happen in the case of BFS and, given the perception which senior management of BIB had of Jones (which was that he was a poor communicator and that he undertook little involvement in the affairs of BFS, as opposed to BSS) the risk of

13. Conclusions

a failure of operational controls relating to BFS should have been recognised and acted upon at an early stage.

- 13.21 A further significant failing was that Barings did not control the high level of BFS's 'switching' positions by the use of gross limits or otherwise (and notwithstanding the fact that James Baker had made a recommendation that this be considered in the internal audit report). This was imprudent. The responsibility for this lay with Ron Baker (as Head of FPG), Walz (as Head of Equity Financial Products), Hopkins (as Director of Group Treasury and Risk) and Norris (as Chief Executive Officer). In addition, Ron Baker and Walz should have taken more vigorous steps than they did to require Leeson not to increase, and where possible to reduce, his positions in accordance with the decision of ALCO on 26 January 1995. In fact, Leeson's positions increased after that date.

Funding of BFS

- 13.22 The manner in which Barings in London funded the trading of BFS was wholly unsatisfactory. Evidence given to the inquiry indicated that Leeson regarded Barings in London as the 'cash cow'. Significant US Dollar amounts were regularly remitted through BSL's client account by way of 'top up' to BFS without any clear understanding on the part of Barings' management on whose behalf those monies were to be applied, and without any real demur. This level of funding became ever higher, both in absolute terms and in terms relative to the authorised 'switching' activities. At the time of the collapse the balance of the 'top up' payments exceeded £300 million.

(1) Settlements and Treasury

- 13.23 There was no clear understanding as to whether or to what extent the sums requested by BFS were for client trading or for house trading. In consequence the true position was not reflected in the accounts. The Settlements Department was simply not able to reconcile the 'top up' payments as loans to clients; and yet that is how the payments seem to have been considered (to the extent that the matter was thought about at all) by most of senior management. The requests by BFS to Barings in London were, for the most part, acted on without question. Granger, Manager of Futures and Options Settlements, BIB, was concerned that she could not reconcile the payments as loans to clients; and was concerned that BSL's client account might be funding house trading. However, she failed to raise her concerns with Gamby, Director of Settlements, or to ensure that those problems which she had identified were appraised by him. Granger further appreciated that inadequate information for the funding requests was being provided by BFS which could not be verified. She should have had a proper understanding of what these large advances actually represented and for what purpose they were being paid before they were authorised (mainly by her) to be paid. Gamby knew that Granger was authorising payments by SWIFT to BFS, only part of which were recoverable from London clients. He was also aware that Granger had expressed concerns about the flow of information coming from BFS. We consider that Gamby, as Director of Settlements, should himself have taken steps to understand what these payments to BFS actually represented and for what purpose they were being paid. Yet neither Gamby nor Granger took sufficient steps to address the position.

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13.24 Granger mentioned her concerns about the lack of reconciliation and about the inadequacy of information provided by BFS to Tony Hawes, Group Treasurer. Tony Hawes had by the end of 1993 himself realised that there was a lack of reconciliation. This issue was eventually (by the autumn of 1994) raised by Tony Hawes with Hopkins. Hopkins told us that he was extremely concerned about it. Furthermore, James Baker (who had himself previously had the point mentioned to him by Tony Hawes) in his internal audit report had recommended a review by Group Treasury of BFS's funding requirements. Yet no effective attempt was made, whether by Hopkins or Tony Hawes or anyone else, to follow up these concerns and recommendations and no prompt and detailed investigation was undertaken into the precise basis for the funding of BFS. Nor was there any significant attempt to consider the Group position taking into account the funding of BFS by Barings both in London and in Japan.

13.25 The upshot was that nothing was done (by the Settlements Department or Treasury Department) properly to respond to the problems identified, in spite of the increasing level of funding and the inadequate details provided by BFS in its requests for payments.

(2) Credit

13.26 There was no system in place to ensure that the credit aspects of this funding were reviewed. Although there were clear credit implications if the sums were indeed considered to be advances on behalf of clients, the Credit Committee did not pay attention to the growth in the advances as recorded on the balance sheets. Tony Hawes was, from late 1993 to August 1994, responsible for BSL's credit unit: knowing that the 'top up' payments were not reconciled to client records, while believing that they represented loans to clients, he should have assessed the credit implications. Hopkins, as Director of Group Treasury and Risk from 23 August 1994 with responsibility for credit matters relating to BSL until the end of 1994, recognised that there were weaknesses in the credit department. By the autumn of 1994 he was also aware (having been told by Tony Hawes, as noted above) that there was a lack of reconciliation to client records of the advances to BFS. We consider that Hopkins and Tony Hawes both have responsibility for the credit failings in this respect. Maclean, as Chairman of the Credit Committee, believed that BSL gave credit to clients in a way which the credit department of BB&Co would not have accepted: we consider that, as Chairman of the Committee, it was his responsibility to ensure that proper details about what he understood to be advances to clients were put before the Committee for their consideration. Russell only became Head of Credit of BIB on 1 January 1995, but his appointment had previously been announced in August 1994; and he had had increasing involvement with BSL's credit department during 1994 and had formed the view that there were shortcomings in it. It was unfortunate that he did not promptly address these shortcomings within BSL from 1 January 1995.

(3) Financial Controls

13.27 There was a failure of financial controls with regard to the 'top up' payments. There should have been a proper understanding of what the large advances as shown on the weekly balance sheets (of which the advances to BFS were, in fact, a major component) actually represented and for what purpose they were being paid. Maclean, as Head of Banking; Barnett, as Chief Operating Officer; Broadhurst, as Group Finance Director (and who had, moreover, agreed with an initial recommendation in an earlier draft of

13. Conclusions

the internal audit report that margin call reconciliation procedures for BFS should be introduced); and Tony Hawes, as Group Treasurer share responsibility in this regard. In addition, Broadhurst and Tony Hawes should have checked that adequate verification of the requests from BFS was being undertaken. Indeed, if it was considered that these advances were advances to clients, there should have been a detailed assessment of the question of charging clients for the costs of the advances, or at the very least, of the cost to Barings of making such advances.

- 13.28 Norris was aware of a continuing debate about the level of funding of BFS and of the 'switching' activities as a whole. We consider that he must, as Chief Executive Officer, take some responsibility for failing to acquaint himself with the position and to make enquiries as to the precise basis of funding being provided to BFS or as to the reconciliation to underlying records of the sums advanced.

Level of reported profitability of BFS

- 13.29 There was no sufficiently informed assessment as to how BFS could generate such large (reported) profits from activities perceived to be essentially risk free (being matched 'switching' activities). Given the very high level of reported profitability, this was a serious failure. This issue of the profitability of the 'switching' activities was of such significance that it ought to have been given much more detailed and critical assessment than it received. Yet there was no informed analysis or appraisal of the issue; indeed, to the extent that queries were from time to time raised about it they seem to have been answered without any thorough investigation. We consider that the responsibility for this rests with the highest level of management within BIB, including Tuckey, Norris, Maclean, Barnett, Hopkins, Ron Baker and Broadhurst; and ultimately must be shared by Peter Baring, as Chairman of Barings plc.
- 13.30 Neither Ron Baker (with responsibility, as Head of FPG, for Leeson's proprietary trading from the end of 1993), nor Walz (as Head of Equity Financial Products and having responsibility for risk for Equity Financial Products) had, in our view, any real understanding of the nature or true profit potential of BFS's apparent trading activities; and even while they expected Treasury to fund BFS's ever increasing requirements, they failed to familiarise themselves with what Leeson was doing or to exercise a sufficient degree of supervision over BFS's trading activities. Moreover, neither Norris, as Chief Executive Officer, nor Maclean, as Head of Banking (of which Division FPG became part), took sufficient steps to satisfy themselves that Ron Baker had proper management control over BFS's trading activities.

Implications of the SLK receivable

- 13.31 We consider that the incident communicated by C&L Singapore to London by the beginning of February 1995 of the alleged receivable from SLK in the sterling equivalent of around £50 million - which the information now available indicates to be a spurious transaction - required much more prompt and firm action by senior management in London and Singapore than it received.
- 13.32 There was no clear understanding in London of what had actually happened, but we were told that the matter was regarded at the time as very unusual. On one version of events (known at least to Broadhurst by the beginning of February 1995) Leeson appeared to have involved BFS, in some way, in trading or broking an OTC option

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transaction - which would have been an unauthorised activity for BFS. On another version of events, known to Norris, Maclean, Barnett and Ron Baker, among others, there had been an 'operational error' (as it was called) within BFS, whereby a payment had in December 1994 wrongly been made to a third party. It is the case that the money was reported as having been repaid on 2 February 1995. But the potential implications were that BFS either had engaged in an unauthorised activity (in the form of OTC option broking or trading) or, at all events, had somehow been involved in the erroneous payment of a very large sum. In operational terms the matter was, on any basis, very serious; and there were obvious risk and large exposure reporting implications. When Hopkins was told of the matter on 6 February 1995 he expressed serious concerns; and circulated a note on 10 February 1995 for MANCO, including (among others) Norris, Barnett and Maclean, which referred to the error as being an incorrect payment relating to an OTC option broked by BFS. But that note by Hopkins was not given the attention which it deserved. It is the case that Tony Hawes went to Singapore on 6 February 1995 to look into this matter, among other things; but this was only part of the purpose for his visit and neither he nor anybody else was requested to establish as a matter of urgency exactly what had occurred. In consequence, Tony Hawes had not concluded his report on that point prior to the collapse.

- 13.33 Because of the obvious seriousness of the matter, the confused and unsatisfactory information available to management in London at the time required an urgent and detailed investigation. Broadhurst and Norris in particular, and also Ron Baker, Maclean and Barnett, should have ensured that the necessary urgent steps were taken to ascertain precisely what had happened.
- 13.34 As to management in Singapore, Jones and Bax should have taken more effective steps than they did to ascertain the precise circumstances of what they understood, by the beginning of February 1995, to have been an unauthorised payment by BFS relating to an OTC option trade.
- 13.35 The appreciation by certain members of management that there were very unsatisfactory features relating to this transaction is, we consider, illustrated by the fact that Broadhurst (at the request of Norris, who had himself been so requested by Bax) asked C&L London that no reference to this transaction be made in the auditors' management letter for BFS. We consider that it was inappropriate for Broadhurst, Norris and Bax to have caused such a request to be made, which was done with a view to attempting to avoid potential problems with the regulators of BFS in Singapore.

Market concerns in 1995

- 13.36 There were, therefore, by the beginning of February 1995, features which should have alerted management to the existence of potential problems within BFS. It was also the case that there were rumours in the market concerning Barings' very large position on OSE, and possible client problems, which were known to management in London in January 1995. Indeed, queries were raised at a high level from reputable sources, and even included a query on 27 January 1995 from the Bank for International Settlements in Basle. These rumours persisted in February 1995.
- 13.37 While management of BIB may initially have been justified in taking no steps with regard to these market concerns, given their perception that the positions in respect of the 'switching' activities were fully matched, nevertheless we consider that at the

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beginning of February 1995 it would have been appropriate for steps to have been taken to investigate the foundation for them.

- 13.38 By the beginning of February 1995 the incident of the SLK receivable had been communicated to London - which at the least suggested that there had been a serious operational error within BFS and which remained unexplained. It was also the case that by 31 January 1995 the letter from SIMEX dated 27 January 1995 had been sent to London; that indicated that SIMEX was seeking an assurance of BFS's ability to fund margin calls at short notice if market conditions should become adverse. Moreover, the fax of 3 February 1995 from Bax drew attention to the fact that Leeson was, in fact, still in charge of both trading and settlement operations of BFS. As Tony Hawes and Railton had gone out to Singapore and were there by 6 February 1995, there was every opportunity to require them to check whether there was any foundation for these market concerns and whether (by reference to BFS's own records) the positions on OSE were indeed fully matched.
- 13.39 Given all this, we consider that the basis for the rumours should have been more vigorously investigated at the time; and Norris, as Chief Executive Officer, and Ron Baker and Walz as being in charge of Leeson's proprietary trading, should have taken steps to verify that the positions were indeed fully matched.

Reporting to regulators

- 13.40 In consequence, to a considerable extent, of the lack of understanding of BFS's trading activities, the lack of reconciliation to client records of the funding provided by Barings in London to BFS and the lack of verification of the (false) information provided by BFS, there were deficiencies and inaccuracies in large exposure reporting to the Bank. The 'top up' payments to BFS were not included in the large exposure reports to the Bank. Concurrently, these 'top up' payments were not included in the SARS returns submitted to the SFA (until the return for January 1995, delivered just before the collapse).
- 13.41 It appears that the question of whether the 'top up' account should be reflected in the large exposure reporting to the Bank was not internally discussed within Barings nor was its very existence drawn to the attention of senior management. It is surprising that it was not raised as an issue for discussion. For if the money was considered to be paid as margin for (unidentified) clients, then it should have raised questions as to whether there were large exposures to particular clients; whereas if the money was considered to be paid in respect of house positions, then it should have raised questions as to the large exposure position to BFS at the solo consolidated level and to SIMEX at the consolidated level. Equally, there is no clear explanation of why the 'top up' account (as substantially reflected in the account maintained by Barings from February 1994 designated BSINGCOLL account) should not, until 31 January 1995, have been reflected in the SARS returns to the SFA, if it was indeed considered that these payments reflected advances for client margin.
- 13.42 There was, overall, an inconsistency in Barings' approach to these 'top up' payments for regulatory reporting purposes. They were not included in the large exposure reports to the Bank because, apparently, they were considered to represent advances to a large number of clients; but, at the same time, they were not included in the SARS

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returns to the SFA as advances to clients and, on the contrary, were reflected in the balance sheets submitted to the SFA as amounts due from affiliated companies.

- 13.43 Barnett and Maclean were the members of senior management principally involved in discussions with the Bank on the large exposure reports. They must share responsibility with regard to the inaccuracies in them, even though they did not know of them. Seal, who, as Financial Controller of BIB from September 1994, signed the reports, and before that, as Financial Controller of BB&Co from November 1993, had responsibility for the BB&Co solo consolidated large exposure reports, failed sufficiently to analyse the information provided to her by BSL for this purpose and failed sufficiently to consider whether the 'top up' payments (of which she knew by the end of 1994) should be included. In addition Broadhurst (to whom Seal reported), although he informed us that he did not see the large exposure reports, should have appraised himself, as the Group Finance Director of BIB, as to the reliability of the systems and sources generating the information needed for such reports. He was also responsible for the accuracy of the returns to the SFA, which he did see. Tony Hawes, given the concerns which he had about the payments to BFS (which had implications for risk and large exposure reporting) failed sufficiently to apprise senior management of his concerns for the purposes of reporting to the Bank and to the SFA. Norris, as Chief Executive Officer, must bear ultimate responsibility for the accuracy of the reports to the Bank and, as Chief Executive Officer and nominated Senior Executive Officer under the SFA's rules, for the accuracy of the returns to the SFA.

EXTERNAL AUDITORS

- 13.44 For the 15 month period ended 31 December 1993, there were realised and unrealised losses from the trading activities of BFS for that period which we assess to have been in the region of a sterling equivalent of about £19 million. The reported profits of BFS, however, were of a sterling equivalent of about £9 million. These profits, as reported, then flowed through to the group profits of Barings. We have not been permitted access to the working papers of the then auditors of BFS, D&T Singapore, and we have not been able to interview any of the relevant personnel engaged in the audit for that period or the preceding year. We do not, therefore, know what records, explanations and details were provided to them by BFS. In the event, it is now apparent from the reality of Leeson's trading activities that the profits from the activities of BFS must have been materially misstated.
- 13.45 C&L Singapore undertook the audit of BFS for the year ended 31 December 1994. Its audit of BFS had substantially been completed by the time of the collapse. On 3 February 1995 C&L Singapore provided to C&L London (who were, and had for some years been, the auditors of Barings plc and others of its subsidiaries) an Audit Report to the Directors of Barings plc, with consolidation schedules for BFS for the year ended 31 December 1994, which, without qualification, C&L Singapore stated were presented fairly for the purposes of the audit of the consolidated financial statements of Barings plc. A first stage of the subsequent events review for BFS was signed by C&L Singapore on 23 February 1995, which gave confirmation to C&L London that no events had occurred subsequent to the year end which would affect C&L London's signing of the Group accounts, subject to the finalisation of the bonus provision.

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- 13.46 It is not established if C&L Singapore were ever provided with a copy of the internal audit report of James Baker. An Audit Strategy Memorandum prepared by C&L Singapore in November 1994 stated that no major issues were raised by the internal auditors from London during their visit in August 1994. In the absence of detailed comments from C&L Singapore we cannot properly assess the basis for that statement.
- 13.47 C&L Singapore performed an assessment of BFS's control environment as part of their audit planning, which was completed in November 1994. This concluded that the control environment within BFS was satisfactory. C&L Singapore resolved, as recorded in the Audit Strategy Memorandum, that given the high volume of trades and adequate internal controls a controls-based audit would be done; but that balance sheet trade items would be validated by confirmations, as there were only four clients. Since we have not been permitted access to the work papers of C&L Singapore, for the reasons given in paragraph 1.74, and have not been able to interview any of their personnel engaged in the audit, we do not know the basis on which their conclusion as to internal controls was reached. This conclusion was, on the face of it, not readily compatible with the fact that there was a lack of segregation between front and back office: and this was so whether or not C&L Singapore had seen the internal audit report, or knew that its principal recommendations had not been implemented.
- 13.48 At the time of the collapse of Barings the audit for the year ended 31 December 1994 of Barings plc and BSL by C&L London was well advanced. However, there was a number of important audit matters which had not by then been completed by C&L London which included: agreement of subsidiaries' financial statements and the signature of a working copy of the Group financial statements (scheduled for 10 March 1995); the subsequent events review in London; and the auditors' management letter.
- 13.49 C&L London adopted an audit approach to BSL which was based on the examination and testing of the internal controls in operation. This work included an assessment of the controls in relation to payments of margin. C&L London assessed the control environment to be good. Where such an approach is adopted, adequate testing of the effectiveness of controls which are in place should be performed. As we have concluded, Barings' controls with regard to the payments of margin from BSL and BSLL to BFS were deficient in that BSL could not verify the information provided, and was confused as to whether the payments were for client trading or house trading; did not reconcile the payments to underlying client records; and did not assess the credit implication of such payments.
- 13.50 We do not consider that C&L London performed sufficient tests to satisfy themselves that the controls over payments of margin and the associated accounting balances were operating effectively. In their testing, in December 1994, of the controls of the Futures and Options Settlements Department, managed by Granger, they undertook insufficient compliance testing and relied inappropriately on their perception of Granger's experience. Such testing as took place involved observing her department's handling of funding requests during an interim audit visit, with no analysis and without proper scoping of the sample being tested; in consequence, there was no effective test of funding requests from, or margin payments to, BFS.
- 13.51 We accept that C&L London might have queried the very high level of funding of BFS by BSL which occurred in January and February 1995 during the course of its subsequent events review (which it had not concluded by 23 February 1995).

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Nevertheless, we consider that, had C&L London carried out more thorough tests on the effectiveness of the controls in place with regard to payments for margin at the time of their controls testing, it is likely that the inadequate support for the funding requests from BFS would have been revealed at that stage, and the amounts paid which could not be reconciled to individual client balances identified.

- 13.52 As noted above, we have not been permitted access to the working papers of C&L Singapore and have not been able to interview any of their personnel engaged in the audit. We are thus unable to express any conclusion as to the sufficiency of the steps taken by C&L Singapore with regard to the matter of the SLK receivable - it was, in fact, C&L Singapore who first queried the entry relating to the SLK receivable - or with regard to the confirmations purportedly emanating from Ron Baker in London and from SLK, or the purported summary of transactions through BFS's Citibank account. Nor do we know what explanations were given to C&L Singapore by the management of BFS.
- 13.53 C&L London were aware of the matter of the SLK receivable and were aware that varying explanations for it had been given. They took the report of C&L Singapore of 3 February 1995 and explanations of management to be confirmation that the outstanding audit issue, so far as it affected the audit of financial statements, relating to the receivable had been resolved. They did not themselves at that stage inquire further with a view to resolving the conflicting explanations of which they were aware.
- 13.54 The conflict between the explanations which had been given about the transaction (most notably as to whether or not BSL had been a counterparty) was not resolved by the comments of Broadhurst at the meeting with C&L London on 9 February 1995. Although C&L London were told by C&L Singapore on 2 February 1995 that the sum involved had been paid, even so the whole transaction, on whatever version of events was put forward, was unusual. It involved a very large sum, and raised a serious question as to the validity of the controls, by reference to which the audit had, to a considerable extent, been conducted. Moreover, Broadhurst had, as noted above, requested C&L London that reference to the SLK receivable be excluded from the management letter relating to BFS. C&L London rightly left that to the decision of C&L Singapore; but it was an unusual request in itself and one which should have indicated to C&L London that management believed that there were very unsatisfactory aspects involved in the issue of the SLK receivable.
- 13.55 Accordingly, we consider that the matter required further investigation by C&L London before the conclusion of the audit process. However, by 23 February 1995 C&L London had not completed their audit. As noted above, the signing of a working copy of the financial statements was planned for 10 March 1995; and the group subsequent events review in London and the management letter had not been finalised. We consider that C&L London were entitled, having had discussions with management in the early part of February 1995, to proceed at that stage on the footing that the money had been paid, as reported to them by C&L Singapore on 2 February 1995. While we think that C&L in London would have been fully justified in insisting on more detailed explanations at that stage, we conclude that it would be a judgement of hindsight to say that they positively should have done so then: and they were entitled to leave the matter for a later stage of the audit process.

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THE BANK OF ENGLAND

Supervision by the Bank

- 13.56 As noted in Section 1 of this report, the conclusions expressed here are those of the independent members of the Board. The ex-officio members have not participated in this part of the report.
- 13.57 The Bank was at all relevant times the consolidated supervisor of the Barings Group and lead regulator of BB&Co. The supervision was primarily carried out by its Supervision and Surveillance Division (S&S). The only relevant supervision for the purposes of this report was that of S&S. From April 1991 the senior manager in that division with responsibility for UK merchant banks (including Barings) was Thompson. Until March 1993 he reported to the Head of Banking Supervision, Barnes; from that date he reported to the Head of Major UK Banks Supervision Division, Sergeant, who in turn reported to the Deputy Director in charge of S&S, Foot (from September 1993). Thompson had a number of different individual analysts assisting him over a period of time in supervising Barings.
- 13.58 The Bank was told of the intention of Barings' management to apply BB&Co's standards of control to BSL. The Bank regarded the controls in Barings as informal but effective. It had confidence in Barings' senior management, many of whom were longstanding Barings' employees. Accordingly, it placed greater reliance on statements made to it by management than it would have done had this degree of confidence not existed. With regard to Barings' overseas subsidiaries the Bank undertook no reviews. In that respect, it placed reliance on what it was told by Barings and its auditors and reporting accountants (C&L); on the existence of a 'connected lending' limit on BB&Co's (or the solo consolidated group's) exposure to the overseas securities subsidiaries of 25% of unconsolidated (or solo consolidated) capital base; and (in accordance with recognised supervisory practice) on the supervision performed by the relevant overseas regulators.
- 13.59 While the Bank's supervision was primarily focused on BB&Co, as the authorised institution, the Bank's supervisory responsibilities extended, and were understood by the Bank to extend, to the activities of other parts of the Group insofar as such activities were capable of affecting the financial soundness and reputation of BB&Co.
- 13.60 In the event, Barings in London received false information from its subsidiary, BFS, and Barings in London itself failed to distinguish adequately between its house and client trading. In consequence, it was not aware that it was not complying with the connected lending limit and not providing the Bank with accurate information. It is true that the Bank knew that the Far Eastern operations of Barings were reporting very significant profits; it knew that there were issues relating to large exposures and that large and increasing funding was required for these operations; and it would have appreciated that there could be reputational risks to BB&Co arising from any significant default in these operations. However, we consider that the Bank reasonably placed reliance on local regulators of the overseas operations; and it was also entitled to place reliance on the explanations given by management as to the profitability of these operations and on the other information provided by Barings to the Bank.

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13.61 Had the Bank had a greater understanding of Barings' Far Eastern operations and a greater awareness of the degree of control of these operations as exercised by Barings in London it would have been better placed to supervise the consolidated group. There does not appear to have been any guideline or system in place within the Bank for determining whether the situation with regard to a member of a banking group for which the Bank was responsible for consolidated supervision was material such that it could affect the well-being of the bank. Although consolidated supervision requires an evaluation of risks presented to a bank by the activities of other members of the same group that evaluation is left to the unaided discretion of individual managers. We consider that there should be guidelines to assist this process. From this a wider lesson can be identified and it is one which we address in Section 14 of this report.

Large exposures

13.62 One key aspect of the Bank's supervision for the purposes of monitoring credit risk was the large exposures rules which it imposed, or which were imposed by the Act, on banks. These included a requirement that (to the extent that the Bank had a discretion to allow exposures to exceed 25% of capital base) BB&Co should first notify the Bank of any proposed exposures that would exceed 25% of its or its Group's capital base; and from 1 January 1994 a requirement (under the EU Large Exposure Directive) that, subject to certain specific exceptions and transitional arrangements, consolidated large exposures should not exceed 25% of consolidated capital base.

13.63 In 1993 Thompson permitted Barings, by what he described as an 'informal concession', to exceed the 25% limit with regard to the Group's exposure to OSE. This concession, not surprisingly, was taken by Barings also to apply to its exposure to SIMEX. Further, Barings apparently took the concession to release it from the obligation to pre-notify those exposures. The concession was granted without any apparent reference to more senior management at the Bank, which was a breach of the relevant internal Bank guideline. Moreover, no limit was at any time imposed on the concession. In consequence, Barings in London was prepared to allow exposures to the exchanges often to exceed 25% and latterly (by February 1995) to reach 73% on OSE and 40% on SIMEX. We consider that this informal concession, permitting Barings to exceed the 25% limit and without imposing any limit on the concession, was an error of judgement. Although we do not suggest that the Bank could, on the information then known to it, have appreciated that this concession involved any material risk to Barings, the unfortunate consequence of this concession, which continued over a lengthy period, was to facilitate the increasing transactions being undertaken by BFS.

13.64 The informal concession was granted pending a review within the Bank as to whether Barings could be exempted from the 25% limit in respect of its exposures to overseas exchanges. Barings referred this matter to the Bank in January 1993. It was recognised that it involved a policy issue but nothing was done by the Bank to progress it until May 1994. Even the coming into effect of the EU Large Exposure Directive on 1 January 1994 did not cause the Bank to consider whether it should continue the concession, which had been granted pending resolution of the issues regarding the correct treatment of the exchange exposures. Barings prompted the Bank, by their letter of 29 April 1994, for a response. While the Bank's S&S Policy Group was then consulted, it was only asked the narrow question whether exposures could be reported net of segregated clients' funds. The point was then discussed by Thompson at a meeting with senior management of Barings on 18 May 1994. The result of this

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meeting was that the Bank, through Thompson, indicated that it would write to Barings setting out its understanding of the position. Again, nothing was done until eventually (in January 1995) the question as to whether there could be an exemption from the 25% limit in respect of exposures to exchanges was raised with the Bank's S&S Policy Group, who confirmed that no such exemption was possible. This view was then passed on to Barings by Thompson by letter dated 1 February 1995.

- 13.65 We have considered whether, but for this delay, the unauthorised trading activities within BFS might have been curtailed or uncovered earlier. If the Group's exposure to OSE had been kept within the 25% limit throughout the period from 1 January 1994 (the date on which the EU Large Exposure Directive took effect), the authorised 'switching' activity between OSE and SIMEX would have had to be reduced in the absence of third party guarantees of the exchange exposures. The maintenance of smaller positions, however, would not necessarily have caused a curtailment in Leeson's unauthorised activities until around the end of January 1995. Until that time the concealment of the unauthorised activities booked in account '88888' was unrelated to the authorised 'switching' business; and therefore, because all trades in account '88888' were through SIMEX, they would not have been affected by any reduction of exposure to OSE. However, from the end of January 1995 the funding ostensibly obtained for authorised 'switching' activity was used in part to finance the unauthorised activities. From that time, therefore, had the 25% limit been strictly enforced and complied with and in the absence of third party guarantees of the exchange exposures, Leeson would have had either to curtail significantly the positions on account '88888'; or to call for significantly increased funding from London by way of 'top up'; or to seek some other unauthorised means of funding the positions. If the second course had been adopted it might have caused senior management at Barings to investigate the positions and thereby uncover account '88888'.
- 13.66 We are therefore unable to determine whether or not the delay on the part of the Bank in imposing the 25% limit with regard to Barings' exposure to OSE was a contributory factor in Barings' collapse. Nevertheless, we consider that the delay was unacceptable; the Bank was not entitled to assume that the delay would be inconsequential.

Solo consolidation

- 13.67 A lack of rigour was also displayed by the Bank in the context of the solo consolidation of BSL with BB&Co towards which Barings had been moving from 1992. This was a very significant step - since it would result in BSL (a substantial securities operation) being included in the unconsolidated returns submitted by BB&Co to the Bank and in BSL being, in effect, treated as one with BB&Co for capital adequacy and large exposures purposes. It was also novel, being the first solo consolidation of such a kind which the Bank had experienced. Yet the Bank failed properly to address all the issues regarding the solo consolidation of BSL with BB&Co or to finalise conclusions on points which had been raised.
- 13.68 Sergeant, in handwritten notes to Thompson dated 20 October 1993, made a number of relevant comments as to whether solo consolidation was appropriate. There is no record of all the issues raised by her being properly answered. By the letter from Thompson to Barings of 4 November 1993 a number of proposals were put forward, with the Bank indicating that it was prepared to treat BSL as solo consolidated with BB&Co on a provisional basis, pending further review by the Bank. But there was no

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follow up to this letter; nor (although the letter indicated that the Bank was giving consideration to whether solo consolidation was appropriate) does there appear to have been any further review (save with regard to capital adequacy measurements) undertaken by the Bank. Given the novelty of solo consolidating a substantial securities company with a bank, and the questions already raised, we believe that the matter should not have been left on this provisional basis with no further consideration of all the outstanding issues being undertaken after 1993. Indeed, the whole issue of the solo consolidation of BSL with BB&Co was of sufficient importance to warrant its being referred up to the highest level within the Bank. We would have expected that the matter, because of its novelty and importance, would then have been referred to BoBS itself.

- 13.69 In consequence of the informality with which solo consolidation was permitted, important points - including the need to give a direction under Section 38(3) of the Act - were not addressed. As a result the criminal sanctions potentially available under Section 38 in respect of failures to make reports of large exposures as required by that section were not extended to cover transactions of BSL; although we accept that BB&Co would probably have established that no offence had been committed because it did not know the facts requiring it to make the reports.
- 13.70 We consider that the Bank did not fully assess the impact of BSL being solo consolidated with BB&Co. A consequence of solo consolidation was that no limit was imposed on the amount that could be advanced by BB&Co to BSL; as a result, owing to the inadequate controls within BIB the remittance of large advances from BB&Co via BSL to BFS, ostensibly to finance client trading but in fact (as it has transpired) substantially to finance the concealed trading, was in practice facilitated. We accept that it could not have been appreciated by the Bank at the time that such trading on the part of BFS would be so facilitated, and we also accept that solo consolidation was not of itself the cause of the collapse. Nevertheless we consider that, because of its importance, the Bank should not have permitted solo consolidation of BSL with BB&Co to continue on a provisional basis for so long without a proper analysis of the issues that arose.

THE SECURITIES AND FUTURES AUTHORITY (SFA)

- 13.71 As noted in Section 1 of this report, the conclusions here expressed are those of the independent members of the Board. The ex-officio members have not participated in the formulation of the conclusions set out in this part of the report because of the potential overlap between the responsibilities of the SFA and the Bank.
- 13.72 The SFA was at all relevant times the regulator of BSL and BSLL. The regulation was primarily carried out by its Surveillance Division.
- 13.73 The review of financial returns submitted to the SFA and the annual review of the systems and methods used to prepare and complete the returns were the SFA's principal methods of supervising BSL and BSLL's financial resources and checking that customer assets were properly safeguarded. In addition, the external auditors, C&L, reported to the SFA annually.
- 13.74 The information provided by BSL to the SFA on the Segregated Account Reporting Statements (SARS) did not until a late stage include the advance margins placed with

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exchanges ostensibly on behalf of clients because the BSINGCOLL account (which reflects the advance margins funded by BSL) did not feature in those returns. In 1994, margin excesses of up to £35 million had been shown by BSL in its returns; but they were not so great or unusual that they should have attracted the attention of the SFA, whose principal interest in the SARS was to check that it did not show a deficit. The BSINGCOLL account was (for the first time) included in the SARS for the period up to 31 January 1995, delivered to the SFA on 22 February 1995. It showed a margin excess of nearly £160 million, apparently indicating that BSL had advanced on behalf of clients substantial amounts in excess of those actually required for their margins. The revelation of so large a figure could have caused the SFA to investigate further, but by then it was too late.

- 13.75 The SFA did not regard itself as required to consider the activities or financial position of the subsidiaries of BSL and considered that its responsibilities with regard to subsidiaries were limited to the express notification requirements relating to subsidiaries set out in its rules. However, we consider that the SFA's responsibility for monitoring a member firm's obligation to maintain adequate financial resources to meet its investment business commitments and to withstand the risks to which its business is subject requires it to have regard to the activities and financial soundness of a member firm's subsidiaries insofar as they are capable of materially affecting the financial integrity of the member firm.
- 13.76 A consequence of the SFA's perception of what it was required to do was that the individuals concerned on behalf of the SFA with the regulation of BSL did not give consideration to the question of whether or to what extent BSL's exposure to its subsidiary BFS might adversely affect BSL's financial integrity. We consider that a wider lesson should be drawn from this, to which we refer in Section 14.
- 13.77 The SFA knew, or should have known, from the ample information in the public domain that the Far Eastern operations were very significant to BSL. However, BSL did not provide the SFA with accurate financial returns; and BSL at no time informed the SFA of any exposure that it had to BFS or BSJ or of the level and nature of BSL's funding of BFS's trading activities. The financial returns submitted by BSL to the SFA did show substantial balances receivable by BSL from its affiliates in aggregate; for example £178 million at 31 December 1993 and £254 million at 31 December 1994, having risen to over £500 million in May 1994. We consider that the SFA's regulation of BSL should have had regard to any material exposure of BSL to its affiliates; but on the information contained in the returns submitted by BSL to the SFA, and given the SFA's perception of those balances (which was that they represented transactions undertaken through affiliates on behalf of clients) we consider that it would not be right to criticise the SFA for failing to raise queries as to those balances on receipt and appraisal of the returns.

OVERSEAS REGULATORS

- 13.78 We have not been able to make detailed enquiries as to the overseas regulation of Barings, and have not had sufficient information to enable us to express any conclusions on that aspect.

13. Conclusions

GENERAL

- 13.79 We should record that, since that we have not had access to evidence from a number of sources including Leeson himself, we are unable to determine what the motives were for Leeson's activities. Leeson was awarded very sizeable bonuses for what were thought at the time to be his consistently profitable activities; such bonus for 1994 being proposed as £450,000 (compared to £130,000 for 1993). Whether the prospect of an increased bonus was, in whole or in part, the motivation to Leeson for his unauthorised trading which resulted in such massive positions being taken cannot at present be determined. We also cannot determine, in the absence of full access to documentation in Singapore, whether or not there was a misappropriation of any of the funds advanced to BFS. Moreover, we cannot rule out the possibility that Leeson may have been acting in concert with one or more persons.
- 13.80 We have set out in the previous sections of this report the matters which we have, on the information available to us, identified as the events leading to the collapse of Barings. This collapse was brought about by the unauthorised trading activities within BFS - one overseas subsidiary within a large group but whose activities accumulated losses of around £830 million and caused the ultimate parent company, Barings plc, to be placed in administration. Most of the assets and liabilities of the Barings Group were subsequently purchased by ING and the interests of depositors and creditors were thereby protected. But others, including the shareholders and loan note holders of Barings plc, the providers of capital, have suffered serious loss. The collapse of Barings is an illustration of how a viable and prosperous group can, in circumstances where controls are ineffective, be brought down by unauthorised activities within one of its subsidiary operations.
- 13.81 We have concluded that the system of checks and balances necessary for the proper management and control of a financial institution failed in the case of Barings with regard to BFS in a most serious way, at a number of levels and in more than one location. That lessons can be learned from the collapse is clear to us; and it is to these lessons that we turn in the following section of this report.

14. LESSONS ARISING FROM THE COLLAPSE OF BARINGS

Introduction

- 14.1 Barings' collapse was due to the unauthorised and ultimately catastrophic activities of, it appears, one individual (Leeson) that went undetected as a consequence of a failure of management and other internal controls of the most basic kind. Management failed at various levels and in a variety of ways, described in the earlier sections of this report, to institute a proper system of internal controls, to enforce accountability for all profits, risks and operations, and adequately to follow up on a number of warning signals over a prolonged period. Neither the external auditors nor the regulators discovered Leeson's unauthorised activities.
- 14.2 Management and directors of all financial institutions will draw lessons for themselves. However, we would emphasise the following five significant lessons of the Barings case, which we discuss later in this section, to which particular attention needs to be paid:
- (a) Management teams have a duty to understand fully the businesses they manage;
 - (b) Responsibility for each business activity has to be clearly established and communicated;
 - (c) Clear segregation of duties is fundamental to any effective control system;
 - (d) Relevant internal controls, including independent risk management, have to be established for all business activities;
 - (e) Top management and the Audit Committee have to ensure that significant weaknesses, identified to them by internal audit or otherwise, are resolved quickly;
- 14.3 The failings at Barings were not a consequence of the complexity of the business, but were primarily a failure on the part of a number of individuals to do their jobs properly. Both before and since the collapse of Barings much has been written about the derivatives markets. While the use of futures and options contracts did enable Leeson to take much greater levels of risk (through their leverage) than might have been the case in some other markets, it was his ability to act without authority and without detection that brought Barings down.
- 14.4 The standards and practices required of external auditors in the UK are found in auditing guidelines issued by the Auditing Practices Board. These include specific guidance for the auditors of banks which are presently being revised. We do not think that it is for us to anticipate these revised guidelines. We would emphasise the importance of a close working relationship between internal and external auditors, both in the UK and in respect of overseas subsidiaries, including exchanging significant information such as that contained in internal audit reports and management letters. We do not think it necessary or appropriate for us to refer further to lessons for external auditors.

14. Lessons arising from the collapse

- 14.5 The events leading up to the collapse of Barings do not, in our view, of themselves point to the need for any fundamental change to the framework of regulation in the UK. There is, however, a need for improvements in the existing arrangements. Mindful of our terms of reference we concentrate our comments on regulation to the UK system of regulation and, in view of our experience, the majority of the lessons we draw relate to the Bank.
- 14.6 We believe that some of our comments on the Bank may also be relevant to the SFA: understanding the business and associated risks; liaising with internal auditors, external auditors and, for larger institutions, the Audit Committee; and liaising with other regulators. We set out in paragraph 14.63 a particular recommendation concerning the extent to which the SFA should have regard to companies related to a member firm. We also set out in Appendix XV a number of other matters for consideration by the SFA.
- 14.7 While it is outside our terms of reference to comment on broader issues facing the derivatives markets, we do note and welcome the initiatives which have been taken by the SIB and the Commodity Futures Trading Commission (through the Windsor Declaration and their commitment to further studies), the Futures Industry Association (in its recent report on financial integrity recommendations for futures and options markets and market participants), and by other regulatory bodies and trade associations. These initiatives have addressed international cooperation and information sharing as part of their remit, and have also considered some of the internal control implications of the collapse of Barings. We would also note that all of the positions on the Far Eastern exchanges in which Barings executed derivatives trades, were either liquidated (proprietary positions) or transferred to other clearing members (client positions) at, we understand, no loss to the exchanges, members of the exchanges or their clients, following the collapse of Barings.

14. Lessons arising from the collapse

LESSONS FOR MANAGEMENT

Management teams have the duty to understand fully the businesses they manage

- 14.8 Senior management is responsible for directing the business which, for many financial institutions, has become increasingly complex and diverse. What is essentially the same business may now operate in a number of financial centres and marketplaces, through varying legal entities and under different legal and regulatory jurisdictions. Also, the reliance on trading activities to generate an increasing proportion of total revenues has changed the nature of risk for many institutions within the industry. Rapid product innovation and sophisticated technology, alongside vastly improved communication systems, have to be understood and managed actively.
- 14.9 At Barings, neither the top management nor the relevant members of the management of the FPG had a satisfactory understanding of the business that was purported to be transacted in BFS, despite the significant profits that were reported and the funding that it required.
- 14.10 Barings' experience shows it to be absolutely essential that top management understand the broad nature of all the material activities of the institution for which they are responsible and that product management have a detailed understanding of all aspects of the activities they manage. This detailed understanding must include a thorough and continuing analysis of the risk and potential return of each product, how they relate to one another, and the type of control systems required to reduce the risk of error or fraud to a level acceptable to the institution. Management must demonstrate in their everyday actions their belief in, and insistence on, the operation of strong and relevant controls throughout the institution. This is particularly important in high volume, volatile products where the associated risks are correspondingly higher. This understanding, which is no less important in the case of an area of business which is perceived to be very profitable, can be gained through an appreciation of the specific market characteristics, the risks the institution faces, the competitive position of the institution in the relevant marketplace, the identity and requirements of customers, and the basis of the reported profits and risks.
- 14.11 It is important for the relevant managers to make visits with reasonable frequency to overseas offices engaged in trading, especially where the office is geographically remote from the head office. These visits should include discussions with traders, risk managers, office managers and support staff about the activities, and talking to competitors and other institutions in the market (such as exchanges), about the perceptions of the institution's activities and traders. It is only with an understanding and feel for the business that management will be able to ensure that it receives the right information and can ask the right questions. Senior managers at Barings did not have this level of understanding and also did not enquire into the activities of BFS in sufficient depth, even when a number of warning signals arose.

Responsibility for each business activity has to be clearly established and communicated

- 14.12 We have described in Section 2 of our report the ambiguities that existed in Barings concerning the reporting lines of Leeson. Whatever form of organisational structure is

14. Lessons arising from the collapse

chosen by an institution, clearly defined lines of responsibility and accountability covering all activities must be established and all managers and employees informed of the reporting structure. The identification of accountability extends beyond profit performance to encompass risks, clients, support operations and personnel issues.

- 14.13 All institutions should maintain an up-to-date organisational chart which shows clearly all reporting lines and who is accountable to whom and for what. There must be no gaps and no room for any confusion so that the situation of one manager believing another manager has responsibility for an issue, and vice versa, is avoided. Each individual in the institution should have a job description which clearly identifies his or her responsibilities and to whom and for what he or she is accountable. It is often said that the de facto reporting lines are determined by those who propose or set remuneration levels. It is therefore important that this is recognised when forming the organisational structure, especially when a substantial portion of an individual's income is in the form of bonus.
- 14.14 The need for clarity in accountability becomes increasingly important in a structure where an individual is responsible to one manager for a certain part of the business and to one or more other managers for other aspects of the business. This form of organisational structure is commonly referred to as a 'matrix' and was used by Barings. We make no criticism of the matrix style of management and, indeed, would observe that many institutions successfully operate such a matrix.
- 14.15 Nonetheless, there are some specific lessons to be learnt from the Barings collapse for organisations which operate a form of matrix structure. First, in a structure which has responsibility for products on a global basis and responsibility for operations on a local basis, the integrity of the controls over the activities of the local office must not be compromised. This means that the management of the local office must have a clear understanding of the business that is being conducted within the sphere of their geographical responsibility, notwithstanding reporting lines which are established along product lines. While local management may not be involved in day-to-day business decisions, it should have the authority to act to ensure that standards of control prescribed by the organisation are adhered to. Secondly, activities which are out of the mainstream may not find a natural home in the organisational structure and the risks of such activities being unmanaged and unsupervised is thus increased substantially. Close attention must therefore be given to ensuring a proper level of management control is exerted over such activities. Thirdly, because of the distribution of accountabilities and responsibilities in a matrix style organisation which involves dual reporting lines, effective communication between senior managers is essential.
- 14.16 When an institution is making significant changes to its organisational structure, as in the case of Barings during the two years prior to the collapse, the risk of there being a lack of accountability for parts of the business or ambiguities in reporting responsibilities is substantially increased, particularly when the reorganisation involves bringing together business units having very different characteristics and management cultures. It is therefore important when an institution is moving from one structure to another, that senior management ensure lines of responsibility are clear and that there is independent monitoring of internal controls at each stage of transition.

14. Lessons arising from the collapse

Clear segregation of duties is fundamental to any effective control system

- 14.17 Perhaps the clearest lesson that emerges from the Barings collapse is that institutions must recognise the dangers of not segregating responsibility for 'front office' and 'back office' functions. Clear segregation of duties is a fundamental principle of internal control in all businesses and has long been recognised as the first line of protection against the risk of fraudulent or unauthorised activities. In the exceptional case of segregation of duties not being feasible due, for example, to the small size of the operation, controls must be established such that they compensate for the increased risks this brings, including close and regular scrutiny by internal audit. Management should also be wary of situations where it is apparent that only one individual is able to field all the key questions about a particular activity.
- 14.18 The term 'back office' typically covers trade entry, settlements and reconciliations. By necessity, it is often the case that 'back office' personnel work closely with traders on a day by day basis. However, this close and necessary working relationship must not develop to the point where the 'back office' becomes subordinate to the traders, as it appears happened in BFS. Institutions should have documented procedures and controls covering all aspects of transaction processing, accounting and reporting. Personnel who are asked to deviate from these should question why, and if they are dissatisfied with the answer given should be encouraged to report the matter immediately to senior management.

Relevant internal controls, including independent risk management, have to be established for all business activities

- 14.19 A breakdown in, or absence of, internal controls at a basic and fundamental level enabled Leeson to conduct unauthorised activities without detection. Each institution must determine for itself the controls most relevant and applicable to its business. However, we draw attention to aspects of control which the collapse of Barings confirm are of crucial importance.
- 14.20 A significant lesson concerns the failure of Barings London adequately to establish and verify the purpose of various large payments to BFS before they were processed. A basic principle of prudent management is the maintenance of robust systems of verification and reconciliation in the settlements function, irrespective of whether the payments are to group companies or third parties.
- 14.21 A particular concern in the case of Barings was that the funding from London to Singapore, much of which purported to be on behalf of clients and which therefore apparently generated client credit exposure, was not subject to the same rigour of checks and verification as if the payments had been drawdowns on a standard loan arrangement. All institutions should ensure that they have controls to identify the points at which a credit exposure may arise and to ensure that the exposure has been properly approved before payment is made. The sum of individual client loans should be reconciled to the total client loans shown in the balance sheet on a regular basis. Institutions which have acquired or developed securities businesses should take particular care to ensure that they have adequate controls over credit risk, an area which was weak in Barings.

14. Lessons arising from the collapse

- 14.22 A related matter concerns the co-mingling of house and client monies in payments made for margin. Institutions should distinguish between payments made on behalf of the house and those on behalf of clients: whenever possible before payment, but, failing that, as soon thereafter as possible, so that the necessary checks can be performed and the correct accounting entries raised.
- 14.23 A number of industry studies have strongly advocated the establishment within a financial institution of an independent risk management function overseeing all activities, including trading activities, and covering all aspects of risk. We support this view.
- 14.24 A primary objective of the risk management function is to ensure that limits are set for each business. These limits should reflect the risks being run and the level of risk that management is willing to take. The function also should serve as an independent check to ensure that traders operate within their limits; that exceptions are reported and actioned promptly; that sensitivity to changes in the market and their impact on the value of the position are assessed and reported; and should ensure that profits and losses are regularly recomputed and reconciled to the accounting records and, if necessary, the records maintained by the traders.
- 14.25 Unlike the situation at Barings, where Group Treasury and Risk focused on market and credit risk, an independent risk management function should oversee all types of risk. These other risks include: liquidity risk, concentration risk, operational risk, legal or documentation risk and reputational risk. Senior management in particular should be concerned about the risk of its institution attracting an adverse reputation and the impact of that on its business.
- 14.26 For the 'switching' activity, Barings only considered outright market risk (i.e. net long or short positions), reflected in the close of day market risk limit of zero and a small intra-day market risk limit. They did not establish gross position limits for each side of the 'switching' positions. Furthermore, an arbitrage business such as 'switching' attracts basis risk between two different markets (i.e. price movements are not one hundred percent positively correlated) and also exposes the institution to the settlement characteristics of these different markets, creating liquidity and funding risk. The events at Barings show the need for institutions to consider setting gross limits in respect of their arbitrage activities. Institutions should also consider allocating funding limits amongst its activities, relating them to the various risk limits.
- 14.27 Barings erroneously concluded that BFS's activities were low risk. Higher risk activities not only necessitate stronger and more extensive internal controls but also provide opportunities for higher remuneration levels for employees engaged in, or managing, them. We do not consider it is for us to suggest to institutions how they should reward their management and employees and, if there is a bonus element in the remuneration arrangements, how the bonus should be calculated, shared and paid. However, we would note that the opportunity to earn significant bonus based on revenue or profit, in relation to base salary, emphasises the need for vigilance in the design of the systems of internal controls.

14. Lessons arising from the collapse

Top management and the Audit Committee have to ensure that significant weaknesses, identified to them by internal audit or otherwise, are resolved quickly

- 14.28 A few months prior to the collapse, Barings established a group internal audit function. Prior to that the internal audit functions in the bank and in the securities business were separate and there was no effective communication between them.
- 14.29 For institutions engaged in a variety of activities we consider that the internal audit function should be established or overseen at group level. This would facilitate critical issues or weaknesses being communicated to top management on a timely basis and enable the head of internal audit to plan or review the allocation of resources across the entire group. The greater the size, risk, complexity or geographical spread of the business, the greater the need for experienced internal auditors with strong technical abilities and expertise in the relevant market sectors.
- 14.30 Internal audit should coordinate its activities with the external auditors and communicate key findings to them. The head of internal audit should have unrestricted access to the Chief Executive Officer, Chairman and the Chairman of the Audit Committee, irrespective of the person to whom he or she reports. Internal audit should be a core part of an institution's control systems and we think it essential that it is accorded a status in the organisation which it often lacks. One of the responsibilities of the Audit Committee should be to satisfy itself on the effectiveness of the internal audit function.
- 14.31 By the time of the collapse, neither senior management nor internal audit had followed up to ensure the implementation of the management actions as agreed following the recommendations in the October 1994 internal audit report on BFS. In preparing internal audit reports, major control weaknesses should be highlighted, and a management action plan to remedy the weaknesses should be agreed with a timetable. It is the responsibility of management to implement internal audit recommendations and, when major issues arise, to ensure they are remedied expeditiously. In the case of significant weaknesses, internal audit should plan return visits within a short period of the completion of the audit to ensure corrective action has been taken. Failure of management to implement recommendations within a timeframe agreed with internal audit should be reported to the Audit Committee.

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LESSONS FOR THE BANK OF ENGLAND

Introduction

- 14.32 The Bank is responsible for the consolidated supervision of all major UK banking groups. The Bank has no responsibility for the direct supervision of companies within banking groups which are not authorised by it (even where it is the consolidated supervisor of such groups). Such powers as it has in respect of such companies are exercisable only to the extent that such companies may adversely affect the interests of depositors with the bank itself.
- 14.33 The matter with which we are primarily concerned in this section is how the Bank's existing arrangements for the supervision of groups, such as Barings, with substantial operations outside the banking entity, should be improved.

Understanding the business and associated risks

- 14.34 In its conduct of consolidated supervision of banking groups the Bank has hitherto concentrated on collecting data from such groups concerning their consolidated capital adequacy and consolidated large exposures. We understand that this approach is followed by many regulators abroad and is currently regarded as good practice. We believe the collection and monitoring of this information is important and should continue to form an important part of the Bank's consolidated supervision.
- 14.35 However, we recommend that the Bank should go further than this. We believe the Bank should explore ways of increasing its understanding of the non-banking businesses (particularly financial services businesses) undertaken by those banking groups for which it is responsible for consolidated supervision, and how those businesses interrelate to one another and to such groups' banking businesses. It should also seek to obtain a more comprehensive understanding of how the risks in those businesses are controlled by the management of the group. By doing this the Bank will be better able to determine which companies within those groups, or which activities of such companies, are so significant that problems with respect to them might reasonably be expected to pose difficulties for the bank. In doing this the Bank should ensure that it defines clearly its relationship with other regulators, since their responsibilities for the regulation of the relevant entities within a group are unchanged. However, it should also co-ordinate effectively with them, possibly including assembling joint teams of supervisors with other regulators in appropriate cases.
- 14.36 We urge the Bank to prepare internal guidelines to assist its staff in identifying those parts or activities of a banking group which are capable of posing material risks to the bank concerned and to advise them of the steps which they should take to assess and monitor, and to ensure that safeguards are in place to protect depositors against, such risks. We understand that the Bank has been progressively setting up regular bilateral meetings with the management of significant overseas, and non-banking UK based, businesses for some time. Such meetings should be formally incorporated as a requirement in management guidelines and should include questioning, inter alia, the sources of profitability, sources of funding and control systems within relevant parts of the group. Where a banking group has substantial operations overseas this should result in an increased dialogue between the Bank and the relevant local regulator regarding such operations.

14. Lessons arising from the collapse

- 14.37 The Bank should ensure that it understands the key elements of the management and control structures of those banking groups where it is responsible for consolidated supervision. Where the Bank has confidence in the management of an institution its practice has been to discuss organisational issues at regular prudential meetings. In some instances, it has received details of changes to management responsibilities but, as with Barings, this has not always been the case. As previously stated, the potential for confusion as to management responsibilities is greatest during the course of a reorganisation. The Bank should receive prior notice of a significant reorganisation within, and of significant new operations being commenced by, a banking group, together with relevant reporting responsibilities. What is significant for one institution may not be for another and we have, accordingly, requested the Bank to develop proposals to BoBS regarding the most practical way in which our recommendation can be implemented.
- 14.38 The information currently received by the Bank goes some way in assisting the Bank in the discharge of its supervisory responsibilities. However we think that, to enable the Bank to improve its understanding of the businesses of the institutions it supervises and to ask relevant questions of management, the scope of the returns currently submitted should be extended to include more information about the businesses of the groups as a whole. For example, this might include details of profitability by product line. The Bank should review the existing content of returns with this objective in mind.
- 14.39 We are concerned that senior management of institutions may not always be aware of the standards of accuracy being applied in the preparation of returns to the Bank. The monitoring of these returns forms a central part of the Bank's supervisory approach and therefore it is of fundamental importance that they are accurate in all material aspects. We believe that senior management should more openly acknowledge their responsibility for the accuracy of the returns and that a senior director previously notified to the Bank under Section 36(1) of the Act should be nominated by the institution to sign the most important returns - the BSD 1 and the LE - on behalf of the board of the institution. We think this will emphasise to management the need to ensure high standards within the institution. The nominated director should meet the Bank at least once each year (probably as part of a prudential meeting) to discuss the accuracy and timely completion of returns.

Solo consolidation

- 14.40 We have described in Section 12 the meaning of solo consolidation. Because of the failure of controls in Barings, following the solo consolidation of BSL with BB&Co, funds which as a matter of law constituted loans by BB&Co to BSL were passed to BFS without limit.
- 14.41 We understand that solo consolidation was originally intended to facilitate the utilisation of special purpose financing vehicles by banks.
- 14.42 The solo consolidation of a bank and a substantial UK securities company poses a number of difficult issues with regard to the division of supervisory responsibilities between the Bank and the SFA, in particular because the bank may incur exposures to its securities subsidiary without limit, and therefore the Bank places increased reliance on the regulation by the SFA of that subsidiary. We consider that solo consolidation of any

14. Lessons arising from the collapse

active trading entity with a bank should require the formal approval of the Executive Director in charge of S&S or one of the Bank's Governors. Solo consolidation should only be proposed if, as a minimum, the following requirements are met (in addition to the criteria which the Bank already requires to be satisfied): first, solo consolidation must result in supervision, whether by the Bank or another regulator but in any event to the satisfaction of the Bank, of every solo consolidated entity and should only be contemplated where this is practicable; secondly, the controls within all of the proposed solo consolidated entities must be adequate to ensure that exposures to companies outside the solo consolidated group can only be incurred in a controlled manner; and thirdly, the Bank must have the means to receive on a continuing basis suitable reassurance regarding such controls, either through Section 39 reports into systems and controls across the solo consolidated group or through other equivalent means agreed with the other regulator (if any).

- 14.43 Internal guidelines should be prepared for Bank staff as to the procedures to be followed with respect to the granting of solo consolidation and the supervision of the solo consolidated group thereafter. Such guidelines should include a requirement that once solo consolidation has been granted a notice should be served under Section 38(3) of the Act to ensure that the criminal sanction imposed by Section 38 applies to the solo consolidated group.

Liaison with other regulators

- 14.44 The Barings case illustrates the need for close collaboration between the Bank and other regulators, both in the United Kingdom and overseas. We understand that plans are in place for the Bank and the SFA to review their method of working together, including a review of the Memorandum of Understanding (MoU) between them. We welcome such a review, which will provide a useful opportunity to take into account our recommendations above regarding the coordination of supervisory functions and solo consolidation. A similar review should, in our view, take place of the MoUs between the Bank and other UK regulators.
- 14.45 Our terms of reference do not extend beyond the UK system of regulation. However, we note that the existence of regular and open contact between regulators internationally, in order to assist them in the discharge of their respective responsibilities through such measures as the exchange of information, is desirable and is to be encouraged. We also support the development of formal MoUs between regulators internationally, in order to provide a sound basis for the relationship and to set out what one regulator can reasonably expect the other to do.
- 14.46 We recognise that considerable progress has been made in promoting and removing legal impediments to the free flow of information between banking supervisors in the G10 countries and that this is progressively extending to a wider group. We support the continuation of these efforts and would suggest that this process be further extended to include other regulators of financial services businesses, such as those involved in securities trading.

Internal audit

- 14.47 The Audit Committee and the internal audit function should be a valuable source of information to the Bank. It is not realistic for the Bank to review all internal audit

14. Lessons arising from the collapse

reports as a matter of course, but we note that the Bank has started meeting the internal audit departments of major UK banks. We commend this initiative and believe it should be extended to other areas of the Bank's supervision of banks covered by S&S. Where the Bank acts as consolidated supervisor the scope of these meetings should extend to include the group internal audit function.

- 14.48 We also recommend that for large UK incorporated institutions the Bank liaises regularly with the Chairman of the Audit Committee. This would provide the Bank with an opportunity to discuss internal audit, control and related issues with a non-executive director and to ask whether there are matters he or she is aware of which should be brought to the attention of the Bank.

On-site visits

- 14.49 At present the Bank conducts a limited number of visits in the UK to authorised institutions. These visits are an adjunct to the Bank's primary supervisory processes and much of the work performed involves discussion with management and staff. It is not intended that detailed testing or checking should be performed during such visits, although a sample of credit files will normally be reviewed in the smaller institutions. These visits provide an opportunity for the Bank to make a more informed assessment of management, gain a better understanding of the institution through seeing it operating first hand, and, to a limited extent, check whether the results of the visit are consistent with the information the Bank receives from other sources, including management, the auditors and the reporting accountants.
- 14.50 We note that no such visit to Barings was ever undertaken, although we understand two were planned for 1995. In the past the selection of banks to visit was generally determined by the quality of the bank's loan portfolio. During 1994 the Bank established a traded markets team to examine risk models on site. The primary function of the team is to determine whether banks have appropriate systems to assess the capital required for their trading activities using such models, although it also advises S&S more generally on trading issues. We commend this development and recommend that the Bank undertakes a review, 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 on banks' credit portfolios.
- 14.51 We have considered whether the supervision of UK banks would be improved if the Bank were to undertake, as a matter of course, regular inspection visits to all authorised institutions (or possibly all banking groups) and perform extensive detailed testing; an approach akin to that employed in a number of other countries. This might provide the Bank with more first hand knowledge about each institution (although we note that bank failures resulting from the unauthorised activities of bank personnel have also occurred in inspection based regimes), but we feel there are a number of disadvantages associated with this kind of approach. It would also involve a very significant increase in the cost of supervision which would ultimately be passed on to the customer or taxpayer. From the work which we have undertaken during this inquiry we do not believe that a wholesale change to this style of supervision is justified. We would prefer to see the existing supervisory tools available to the Bank developed further in the manner set out elsewhere in this section.

14. Lessons arising from the collapse

Reporting Accountants

- 14.52 Under Section 39 of the Act the Bank can require an authorised institution to commission a report from reporting accountants on any matter about which it can require information under the Act.
- 14.53 For the larger or more complex institutions, such as BB&Co, the Bank normally requires work to be commissioned annually covering one prudential return and one aspect of the internal control systems. At present reporting accountants usually undertake Section 39 work in respect of overseas operations of banks or bank subsidiaries (whether in the UK or overseas) only by reference to documents or information received by the authorised institution and do not usually travel overseas. We acknowledge that these operations and subsidiaries may be under the remit of other regulators. However, we believe that, in appropriate circumstances, the scope of Section 39 reports should be extended and reporting accountants required to go outside the bank and, if necessary, outside the UK. (We understand that both have been done in the past, but not frequently.) We suggest this matter be included within the guidelines referred to in paragraph 14.36.
- 14.54 When reporting on a particular return the reporting accountants are presently required to report on whether all relevant and material information has been extracted from the accounting and other records and accurately reflected in the return. They are not generally required to form an opinion on whether such records are themselves accurate or on the effectiveness of the systems of control which have been established to ensure the accuracy of the information in the records and the correct transfer of that information to returns. However, we understand that in 1994 the Bank began requiring certain major banks it supervises to commission reports on their systems of control over the accuracy of the information in their records and its transfer to returns; we understand these reports covered the systems and controls over the preparation and inputting of data in major overseas locations. We believe the Bank should periodically require authorised institutions to commission such reports. We also believe that all Section 39 reports should indicate the extent of the work performed by the reporting accountants for the purposes of their preparation, and we recommend that the Bank initiate discussions with the accountancy profession on this matter.
- 14.55 At present the Bank normally requires Section 39 reports to be commissioned annually, although it does require work to be commissioned on an ad hoc basis in certain circumstances. We would encourage the Bank to require Section 39 reports on a more flexible basis, particularly in circumstances where control systems or management structures materially change during the course of a year, where there is a plan to develop significantly or grow a specific aspect of the business, or where a previous Section 39 report has highlighted significant errors or weaknesses.

Large exposures

- 14.56 In Sections 12 and 13 we pointed out shortcomings in the implementation of the Bank's large exposures policy. We regard these errors as shortcomings in implementation, rather than as failures of the underlying policy, but are of the view that it is desirable for the Bank's policy to be made more explicit, by means of further guidance to managers. For the future we recommend that the internal guidelines are

14. Lessons arising from the collapse

extended so that existing concessions are formally reported to the relevant Head of Division on an annual basis to ensure that he or she is content for them to continue.

- 14.57 Repeated or significant breaches of the large exposure rules warrant prompt investigation by the Bank. Heads of Division should receive a summary of such breaches on a regular basis. Furthermore, in order to be provided with an overview, BoBS will in future wish to receive a regular report summarising breaches of the large exposure rules.

Guarantees and comfort letters

- 14.58 The Barings case also illustrates the need for regulators to be aware of guarantees and comfort letters given by banks in respect of the obligations of other group members. While a guarantee is a legally binding obligation, the status and effect of a comfort letter are not always as clear, largely because the term is one of art only: such letters can range from virtual guarantees to mere statements of awareness (although letters falling within the latter category should not be disregarded, since they may pose reputational risks for the bank issuing them). We understand that the Bank was in the process of determining the extent of the issuance of comfort letters and guarantees at the time of the Barings collapse. We think that this should be clarified as soon as possible. The supervisory treatment of these instruments internationally is not uniform at present, with regulators in different countries adopting varying approaches; as a result, any immediate change in the approach adopted by the Bank may have implications for the competitiveness of UK banks. We encourage regulators to agree a common approach which properly takes into account the risks attendant upon the issuance of these instruments as soon as practicable.

Quality assurance review

- 14.59 At the present time supervisors in the Bank are not subject to an independent quality assurance group review of their supervision of banks in their section. We would commend such a practice to the Bank, believing it would assist in the continuous improvement of supervisory practices and procedures and challenge important decisions made. The modus operandi of such reviews should be determined by the Bank. We have asked the Bank to make regular reports to BoBS regarding the results of such reviews.

Resources

- 14.60 We acknowledge that implementation of our proposals will require additional resources to be devoted to banking supervision, including specialists with the required experience and expertise. We see this additional burden as a necessary consequence of performing effective supervision of institutions involved in material and complex trading activities.

Changes to the Banking Act

- 14.61 From this inquiry we have not identified any matters that make an immediate amendment to the Act necessary. With reference to paragraph 14.46, however, if there are legal obstacles to the Bank sharing information with other regulatory authorities then appropriate legislative changes should be made to remove them.

14. Lessons arising from the collapse

Implementation

- 14.62 We have asked the Bank to report to us by 31 December 1995 on the progress made towards implementation of our recommendations.

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LESSONS FOR THE SFA

14.63 A particular matter which needs to be resolved is the extent of the SFA's responsibilities in connection with companies related to an SFA member firm. We recommend that the SFA should seek to clarify the extent to which it should have regard to the position of subsidiaries so far as they may have an adverse impact on the financial integrity of the member firms. The SFA should also consider the extent to which such assessment may be affected in situations where the Bank is the lead regulator or consolidated supervisor; and the regulation by overseas regulators of overseas companies which are related to the member firms.

Depending on the outcome of this assessment, changes may be required to the Financial Services Act 1986 or the SFA's rules.

We set out in Appendix XV a number of other matters for consideration by the SFA.

APPENDIX I LIST OF INTERVIEWEES

The following people gave evidence to the enquiry in an interview transcribed for the record.

| Name | Responsibility | Other Relevant Details |
|---------------------|--|---|
| Barings | | |
| James Baker | Former Internal Audit staff member, BSL | Joined Barings in September 1993. Moved from Internal Audit in September 1994 to become Assistant to Tony Hawes. |
| Ron Baker | Head of Financial Products Group, BIB; Director, BB&Co | Joined Barings in April 1992 from Bankers Trust, set up the Debt Financial Products Group which became the Financial Products Group. |
| Michael Baring | Head of Strategy, BIB; Director, BB&Co and BSL | Joined Barings in 1970. Became a director of BB&Co in 1984. Was head of Treasury and Trading and then became head of Equity Capital Markets in 1993. |
| Peter Baring | Chairman, Barings plc | Became a director in 1967. Group Finance Director from 1986 to 1992. Became Chairman of Barings plc in 1989. |
| Geoffrey Barnett | Chief Operating Officer, BIB; Director, BB&Co | Joined Barings in 1971. Became a director of BB&Co in 1979. Appointed Chief Operating Officer of BB&Co in September 1992 and then became Chief Operating Officer of BIB. |
| Iain Blyth | Head of Operational Credit, BIB; Assistant Director, BSL | Joined Barings in July 1994 from BZW. Responsible for monitoring counterparty risk across BIB. |
| John Bolsover | Chairman and Chief Executive of BAM; Director, Barings plc | Joined Barings in 1983. |
| Geoffrey Broadhurst | Group Finance Director, BIB | Joined Barings in 1986. Became Financial Controller of BB&Co in 1988, Finance Director of BSL in February 1992, Group Finance Director of BSL in April 1993 and then Group Finance Director of BIB. |
| John Dare | Director, Barings plc | Became a Director of BB&Co in 1978 and of Barings plc in 1989/90. Responsible for private equity business. |
| Nick Farley | Head of IT, BIB | Joined Barings in May 1992, initially as Head of IT for BSL, then for BIB. |

| Name | Responsibility | Other Relevant Details |
|----------------------------|---|--|
| Barings (continued) | | |
| Andrew Fraser | Head of Equity Broking and Trading, BIB; Director, BSL | Joined Barings in 1984 along with Heath when BSL was set-up. Role was to set up and control South East Asian broking network. Became head of Equity Broking and Trading in late 1993. |
| Tony Gamby | Settlements Director, BIB; Director, BB&Co | Joined Barings in 1979. Became Settlements Director of BIB in January 1994. |
| Brenda Granger | Manager Futures and Options Settlements, BIB | Joined Barings in 1992 as manager of London settlements, primarily focused on agency business. |
| Fernando Gueler | Head Proprietary Equity Derivatives Trader, BSJ | Joined BSJ in Tokyo in 1988 working in derivatives research. Joined the BSL proprietary trading team. Head of Equity Derivatives in Tokyo from January 1994. |
| Bill Hawes | Head of Derivatives Settlement, BIB | Joined Barings' settlement department in 1984. Became head of derivatives settlements in BIB on its formation, initially just OTC business but latterly including exchange traded business. |
| Tony Hawes | Group Treasurer, BIB | Joined Barings in 1961. Worked in Treasury and Trading Department. Became Deputy Head of Treasury and Trading. Seconded to BSL in 1992, becoming Group Treasurer in May 1993, then Treasurer of BIB. |
| Christopher Heath | Formerly Director, Barings plc | Joined Barings in June 1984 and set up the Far East broking operation which became BSL. Managing Director then Chairman and Chief Executive of BSL. He was a director of BB&Co from 1986 (in a non-executive capacity) and a Director of Barings plc from 1992. He relinquished the role of Chief Executive when Norris became Chief Operating Officer in September 1992 and left Barings in March 1993. |
| Ian Hopkins | Director and Head of Group Treasury and Risk, BIB; Director, BB&Co | Joined Barings in 1986 as a director of BB&Co, becoming Finance Director in 1987. Became joint Head of Treasury and Trading, BB&Co, in 1990 and sole head in 1993. Moved to present role in August 1994. |
| David Hughes | Treasury Department Manager, BIB | Joined Barings in 1984. Worked in settlements until 1989 moving to Treasury. |

| Name | Responsibility | Other Relevant Details |
|----------------------------|---|--|
| Barings (continued) | | |
| Richard Katz | Head of Equity Trading, BSL; Director, BSL | Joined BSL in 1985 becoming a director in 1989. |
| Diarmid Kelly | Deputy Head of Equity Broking and Trading, BIB; Director, BSL | Joined Barings in 1984. Responsible for London sales desk for Japanese equities and Japanese equity-linked products. Current position from late 1994. |
| Mike Killian | Head of Global Equity Futures and Options Sales, BIB | Joined Barings in September 1988 to set up BSL's agency business in Tokyo. |
| Ash Lewis | Head of Internal Audit, Barings plc; Assistant Director, BB&Co | Joined Barings in 1991 as head of Internal Audit of BB&Co and BAM. Took over responsibility for BSL in late 1994. |
| George Maclean | Head of the Bank Group, BIB; Director, BB&Co | Joined Barings in 1966. Worked in Project Finance and Corporate lending. Appointed director BB&Co in 1982. |
| Ian Manson | Former Head of Internal Audit, BSL | Joined BSL in 1993 as head of BSL Internal Audit. Moved to Financial Control in 1994 following merger of BSL and BB&Co internal audit functions. |
| Michael Miles, OBE | Director, Barings plc | Became a non-executive director of Barings plc in April 1989 and an Executive Director from March 1994. |
| Peter Norris | Chief Executive Officer, BIB; Director, Barings plc | Joined Barings in 1976. Became Chief Operating Officer of BSL in September 1992 and Chief Executive officer in March 1993. Was Chief Executive Officer designate of BIB from November 1993 and Chief Executive Officer from November 1994. |
| Deidre O'Donaghue | Head of London Credit Unit, BSL, and subsequently BIB | Joined Barings in April 1993 to work on the regulatory aspect of the merger of BSL and BB&Co and to assist in ad hoc projects. Moved to the Credit Unit in November 1993, becoming its head in December 1993. |
| Jim Peers | Company Secretary, Barings plc | Joined Barings in 1967 in Corporate Finance. In 1984 moved into central administration, latterly becoming Company Secretary of BB&Co and Barings plc. |

| Name | Responsibility | Other Relevant Details |
|----------------------------|--|---|
| Barings (continued) | | |
| Tony Railton | Futures and Options Settlements Senior Clerk, BIB | Joined Barings in February 1992 in Futures and Options Settlements. In December 1993 became supervisor for Japanese Yen settlements and had client margining responsibilities. |
| Johnnie Russell | Director Credit Exposure Management, BIB; Director, BB&Co | Joined Barings in 1974 in the banking department. Became director in 1987, after periods in Hong Kong and Singapore. Appointed Head of Credit for BIB from January 1995. |
| Sir William Rylie | Director, Barings plc | Joined Barings as a Director in April 1994. Formally Head of the International Finance Corporation, part of the World Bank. |
| Sajeed Sacranie | Personal Assistant to Peter Norris | Joined Barings in May 1989 as an internal auditor in BB&Co. Transferred to BSL Internal Audit in December 1992. Assumed responsibility for risk management in BSL during 1993 before becoming Norris' Personal Assistant in late 1994. |
| Liz Seal | Financial Controller, BIB; Assistant Director, BB&Co | Joined Barings in November 1992 as Financial Controller of BB&Co, becoming Barings plc Group Financial Controller in October 1993. In September 1994 became one of two Financial Controllers of BIB with responsibility for BIB Group statutory, regulatory and management reporting. |
| Valerie Thomas | Compliance Officer, BIB; Assistant Director, BSL | Joined Barings from the SFA in 1992 as Head of Compliance Department for BSL London office. Role was extended in 1993 to include overseeing BSL's global compliance arrangements. |
| Andrew Tuckey | Deputy Chairman, Barings plc; Chairman, BIB | Joined Barings in 1968 in Corporate Finance. Had a range of responsibilities in Corporate Finance and International Capital Markets becoming Chairman of BB&Co in 1989. Became Chairman of BIB on its formation. |
| Mary Walz | Global Head of Equity Financial Products, BIB; Director, BB&Co | Joined Barings in July 1992. Worked with Ron Baker to develop FPG. |

| Name | Responsibility | Other Relevant Details |
|---------------------------------------|--|---|
| Coopers & Lybrand (London) | | |
| Gareth Davies | Partner, London | Partner with responsibility for audit of Barings plc and BIB. |
| Duncan Fitzgerald | Manager, London | Manager responsible for 1994 audit of BSL. |
| Michael Higgin | Partner, London | Senior partner, Banking Practice. |
| Peter Smith | Partner, London | Senior partner, United Kingdom. |
| Andrew Turner | Partner, London | Second partner, primarily responsible for 1994 audit of BSL. |
| Bank of England | | |
| Roger Barnes | Former Head of Banking Supervision | Head of Banking Supervision from April 1988 until August 1993. |
| Michael Foot | Deputy Director, Supervision and Surveillance | Appointed Head of Banking Supervision in September 1993 and Deputy Director of Supervision and Surveillance (the equivalent position post reorganisation) in July 1994. Responsible for the five Supervision and Surveillance divisions. Reporting directly to Quinn. |
| John Mackintosh | Former Analyst, Supervision and Surveillance | Analyst responsible for Barings from March 1993 to April 1994. |
| Brian Quinn | Executive Director, Banking Supervision | Appointed in April 1988. Had ultimate responsibility for function and running of the Division. |
| Carol Sergeant | Head of Major UK Banks Supervision | Appointed in March 1993. As head of one of the five Supervision and Surveillance Divisions, was responsible for setting objectives of Senior Managers and dealing with policy issues or referred problems. |
| Christopher Thompson | Senior Manager, Merchant Banks, Major UK Banks Supervision | Appointed manager in Banking Supervision in April 1991. Manager responsible for Barings from that date. |
| Howard Walwyn | Analyst, Supervision and Surveillance | Joined Supervision Division in 1994. Took over from Mackintosh as analyst supervising Barings in April 1994. |

| Name | Responsibility | Other Relevant Details |
|-------------------|--|--|
| SFA | | |
| Rupert Armistead | Former SFA employee | Former SFA Team Manager responsible for supervising Barings. Left SFA in August 1994. |
| Pam Chambers | Senior Supervisor, Information Unit | Interviewed for technical background only. |
| Matthew Dunster | Policy Assistant, Policy Division | Interviewed for technical background only. |
| Richard Farrant | Chief Executive | |
| Vicki Fitt | Deputy Director - Risk Assessment, Surveillance Division | Interviewed for technical background only. |
| Nick Gibson | Assistant Director, Surveillance Division | Joined Surveillance Division of Stock Exchange in 1984. Appointed Assistant Director in August 1994, taking responsibility for Barings. |
| David Gittings | Staff Director, Surveillance Division | Appointed Director of Surveillance in December 1993. Overall responsibility for the direction of SFA surveillance activities and running the surveillance operation. |
| Peter Haines | Deputy Director, Policy Division | Interviewed for technical background only |
| Les Hughes | Principal Investigator, Investigations Department | Joined Investigations Department in early 1994. Formerly manager of Individual Registration. |
| Sophie Hutcherson | Head of Financial Regulation, Policy Division | Interviewed for technical background only. |
| Stephanie James | Principal Inspector, Surveillance Division | Joined SFA in September 1992 as an inspector with Surveillance. Her team had responsibility for Barings from August 1994. |
| Alan King | Director of Enforcement | |
| Alison McMillan | Assistant Director/ Project Manager | Joined AFBD in 1988. Became Assistant Director of SFA in April 1991, with responsibility for Barings from May 1992 until she left in December 1993. |
| Mike O'Hagan | Assistant Director, Surveillance Division | Joined AFBD in 1987. Appointed Assistant Director in January 1994. Responsible for Barings from January 1994 to July 1994. |

| Name | Responsibility | Other Relevant Details |
|------------------------|--|---|
| SFA (continued) | | |
| Carol Raymond | Team Manager, Surveillance Division | Joined TSA in 1990. Became a team manager in August 1993, and team manager responsible for Barings in August 1994, succeeding Armistead. |
| John Simmons | Senior Manager, Information Unit | Interviewed for technical background only. |
| Sarah Varney | Former SFA employee | Joined SFA in November 1991 as inspector in Surveillance Division. Was in team responsible for Barings for six months prior to leaving the SFA in April 1994. |
| Chris Woodburn | Chief Operating Officer | Became Chief Operating Officer of the SFA in April 1991. |

Note: The SFA was formed in April 1991 when the TSA merged with the AFBD. Prior to that the TSA had combined with the Surveillance Division of the Stock Exchange.

APPENDIX II LIST OF OTHER PEOPLE REFERRED TO IN THE REPORT

| Name | Responsibility |
|-----------------------------|--|
| Gerald Ashley | Former Manager, Treasury and Trading |
| James Bax | Regional Manager South Asia, BIB; Director, BFS; Managing Director, BSS |
| Andrew Bayliss | Former Deputy Chairman, BSL |
| Philippe Bonnefoy | EBT trader |
| Gordon Bowser | Risk Manager, Hong Kong |
| Adrian Brindle | FPG Trader, Tokyo |
| Eric Chang | BFS Floor Trader |
| Geoff Clark | BSGT personnel |
| Rt Hon Kenneth Clarke QC MP | Chancellor of the Exchequer |
| Mark Cooke | Former Regulatory Reporting employee, BIB |
| David Crookston | Financial Controller, BIB |
| William Daniel | Branch Manager, BSJ |
| Nigel Davis QC | Counsel to the inquiry |
| Gary Dolman | Regulatory Reporting, BIB |
| Richard Evans | Derivatives and Risk Management adviser to the inquiry |
| Mike Finlay | Futures and Options Settlements clerk, London |
| Mark Fisher | Senior FPG employee; Director, BB&Co |
| Jon Foulds | Independent member of BoBS |
| Benjamin Fuchs | FPG Trader, Tokyo |
| Eddie George | Governor of the Bank |
| Peter Gerrard CBE | Independent member of BoBS |
| Sir Alan Hardcastle | Independent member of BoBS |
| Norhaslinda Hassan | Senior Settlements Clerk, BFS |
| Lynn Henderson | Former Assistant Director, Finance |
| Richard Hogan | Managing Director SLK |
| Peter Hynd | Assistant Director, IT |
| Andrew Jennings | Former Senior Director and Head of Surveillance of SFA |
| Roy Johnson | Company Secretary, BSL |
| Simon Jones | Regional Operations Manager South Asia; Chief Operating Officer, BSS; Director, BFS |
| Nisa Kader | BFS Settlements Clerk, Singapore |
| Philip Kelly | Former Bank analyst |
| Khoo Kum Wing | Partner, C&L Singapore |
| Rob Leaning | BFS Floor Trader |
| Nick Leeson | Former Head Trader and General Manager, BFS |
| Ian Martin | Former Finance Director, BSL |
| Sheila Millbank | Head of Personnel; Assistant Director, BB&Co |
| Alexander Murray | Former Barings employee |
| Heather Nicol | Senior FPG employee, New York; Director, BB&Co |
| Jeremy Palmer | Head of Baring Securities Hong Kong; Director, BSL |
| Rupert Pennant-Rea | Former Deputy Governor of the Bank |
| Helen Smith | Head of Market Risk, BIB |

| Name | Responsibility |
|-------------------------|---|
| Jeremy Stunt | Financial Control, BIB |
| Vincent Sue | Risk Manager, BSJ |
| Lord Swaythling | Independent Member of BoBS |
| Harry Taylor | Independent Member of BoBS |
| Mike Thoms | FPG personnel, Hong Kong; Director, BB&Co |
| Trevor Wallace | Futures and Options Settlements clerk |
| Ian Watt CBE | Head of the Bank's Special Investigation Unit |
| Sir Dennis Weatherstone | Independent Member of BoBS |
| Alan Wheat | Bankers Trust employee |
| Dr Edmund Wong | Independent systems consultant to BFS |
| Satoshi Yamada | Manager, Futures and Options Settlements, BSJ |
| Rachel Yong | Financial Controller, BSS |

APPENDIX III**ABBREVIATIONS**

| Abbreviation | Definition |
|---|---|
| Barings plc and its subsidiaries | |
| BAM | Baring Asset Management Limited |
| Barings | Baring Investment Bank or its component companies and operating units |
| BB&Co | Baring Brothers & Co., Limited |
| BFS | Baring Futures (Singapore) Pte Limited |
| Board | Board of Directors of Barings plc |
| BSB | Baring Sterling Bonds |
| BSHK | Baring Securities Hong Kong Limited |
| BSJ | Baring Securities (Japan) Limited |
| BSL | Baring Securities Limited |
| BSLL | Baring Securities (London) Limited |
| BSS | Baring Securities (Singapore) Pte Limited |
| Dillon Read | Dillon, Read & Co Inc |
| Barings Group or the Group | Barings plc and its subsidiaries |
| Other Barings entities | |
| BIB | Baring Investment Bank |
| BSGT | Baring Securities Group Treasury |
| FPG | Financial Products Group |
| GTR | Group Treasury and Risk |
| IBG | Investment Banking Group |
| SPG | Structured Products Group |
| Barings committees | |
| ALCO | Asset and Liability Committee |
| EXCO | Baring plc Executive Committee |
| MANCO | Management Committee |
| Baring miscellaneous | |
| BSINGCOLL | US Dollar segregated cash collateral account |
| Other miscellaneous | |
| Act | Banking Act 1987 |
| AFBD | Association of Futures Brokers and Dealers |
| Bank | Bank of England |
| BIS | Bank for International Settlements |
| BNP | Banque Nationale de Paris |
| BoBS | Board of Banking Supervision |

| Abbreviation | Definition |
|--|---|
| Other miscellaneous (continued) | |
| C&L | Coopers & Lybrand |
| CAD | Commercial Affairs Department, Singapore |
| CCB | Consolidated Capital Base |
| the Court | Singapore High Court |
| CRR | Counterparty Risk Requirement |
| D&T | Deloitte & Touche |
| E&Y | Ernst & Young |
| EBT | European Bank and Trust Limited |
| FCT | First Continental Trading Limited |
| FSA | Financial Services Act 1986 |
| IMRO | Investment Managers Regulatory Organisation |
| ING | Internationale Nederlanden Groep N.V. |
| the Inspectors | Singapore Inspectors |
| IOSCO | International Organisation of Securities Commissions |
| JGB | Japanese Government Bond |
| LCH | London Clearing House |
| LE | Large exposure |
| LED | EU Large Exposure Directive |
| LIFFE | London International Financial Futures Exchange |
| LSE | London Stock Exchange |
| MAS | Monetary Authority of Singapore |
| MoF | Japanese Ministry of Finance |
| MoU | Memorandum of Understanding |
| OMLX | OM London Exchange |
| OSE | Osaka Securities Exchange |
| OTC | Over-the-counter |
| PCS | Position Change Sheet |
| PIA | Personal Investment Authority |
| PRR | Position Risk Requirement |
| RFL | Reported Final Long Position |
| S&S | Supervision and Surveillance Division, Bank of England |
| SARS | Segregated Accounts Reporting Statement |
| SFA | Securities and Futures Authority |
| SFO | Serious Fraud Office |
| SIB | Securities and Investments Board |
| SIMEX | Singapore International Monetary Exchange |
| SIU | Special Investigation Unit |
| SLK | Spear, Leeds & Kellogg |
| SPAN | Standard Portfolio Analysis of Risk |
| SRO | Self regulatory organisation |
| SWIFT | Society for Worldwide Interbank Financial Telecommunications |
| TIFFE | Tokyo International Financial Futures Exchange |
| TSE | Tokyo Stock Exchange |
| WMSD | Wholesale Markets Supervision Division, Bank of England |

APPENDIX IV GLOSSARY OF TERMS

| Term | Definition |
|-----------------------------------|--|
| Advance margin (intraday margin) | Amount of cash or securities required to be deposited with a clearing house during the course of a trading day. Typically advance margin is only called during periods of increased volatility when end-of-day variation margin calls are expected to be high and the clearing house wants immediate funds from its members to pre-empt any credit concerns. |
| Aggregate portfolio risk position | A measure of the overall financial risk from a portfolio of derivative contracts determined by the SPAN margining system. |
| Arbitrage | Purchase of a security in one market and the simultaneous sale of the same or an equivalent security in the same or another market for the purpose of profiting from the price differential between the two markets as a result of prevailing conditions in those markets. |
| At best | An instruction to a dealer to buy or sell securities at the best available price obtainable in the market. |
| Back office | Those departments of a financial institution responsible for trade processing, settlement and other administration. |
| Bloomberg | Computer-based data dissemination service to the financial markets. |
| Broker dealer | An intermediary between market and investor which buys and sells securities on behalf of clients and takes positions in securities. |
| cc mail | A computerised electronic mail system linking Barings' offices around the world. |
| Clearing house | An institution which registers, monitors, matches and guarantees trades on a derivatives exchange and which carries out the financial settlement of those transactions. |
| Clearing member | A member firm of a futures clearing house. Each clearing member must also be a member of the relevant exchange. Clearing members may provide registration and settlement services on behalf of other exchange members who are not themselves clearing members. |
| Client account (customer account) | An account maintained by a clearing member on behalf of its customers for their trading in securities or derivatives. Regulatory agencies often require strict segregation of client account balances from the house account. Within Barings, transactions for client accounts were also known as agency business. See also house account. |

| Term | Definition |
|--------------------|---|
| Cross trade | A transaction whereby a dealer buys and sells the same securities or futures contracts either on behalf of two of his clients or between clients' accounts and the house account. In most exchanges, the trading rules require that this cross must be offered to the market in order to maintain transparency. |
| Delta | The theoretical change in the value of an option arising from a small change in the value of the underlying security, expressed in units of the underlying security. |
| Derivative | A contract of instrument that changes in value depending on the price movements in another instrument or index, e.g. future, option. |
| Electronic trading | A trading system whereby contracts are bought and sold by exchange members accessing the market and clearing house via computer terminals at remote locations. See Open-Outcry. |
| Equity balance | The net worth in an account carried by a broker or dealer. It equates to the mark-to-market valuation of all outstanding long and short positions, all margin deposited less any associated costs and commissions. |
| Euroyen | Yen denominated instrument traded outside the formal control of the Japanese monetary authorities. |
| Exercise price | See strike price. |
| Financial futures | Contracts to buy or sell a standard quantity of a specific financial instrument or index (or, in some cases, receive or pay cash based on the performance of an underlying instrument or index) at a pre-determined future date and at a price agreed through a transaction on an exchange. |
| Floor trader | A trader on the exchange floor who executes the orders of his firm's customers, who are not themselves exchange members. |
| Front office | The department of a financial institution where business is initiated. |
| Fungible contracts | Futures or options contracts which are interchangeable between two exchanges. Such contracts have identical specifications and the two exchanges have agreed that such contracts may be settled on either exchange. |
| Gamma | The rate of change of an option's delta with respect to price changes. |
| Hedge fund | A collective investment fund which takes large, and often leveraged, risk with the aim of producing a high return on capital. |

| Term | Definition |
|------------------------|---|
| Hedgers | A generic term for users of derivative instruments whose primary purpose is to reduce their risk exposure. |
| House account | An account maintained by a securities dealer to record transactions undertaken on the dealer's own account for his profit or loss. The house account is used to separate such transactions from those undertaken for clients. |
| Implied volatility | A measure of volatility of the underlying security determined by reference to the market price of options. |
| Initial margin | The amount of cash or securities to be deposited at a clearing house to establish a futures or options position. Initial margin is established at a level estimated as sufficient to enable a clearing member to meet its obligations should it fail to pay variation margin at the end of the day. See variation margin. |
| JGB | Japanese Government Bond. |
| JGB Future 10 Years | A futures contract traded on SIMEX, TSE and LIFFE based on JGBs with 10 years to maturity and with a standardised coupon of 6%. |
| Journal | Accounting entry generated from outside of the normal accounting system e.g. adjustments. |
| Local | A dealer who risks his own capital on a derivatives exchange. The participation of locals is generally held to promote liquidity on an exchange. |
| Long position | A long position is held by a net holder or buyer of an instrument. It appreciates in value when the market price increases. Note that a holder of a put option is long the contract but profits when the underlying market declines. |
| Management letter | Letter issued by auditors to the management of their client detailing internal control weaknesses identified during the course of audit work along with recommendations for improvement. |
| Margin | Cash or securities deposited with an exchange both as a form of collateral and a way of settling realised and unrealised profit and loss on positions. Margin also attempts to ensure that clearing members have sufficient resources to support open positions. |
| Margin call | A demand from an exchange, or from a broker or dealer carrying a customer's position, for additional cash or collateral in respect of a position. |
| Mark-to-market | The valuation of a securities portfolio to current market prices. |
| Matched positions | Equal and offsetting long and short positions. |

| Term | Definition |
|-----------------------------|---|
| Nikkei 225 | An index based on 225 Japanese stocks traded on the Tokyo Stock Exchange. The most widely followed index in Japan and the basis for the major Japanese equity derivatives contracts. |
| Nikkei 225 future | A futures contract based on a multiple of times the Nikkei Stock Index traded on OSE and SIMEX. The contract specification is different between the two exchanges. |
| Nikkei 225 option | An option contract based on the Nikkei 225 future traded on OSE and SIMEX. The contract specification is different between the two exchanges. |
| Non-clearing member | A member of an exchange who is not also a member of the associated clearing house. Non-clearing members generally do not have sufficient capital to satisfy the requirements for clearing membership and their trades are registered and settled in the name of a clearing member. |
| Open outcry | A trading method where trading takes place in a designated physical area of the exchange within an agreed time period. Prices are agreed by traders on the floor of the exchange, after which both traders complete a deal ticket to record the transactions. These tickets are matched by exchange officials, after which the deal is recorded. |
| Open positions | A position in futures and options, either long or short, not matched by offsetting transactions or satisfied by delivery. |
| Option on financial futures | Options on financial futures take two forms: put or call options. Put options are contracts sold for a price (the premium) that gives the holder the right, but not the obligation, to sell to the writer of the contract, over a pre-defined time period, a specified quantity of futures contracts at a specified price (the strike price). Call options are similar contracts sold for a price that gives the holder the right, but not the obligation, to buy from the writer of the option. By their nature, options give rise to different risk profiles between buyers and sellers. Options buyers are exposed to limited loss, but theoretically unlimited profits. Option writers (sellers) in contrast have limited profit opportunities but potentially unlimited loss. |
| OSE | Osaka Securities Exchange, a derivatives exchange offering contracts on the Nikkei Stock Indices. |
| Out-trade | A disputed transaction between two floor traders where the two deal tickets do not agree in detail (e.g. price or quantity). Such trades are not recorded by the exchange until the dispute is resolved. |
| Over-the-counter (OTC) | A security or other instrument that is not traded on an organised exchange. OTC instruments can be created with any provisions allowed by law and acceptable to counterparties. |

| Term | Definition |
|---------------------|--|
| Position | A holding of an instrument. See long position, short position. |
| Premium | The price paid for an option contract at the time of its purchase. |
| Pricing model | In the context of options, a mathematical model, with variables of time, interest rate, volatility and underlying prices used to determine theoretical option prices. Various models have been developed and are used as the basis of computer software to evaluate trading results and develop trading strategies. |
| Proprietary trading | Generally used to describe risk positions for an institution's own account as principal and distinct from client business. |
| Settlement | The process by which a trade is entered onto the books and records of all the parties to the transaction including brokers or dealers, a clearing house, any other financial institution with a stake in the trade. Also the completion of any required payment between two parties to discharge an obligation. |
| Short position | A short position is held by a net seller of an instrument. It appreciates in value when the underlying market price declines, e.g. selling a future. Note that a seller of a put option benefits from an increase in the price of the underlying market or instrument. |
| SPAN margining | Standard Portfolio Analysis of Risk. A system of determining margin used by SIMEX, and some other derivative exchanges. SPAN margining uses statistical models to determine the margin required against individual members' positions using simulations of maximum foreseeable adverse movements in price. |
| Specialist | Member of the New York Stock Exchange who maintains orderly and continuous markets in designated stocks. |
| Speculators | Generic term for traders whose primary purpose is to achieve profits from anticipating price movements. |
| Straddle | An option position achieved by combining a put and call option on the same underlying instrument and with the same strike price. Sellers of straddles anticipate that the underlying price will stay close to the level of the strike price of the options they have sold, or that the volatility of the price will be less than implied in the option prices. |
| Strike price | The price or rate at which an option begins to have a settlement value. The strike price or rate is usually set at the time the option contract originates. |

| Term | Definition |
|------------------------------|--|
| Switching | See Arbitrage. In the case of Barings, this activity typically involved the simultaneous purchase and sale of the same futures contracts on the different futures exchanges. |
| Three month Euroyen contract | A futures contract traded on SIMEX and TIFFE based on the three month interest rate for Euroyen. |
| Theta | The change in value of an option with respect to a decrease in its remaining time to expiry. |
| Tick | The minimum unit of price change of a futures contract |
| Trilateral meeting | Meetings attended by the Bank of England, an authorised institution and the institution's auditors. |
| Variation margin | The amount of cash paid or received by the exchange to reflect changes in the unrealised profit on open futures positions. |
| Vega | The change in value of an option with respect to changes in the volatility of the underlying instrument. |
| Volatility traders | A generic term for traders who trade the volatility parameter inherent in option prices. |

APPENDIX V PRODUCT DESCRIPTIONS

| CONTRACT | NIKKEI 225 STOCK AVERAGE FUTURE OSE | NIKKEI 225 STOCK AVERAGE FUTURE SIMEX | OPTION ON NIKKEI 225 STOCK AVERAGE FUTURE SIMEX |
|------------------------------------|--|--|---|
| <i>Trading Unit (¥)</i> | 1,000 times Nikkei 225 price | 500 times Nikkei 225 Stock Average Futures price | 1 SIMEX Nikkei 225 Futures contract |
| <i>Minimum Price Movement</i> | 10 index points | 5 index points | 5 index points |
| <i>Tick Size & Value</i> | ¥10,000 | ¥2,500 | ¥2,500 |
| <i>Contract Months</i> | Mar, Jun, Sep, Dec cycle (5 contract months listed at all times) | Mar, Jun, Sep, Dec | Three serial months & Mar, Jun, Sep & Dec contracts listed on a five quarterly-month cycle |
| <i>Last Trading Day</i> | One business day before the second Friday of the contract month | One business day before the second Friday of the contract month | One business day before the second Friday of the contract month |
| <i>Initial Margin Requirements</i> | For Members, initial margin is 10% of the transaction value. For Clients, initial margin is 15% of the transaction value (of which at least one fifth must be cash). When the initial margin has been eroded by more than 3% the Member will call the Client for additional margin. | ¥906,250 per contract on a stand-alone basis. However, SIMEX uses a SPAN system (almost identical to the Chicago Mercantile Exchange's SPAN system), which calculates margin calls on a daily basis based on the aggregate position (gross for initial margins & net for variation margins) and current market volatilities. | The buyer of the option pays the full premium in cash immediately. The seller of the option posts margin of roughly the size of the premium received, if this were the seller's only position. However, a short options position as part of a portfolio would be subject to the SPAN margining system. |

| CONTRACT | 3 MONTH EUROYEN FUTURE (SIMEX) | 3 MONTH EUROYEN FUTURE (TIFFE) | 10 YEAR JAPANESE GOVERNMENT BOND (JGB) FUTURE SIMEX | 10 YEAR JAPANESE GOVERNMENT BOND (JGB) FUTURE TSE |
|------------------------------------|--|---|---|--|
| <i>Trading Unit</i> (¥) | ¥100 million | ¥100 million | Standardised 6% 10-yr JGB with a face value of ¥50 million | Standardised 6% 10-yr JGB with a face value of ¥100 million |
| <i>Minimum Price Movement</i> | 0.01 | 0.01 | 1/100 point | 1/100 point |
| <i>Tick Size & Value</i> | ¥2,500 | ¥2,500 | ¥5,000 | ¥10,000 |
| <i>Contract Months</i> | Mar, Jun, Sep & Dec (contracts listed on a three year cycle) | Mar, Jun, Sep & Dec (contracts listed on a two year cycle) | Mar, Jun, Sep & Dec cycle (5 contract months at all times) | Mar, Jun, Sep & Dec cycle (5 contract months at all times) |
| <i>Last Trading Day</i> | Second business day immediately preceding the third Wednesday of the contract month | Second business day immediately preceding the third Wednesday of the contract month | First business day immediately preceding the TSE JGB Futures' last trading day | Ninth business day prior to each delivery date |
| <i>Initial Margin Requirements</i> | ¥54,000 per contract on a stand-alone basis (subject to overall SPAN margining system) | ¥80,000 per contract for clients & ¥50,000 per contract for members | ¥877,500 per contract on a stand-alone basis (subject to overall SPAN margining system) | 2% of nominal transaction value for members. The higher of 3% of nominal transaction value or ¥6 million for clients (of which at least one third must be in cash) |

APPENDIX VI DETAILS OF EXCHANGES

| SINGAPORE INTERNATIONAL MONETARY EXCHANGE (SIMEX) | OSAKA SECURITIES EXCHANGE (OSE) | TOKYO STOCK EXCHANGE (TSE) | TOKYO INTERNATIONAL FINANCIAL FUTURES EXCHANGE (TIFFE) |
|--|--|---|---|
| <p>1 Raffles Place, OUB Centre # 07-00, 0104 Singapore Tel: 65-535-7382 Fax: 65-535-7282 Tlx: 38000</p> <p><i>Executives</i> Chairman: Elizabeth Sam President: Ang Swee Tian Senior Vice-President, Operations: Wong Penn Kong</p> <p><i>Established</i> September 1984</p> <p><i>Members</i> • (corporate clearing) 39, • (corporate non-clearing) 30, • (commercial associate) 12</p> <p><i>Method of trading</i> Open outcry</p> | <p>8-16 Kitahama 1-chome, Chuo-ku, Osaka 541, Japan Tel: 81-(6)-229-8643 Fax: 81-(6)-231-2639 Tlx: 522-2215</p> <p><i>Executives</i> President: Kyoji Kitamura Senior Executive Governors: Takao Tsutsumi, Akira Shintaku, Takuo Noguchi</p> <p><i>Established</i> April 1949</p> <p><i>Members</i> • (regular) 117 • (special participants for futures & options) 4 • (Nakadachi member) 1</p> <p><i>Method of trading</i> Screen</p> | <p>2-1 Nihombashi-Kabuto-cho, Chuo-ku, Tokyo 103, Japan Tel: 81-(3)-3666-0141 Fax: 81-(3)-3663-0625 Tlx: 02 522759 tkose</p> <p><i>Executives</i> President: Mitsuhide Yamaguchi Deputy President: Kenichi Isaka</p> <p><i>Established</i> 1949</p> <p><i>Members</i> • (regular) 124 • (special participants for futures & options) 151</p> <p><i>Method of trading</i> Screen (all derivatives)</p> | <p>1-3-1 Marunouchi 1-chome, Chiyoda-ku, Tokyo 100, Japan Tel: 81-(3)-5223-2400 Fax: 81-(3)-5223-2450</p> <p><i>Executives</i> Chairman & President: Taroichi Yoshida Senior Managing Director: Mamoru Minakuchi Managing Director: Takashi Okada</p> <p><i>Established</i> April 1989</p> <p><i>Members</i> • (trading & clearing) 111 • (trading only) 105</p> <p><i>Method of trading</i> Screen</p> |

| SINGAPORE INTERNATIONAL MONETARY EXCHANGE (SIMEX) | OSAKA SECURITIES EXCHANGE (OSE) | TOKYO STOCK EXCHANGE (TSE) | TOKYO INTERNATIONAL FINANCIAL FUTURES EXCHANGE (TIFFE) |
|--|---|---|---|
| <p><i>Futures contracts cleared:</i></p> <ul style="list-style-type: none"> • 3-mth Eurodollar Interest Rate Future • Option on 3-mth Eurodollar Interest Rate Future • 3-mth Euroyen Interest Rate Future • Option on 3-mth Euroyen Interest Rate Future • 3-mth Euromark Interest Rate Future • Currency Futures (£, DM, Yen) • Deferred Spot Currency Futures (DM, Yen) • Nikkei 225 Stock Average Future • Option on Nikkei 225 Stock Average Future • 10-yr Japanese Govt. Bond (JGB) Future • Gold Future • High Sulphur Fuel Oil Future • Gasoil Future • MSCI Hong Kong Index Future | <p><i>Futures contracts cleared:</i></p> <ul style="list-style-type: none"> • Nikkei 225 Stock Index Future • Nikkei 225 Stock Index Option • Nikkei 300 Stock Index Future • Nikkei 300 Stock Index Option | <p><i>Futures contracts cleared:</i></p> <ul style="list-style-type: none"> • 10-yr Japanese Govt. Bond (JGB) Future • Option on 10-yr JGB Future • 20-yr JGB Future • Tokyo Stock Price Index Future (TOPIX) • Option on TOPIX • US Treasury Bond Future | <p><i>Futures contracts cleared:</i></p> <ul style="list-style-type: none"> • 3-mth Euroyen Interest Rate Future • Option on 3-mth Euroyen Interest Rate Future • 1-yr Euroyen Interest Rate Future • 3-mth Eurodollar Interest Rate Future • US\$/Yen Currency Future |

| SINGAPORE INTERNATIONAL MONETARY EXCHANGE (SIMEX) | OSAKA SECURITIES EXCHANGE (OSE) | TOKYO STOCK EXCHANGE (TSE) | TOKYO INTERNATIONAL FINANCIAL FUTURES EXCHANGE (TIFFE) |
|---|--|--|--|
| <p><i>'House' & 'client' account margining rules:</i></p> <p>'House' and 'client' accounts are treated separately, and both are margined on a gross basis.</p> | <p><i>'House' & 'client' account margining rules:</i></p> <p>Each member maintains a single account but members are not allowed to net 'client' positions. So effectively there is net margining for the member's one account, including the 'house' account, and gross margining for all the 'client' accounts.</p> | <p><i>'House' & 'client' account margining rules:</i></p> <p>Each member maintains a single account but members are not allowed to net 'client' positions. So effectively there is net margining for the member's one account, including the 'house' account, and gross margining for all the 'client' accounts.</p> | <p><i>'House' & 'client' account margining rules:</i></p> <p>'House' & 'client' accounts are margined separately, with effectively net margining for the 'house' account and gross margining for the 'client' account.</p> |
| <p><i>Timing of margin payments:</i></p> <p>Margin flows to & from the Exchange are on T+1 for US\$ & T+2 for ¥ (Initial margin on ¥ denominated contracts can be posted in US\$, but variation margin must be in ¥).</p> | <p><i>Timing of margin payments:</i></p> <p>Margins are due from clients to their member on T+2 and from the member to the exchange (& vice versa) on T+3.</p> | <p><i>Timing of margin payments:</i></p> <p>Margins are due from clients to their member on T+2 and from the member to the exchange on T+3 (although payments from the exchange back to members are for value T+4).</p> | <p><i>Timing of margin payments:</i></p> <p>All margins are due to (and from) the exchange on T+1.</p> |

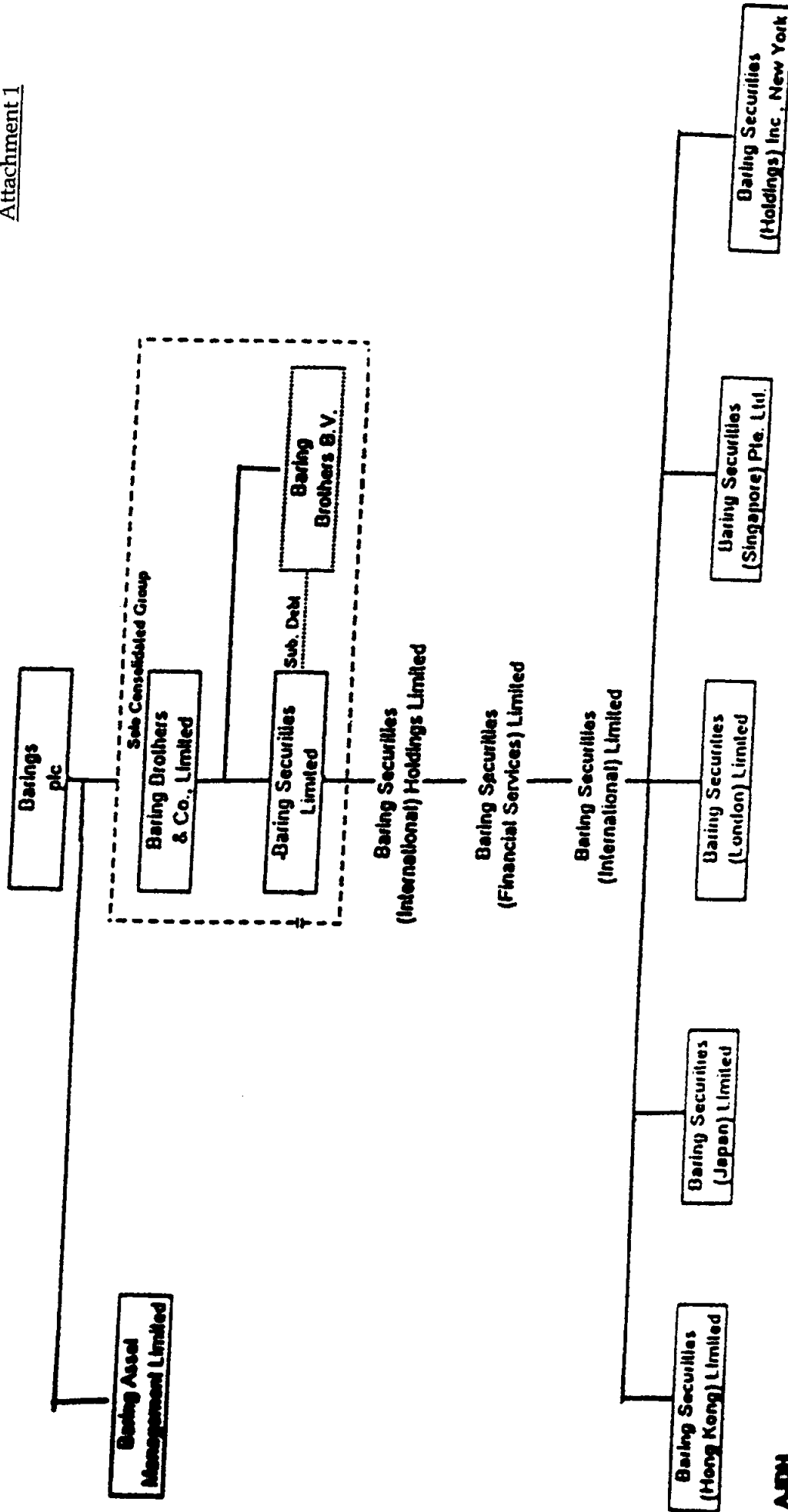
APPENDIX VII CORPORATE STRUCTURE OF BARINGS GROUP

- Attachment 1: Simplified Barings Group Structure showing main Baring Securities companies.
- Attachment 2: Simplified Barings Group Structure showing the relevant regulatory bodies.
- Attachment 3: Barings Group Structure showing the whole BB&Co sub-group.
- Attachment 4: Barings Group Structure showing the whole BAM sub-group.

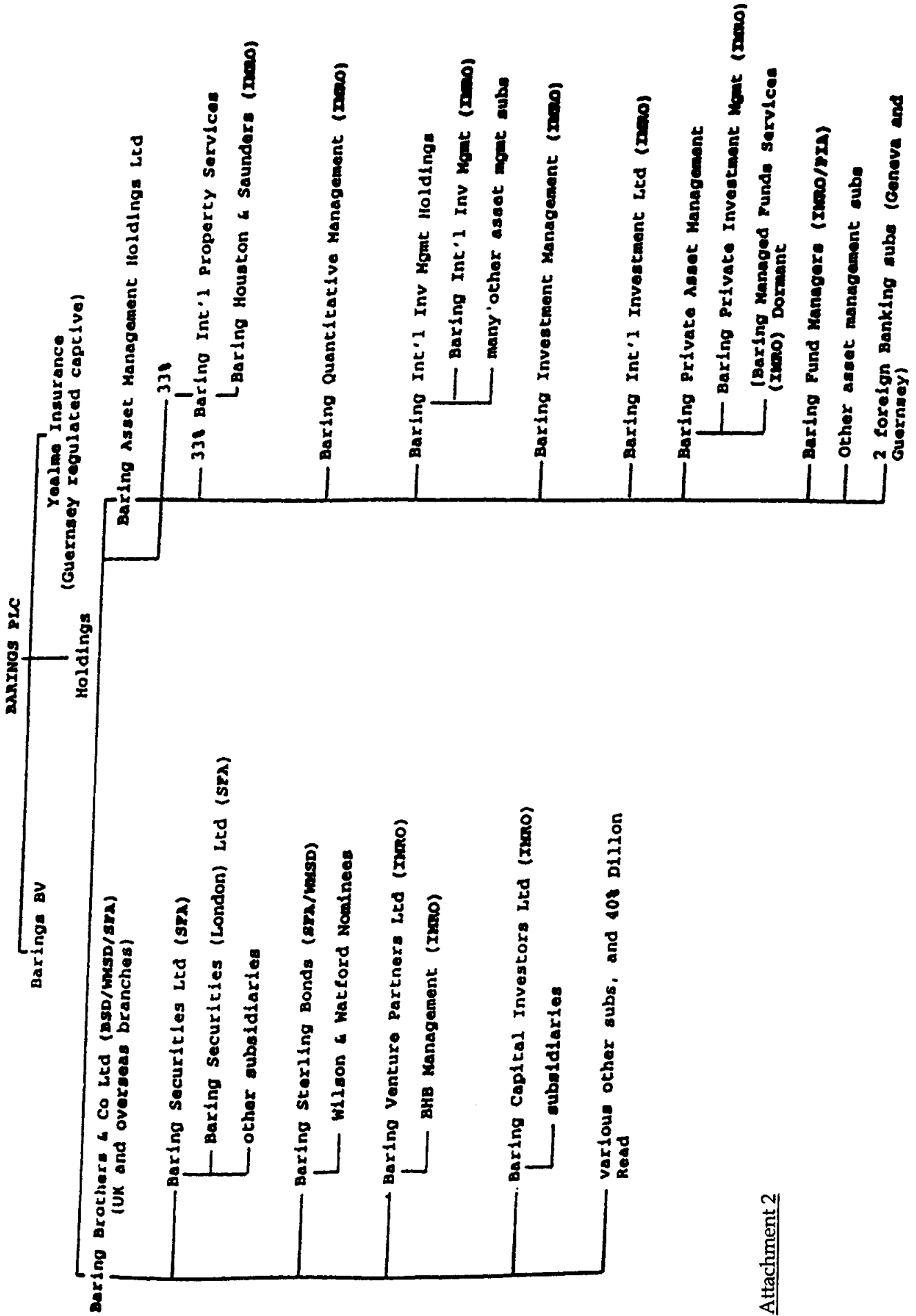
All the attachments were provided to the Inquiry by the Barings Company Secretary.

SIMPLIFIED BARINGS GROUP STRUCTURE SHOWING MAIN BARING SECURITIES COMPANIES

Attachment 1



AJDN
22.8.83



Attachment 2

APPENDIX VIII MEMORANDUM OF UNDERSTANDING BETWEEN THE SECURITIES AND FUTURES AUTHORITY AND THE BANK OF ENGLAND ON THE FINANCIAL SUPERVISION OF BANKS

1 This memorandum sets out the framework agreed between the Bank and SFA for the assessment and monitoring of the financial soundness of entities which are both authorised under the Banking Act 1987 and authorised under the Financial Services Act 1986, and which are incorporated in the UK (or UK partnerships). The arrangements reflect the recognition by SFA and the Bank of the desirability of avoiding the duplication of assessment of financial soundness and of its monitoring. They do not affect the statutory position under the Banking Act and the Financial Services Act that both authorities remain responsible for ensuring that each institution which it has authorised remains fit and proper.

2 On the application of a bank for authorisation by SFA, SFA will promptly notify the Bank of the application and will discuss with the Bank whether the bank concerned is fit and proper from the point of view of capital adequacy, liquidity and other matters relating to financial soundness.

3 If SFA proposes to grant the application, the bank concerned may apply to SFA for the SFA's financial regulation rules (as set out in Chapter III of SFA's rule book) to be modified.

SFA and the Bank will require adequate capital to be maintained at all times, and banks will be liable to spot checks between reporting dates.

All banks will remain subject to certain of the Financial Regulations, (eg the rules concerning Accounting Records) and to all other rules, including the Conduct of Business Rules and Client Money Regulations. Similarly, all banks will remain subject to all the Bank's requirements. For example, all banks will remain subject to the Bank's requirements in respect of large exposures and liquidity.

4 In all cases SFA and the Bank agree that the Bank should be "lead regulator". The capital position of banks will therefore be monitored by the Bank and a quarterly report will be made by the Bank to SFA. This report will state whether or not the relevant requirement was satisfied at the quarter date and, to the best of the Bank's knowledge, throughout the quarter. It will also include a summary balance sheet and information relevant to the investment business being carried on by the bank. A proforma of this return is attached as an appendix to this memorandum.

SFA expects that, although these reports will no doubt sometimes give rise to queries which will need to be answered (which where necessary will be referred to the bank concerned by the Bank), they will normally be adequate in themselves to satisfy SFA that the bank is in compliance with the agreed requirement. In particular, SFA does not expect to need to know details of the bank's banking business as long as the agreed requirement continues to be satisfied.

5 If and when situations occur in which a bank begins to give rise to concern to either the Bank or SFA, there will be close consultation and a much fuller sharing of information between the two authorities. In such cases, SFA will need sufficient information to form a judgment whether action to protect the interests of investors is necessary and whether the bank remains fit and proper.

6 If, as lead regulator, the Bank at any time becomes aware that its capital test has been or is likely to be breached or material concerns otherwise arise relating to the bank's financial soundness, the Bank will immediately inform SFA. Similarly, SFA would inform the Bank if it was the first to become concerned. Concerns which would be expected to give rise to consultation include (but would not be limited to):

- Concerns about the financial soundness (including liquidity) of a bank;
- Concerns about the compliance or control procedures of the bank which are relevant to the bank's investment business;

- Concerns arising from supervisory visits, prudential interviews or reports of the bank's auditors;
- Concerns arising from late or inaccurate prudential returns.

In such cases the Bank would establish the position with the bank concerned and discuss with the bank its plans. The Bank and SFA would then meet to consider the position. It is likely that in many cases SFA would not need to know the full details of the position on the banking side, although it would need to know sufficient to be able to satisfy itself, taking into account the Bank's expertise in assessing problems on the banking side, that the necessary action was being taken. In the unlikely event of their not being of one mind as to the action to be taken, SFA would retain the right to act in accordance with its responsibilities and powers. This would include right of access to all information relating to the bank's business. However, in the case of any initial disagreement between the Bank and SFA on the necessary action, there would be urgent reference to senior levels in both organisations to try to seek an agreed view before any decision was made by SFA to intervene with a bank directly as a result of concerns relating to financial soundness.

7 The framework set out in this memorandum and the detailed arrangements made under it will be subject to regular review by SFA and the Bank (in consultation with the SIB).

April 1991

Quarterly report from the Bank to SFA for a bank member (to be submitted within one month of quarter date).

Name of Bank =

Quarter Date =

1 Submission of Returns

| | | |
|---|-----|----|
| Have all prudential returns due in the quarter been received? (Specify any which have not been) | Yes | No |
|---|-----|----|

2 Capital Position

As at []

| | | |
|--|-----|----|
| (i) The bank exceeded its target risk asset ratio at the quarter date. | Yes | No |
|--|-----|----|

| | | |
|---|-----|----|
| and (ii) To the best of the Bank's knowledge, throughout the quarter. | Yes | No |
|---|-----|----|

| | | |
|--|-----|----|
| Has the target or trigger risk asset ratio been amended since the previous quarter date? | Yes | No |
|--|-----|----|

3 Summary balance sheet as at []

| (a) | <u>Liabilities</u> | <u>Assets</u> |
|-----|--------------------------|-----------------------------|
| | Share Capital | Cash and balance with |
| | Subordinated loans | Bank of England |
| | Reserves | Deposits etc with banks |
| | Liabilities to banks | Loans to non-banks |
| | liabilities to customers | Investments in subsidiaries |
| | Other Liabilities | Securities and other |
| | | investment positions |
| | | Other assets |
| | TOTAL LIABILITIES | TOTAL ASSETS |

(b) Contingents and commitments

NIFs/RUFs
 Other contingents and commitments
 Aggregate net short open foreign exchange position

4 Prudential interviews over the last quarter

Date of interview(s)

Principal points, including indications as to future development, (if any) arising in relation to:

- Securities, futures and options business
- Investment management business
- Commodity swaps business
- Internal control systems relating to securities, futures, options and/or investment business.

| | | |
|---|-----|----|
| Is there an interview planned for the next quarter? | Yes | No |
|---|-----|----|

5 General

| | | |
|---|-----|----|
| To the best of the Bank's knowledge have all matters which are specified in the memorandum of understanding, and such other matters as may be relevant to SFA's supervision of the bank's investment business been notified to SFA? | Yes | No |
|---|-----|----|

Signatures

.....

Date

APPENDIX IX ACCESS TO INFORMATION IN SINGAPORE

Since the collapse of Barings, a number of individuals and entities based in Singapore have had control of access to relevant documentation and individuals. These were:

(a) Judicial Managers

On 27 February 1995, SIMEX petitioned the Singapore High Court for three partners of Price Waterhouse Singapore to be appointed Judicial Managers of BFS. The main grounds for the petition were that BFS had failed to pay a margin call of US\$43 million on 27 February 1995 to SIMEX. The Judicial Managers retained Rajah & Tann as their legal advisers in Singapore. The Judicial Managers retained custody of a majority of BFS's records;

(b) Inspectors

On 10 March 1995, the Minister of Finance in Singapore appointed two partners in Price Waterhouse Singapore to investigate the collapse of Barings under the Singapore Companies Act. The Inspectors were also advised by Rajah & Tann. The Inspectors have had wide ranging powers to obtain information in Singapore;

(c) SIMEX

SIMEX took over and liquidated all BFS positions after the collapse, and have been conducting an in-house investigation of breaches of their rules by BFS. SIMEX have had records of transactions executed by BFS, related margin calls and allocation of trades. SIMEX also had regulatory records of its supervision of BFS. We mainly communicated with SIMEX through their lawyers, Allen & Gledhill;

(d) Commercial Affairs Department

CAD were responsible for conducting the criminal inquiry into BFS's and Nick Leeson's activities in Singapore. They have had a number of relevant BFS documents under their control. CAD informed us at a meeting on 7 March 1995 that they would not disclose any BFS information to us without the permission of the Judicial Managers. Dealings with Judicial Managers on gaining access to BFS records are detailed in Section 1 below.

We have set out below, in a summary form, a chronology of our negotiations with these various Singaporean parties in order to obtain access to information on BFS's affairs. The chronology is set out in separate sections. The first section documents dealings with Judicial Managers and Inspectors. The second section sets out dealings with SIMEX.

1. Negotiations with the Judicial Managers and the Inspectors

| Date | Event |
|---------------|---|
| 7 March 1995 | Meeting with the Judicial Managers. We explained the scope of BoBS' inquiry and we provided a list of preliminary information requirements. The Judicial Managers said it would be difficult to disclose information without approval from the Court. |
| 9 March 1995 | Meeting with the Judicial Managers to discuss our information requirements. Rajah & Tann put forward the terms under which information would be disclosed to us. They provided a draft balance sheet of BFS as at 24 February 1995, adjusted for any liquidation of trading positions. |
| 10 March 1995 | <p>Meeting with Rajah & Tann. We were informed that Inspectors had been appointed by the Minister of Finance in Singapore, and that the Judicial Managers and the Inspectors would be requesting assistance from the UK authorities. They provided us with a preliminary list of information required by the Judicial Managers and the Inspectors from us.</p> <p>Rajah & Tann provided information on funding of BFS and its trading positions. They requested a draft letter setting out our formal information request which they would then review and provide comments on.</p> |
| 11 March 1995 | Draft letter of information required by us sent to Rajah & Tann. |
| 13 March 1995 | <p>We provided to Rajah & Tann a more detailed list of information required by BoBS.</p> <p>At a meeting, Rajah & Tann asked to see our terms of reference of the Barings Inquiry in order to consider our information requirements.</p> |
| 14 March 1995 | <p>Telephone conversation between Rajah & Tann and Norton Rose (BoBS' lawyers) to discuss BoBS' terms of reference. Rajah & Tann needed to understand our terms of reference, purpose of inquiry, and what ability BoBS would have to disclose information received from them. Norton Rose informed them that BoBS would be able to release under UK law any information gathered by them in the UK, subject to certain legal constraints under the UK Banking Act 1987.</p> <p>Norton Rose needed to understand terms of appointment of the Inspectors to progress with their information requests. Rajah & Tann stated that their terms of reference were set out in a press release made on 10 March 1995, and their responsibilities were set out in the Singapore Companies Act.</p> |

| Date | Event |
|----------------------|---|
| | We received a letter from Rajah & Tann confirming the documents that had already been provided to BoBS as of that date and setting out the terms of disclosure. |
| 16 March 1995 | We were informed by Bax that the Inspectors and Judicial Managers had ordered him and other BFS employees not to disclose any BFS information to us. Rajah & Tann later confirmed this restriction in a telephone call to us, and stated that we needed to obtain approval from the Court before any disclosure of documents or access to BFS employees would be allowed. |
| 17 March 1995 | Meeting between David Chong & Co (BoBS' lawyers in Singapore) and Rajah & Tann, where it was agreed that BoBS' terms of reference and reasons for requesting BFS information be put in a letter to the Judicial Managers. This letter would be used by Judicial Managers as a basis for an application that they would make to the Court. |
| 21 March 1995 | Meeting with Rajah & Tann, where they were provided with a draft letter setting out BoBS' terms of reference and responsibilities under the Act. |
| | Rajah & Tann expressed concern that the Court may not recognise BoBS' authority since it raised issues of extraterritoriality and jurisdiction. They ruled out public interest as a proper basis for providing us access to information, but indicated that they would explore benefit to creditors as a basis for the application. |
| | We confirmed to Rajah & Tann that the information they had requested from us on 10 March 1995 was available in the UK. |
| 24 March 1995 | Rajah & Tann informed us that the Inspectors would be travelling to the UK in the following week to negotiate access to information in the UK. |
| 28 March 1995 | A meeting was held in London at HM Treasury where representatives from the Department of Trade, Treasury and BoBS inquiry team met with the Singapore Inspectors. The Inspectors presented a formal request for information. |
| 29 and 30 March 1995 | Meetings with the Inspectors to explore various means of obtaining access into Singapore, and for them to obtain access into the UK. It was agreed that some information could be exchanged between BoBS and the Judicial Managers during the following week. |
| 30 March 1995 | David Chong & Co applied to inspect the Court file relating to BFS. Application rejected. |

| Date | Event |
|---------------|--|
| 3 April 1995 | <p>Rajah & Tann informed us that the application to the Singapore High Court should be brought by us and not by the Judicial Managers. This was contrary to what was said on 17 March.</p> <p>Judicial Managers not prepared to give copies of the documents on the Court file to us.</p> |
| 6 April 1995 | <p>We met with Rajah & Tann where we exchanged the information agreed on 30 March 1995.</p> |
| 7 April 1995 | <p>Draft copies of BoBS' application to the Court and supporting material was provided to Rajah & Tann for their review.</p> |
| 8 April 1995 | <p>David Chong & Co applied to the Court again and this time were allowed to inspect the Court file.</p> |
| 10 April 1995 | <p>Rajah & Tann called us to explain that they needed time to review the draft Court application and suggested that a copy of these documents should also be sent to SIMEX (since they were the petitioners).</p> |
| 11 April 1995 | <p>We met with Rajah & Tann to discuss the draft application to the Court. Rajah & Tann agreed with our approach and provided comments on various supporting material, which we agreed to process.</p> <p>Rajah & Tann also provided us with a letter which expressed concerns regarding confidentiality of information disclosed to us and recent press comments on Barings. The letter also raised certain queries about the draft application, which were discussed at the meeting.</p> |
| 12 April 1995 | <p>Rajah & Tann wrote to David Chong & Co expressing their strong feelings at not being informed of our gaining access to the Court file on 8 April 1995.</p> <p>David Chong & Co wrote to Rajah & Tann on the same day providing copies of documents that had been requested the previous day in Rajah & Tann's letter.</p> |
| 13 April 1995 | <p>David Chong & Co responded to Rajah & Tann's letter of 12 April.</p> |
| 18 April 1995 | <p>Norton Rose responded to Rajah & Tann's letter of 11 April 1995 relating to press comments and addressing the concern of onward disclosure of information received by BoBS from the Judicial Managers.</p> |

| Date | Event |
|---------------|---|
| 19 April 1995 | <p>Rajah & Tann informed us that the Judicial Managers would support BoBS' right to apply for directions, if the Court were to raise this as a potential technical impediment at the hearing for the Court directions. They also informed us that they had been given access in the UK to all the information that they were seeking from BoBS.</p> |
| 20 April 1995 | <p>Rajah & Tann wrote to David Chong & Co raising more issues in relation to the press comments set out in their letter of 11 April 1995.</p> <p>An application was made to the Court for it to direct the Judicial Managers to give:</p> <ul style="list-style-type: none"> <li data-bbox="564 696 1190 730">(a) us access to specified documents of BFS; <li data-bbox="564 763 1469 875">(b) a waiver in respect of the duty of confidentiality owed to BFS by each of the auditors and employees of BFS and SIMEX to provide us with information about BFS affairs. |
| 21 April 1995 | <p>Rajah & Tann wrote to Norton Rose stating that the Judicial Managers would neither oppose nor support our application but would leave the matter for the Court to decide. Any reservations they had had been communicated during the meeting on 11 April 1995.</p> <p>Norton Rose responded to the further concerns set out in Rajah & Tann's letter of 19 April 1995 relating to press comments. Norton Rose also further clarified issues relating to disclosure of any information supplied by the Judicial Managers.</p> |
| 27 April 1995 | <p>Hearing of BoBS application for direction commenced in the Court.</p> |
| 3 May 1995 | <p>The Court declined to give the directions sought and made no order on the application, principally because insufficient commercial benefit could be shown to accrue to BFS as a consequence of the proposed exchange of information.</p> |
| 4 May 1995 | <p>We approached Rajah & Tann to discuss ways of 'exchanging notes', which had been previously suggested by the Singaporean authorities as an alternative to the exchange of evidence originally sought. Rajah & Tann agreed to revert after taking instructions from the Inspectors.</p> |
| 5 May 1995 | <p>Rajah & Tann explained that the Inspectors were not aware of the suggestion to exchange notes. They needed time to discuss the matter internally.</p> |
| 9 May 1995 | <p>We wrote to Rajah & Tann suggesting an agenda for a proposed meeting on exchange of notes.</p> |

| Date | Event |
|--------------|--|
| 12 May 1995 | <p>Rajah & Tann wrote to us suggesting that exchange of notes should take place after both parties had completed their respective investigations.</p> <p>We responded to Rajah & Tann seeking an earlier exchange of notes. We agreed to meet with Rajah & Tann in London on 16 May 1995 to discuss the matter further.</p> |
| 16 May 1995 | <p>Meeting with Rajah & Tann in London to discuss how the process of exchanging notes should work. They raised concerns about press reports in the UK on 15 May 1995. We explained to Rajah & Tann that we had not made any press comments.</p> <p>We suggested to Rajah & Tann that a meeting between Watt and the Inspectors would be very beneficial. We agreed to meet on 19 May 1995 to discuss the matter further.</p> |
| 19 May 1995 | <p>There was a limited mutual exchange of documentary information. A meeting between Watt and the Inspectors was agreed for 24 May 1995.</p> |
| 24 May 1995 | <p>Meeting with the Inspectors to exchange further information. No documentary information relating to Singapore was exchanged, only verbal discussion. It was agreed that we would remain in contact, and if necessary would arrange a meeting to exchange any more information.</p> |
| 31 May 1995 | <p>We wrote to the Inspectors seeking to confirm certain financial information relating to BFS.</p> |
| 6 June 1995 | <p>The Inspectors wrote to us with differences between their information and that provided by us in our letter of 31 May 1995. The Inspectors requested further details to enable them to reconcile the differences.</p> |
| 8 June 1995 | <p>We wrote to the Inspectors with the further information requested by them on 6 June 1995.</p> |
| 21 June 1995 | <p>David Chong & Co wrote to Rajah & Tann requesting a copy of the statement of liabilities of BFS prepared by the Judicial Managers.</p> |
| 22 June 1995 | <p>Rajah & Tann wrote to us declining to provide the information requested on 21 June 1995. They asked us to obtain the information from the Inspectors.</p> |
| 26 June 1995 | <p>We wrote to Rajah & Tann, this time in their role as lawyers to the Inspectors, and requested a copy of the statement of liabilities of BFS prepared by the Judicial Managers.</p> |

| Date | Event |
|-------------|--|
| 6 July 1995 | We called the Inspectors to confirm that they had no significant information to add to that provided at our meeting on 24 May 1995. The Inspectors confirmed that they did not have any such information. The Inspectors agreed to provide the confirmation that we had requested on 31 May 1995 over the next few days. |

The Judicial Managers permitted Bax and Jones to make representations in respect of our preliminary proposed conclusions.

2. Negotiations with SIMEX

| Date | Event |
|---------------|---|
| 6 March 1995 | Meeting with SIMEX. We explained the scope of BoBS' inquiry. We asked for access to SIMEX records. SIMEX informed us that this would be difficult due to duty of confidentiality owed to BFS. |
| 8 March 1995 | We wrote to SIMEX requesting copies of daily transaction and margin statements for BFS. |
| 11 March 1995 | Meeting with SIMEX. We were informed that disclosure could not be made without BFS's consent. |
| 11 March 1995 | Allen & Gledhill requested time to assess our information requirement. |
| 13 March 1995 | Meeting with Allen & Gledhill, who asked for clarification of our information request. |
| 14 March 1995 | Letter to Allen & Gledhill which provided such clarification. |
| 16 March 1995 | Allen & Gledhill provided some of the information requested by us. |
| 17 March 1995 | Letters to SIMEX and Allen & Gledhill where we requested the remaining information. |
| 24 March 1995 | Meeting with Allen & Gledhill where we discussed our remaining information requests. They advised us to ask the Judicial Managers' agreement for such a disclosure. Therefore, we incorporated our SIMEX information requirements in the Court application made on 27 April 1995 as discussed in Section 1 above. |
| 26 April 1995 | Allen & Gledhill wrote to David Chong & Co and stated that SIMEX had little interest in the judicial management proceedings and they would leave it to the Court to decide on disclosure of information. |

| Date | Event |
|---------------|---|
| 27 April 1995 | Our application heard by the Court. |
| 3 May 1995 | The Court ruled that it was unable to make the order requested in our application. Subsequently, a formal request for information about regulatory coverage over BFS was made to the MAS. The MAS responded with most of the information requested, which included details of SIMEX's supervisory functions. |

APPENDIX X

**BARINGS GROUP
KEY COMMITTEES 1992 - 1995**

**ORGANISATIONAL CHARTS
31 DECEMBER 1992, 1993
AND 24 FEBRUARY 1995**

**MEMBERSHIP OF BOARD
AND KEY COMMITTEES**

**MEMBERSHIP OF BOARD AND KEY
COMMITTEES FROM 1 JANUARY 1993
TO 24 FEBRUARY 1995**

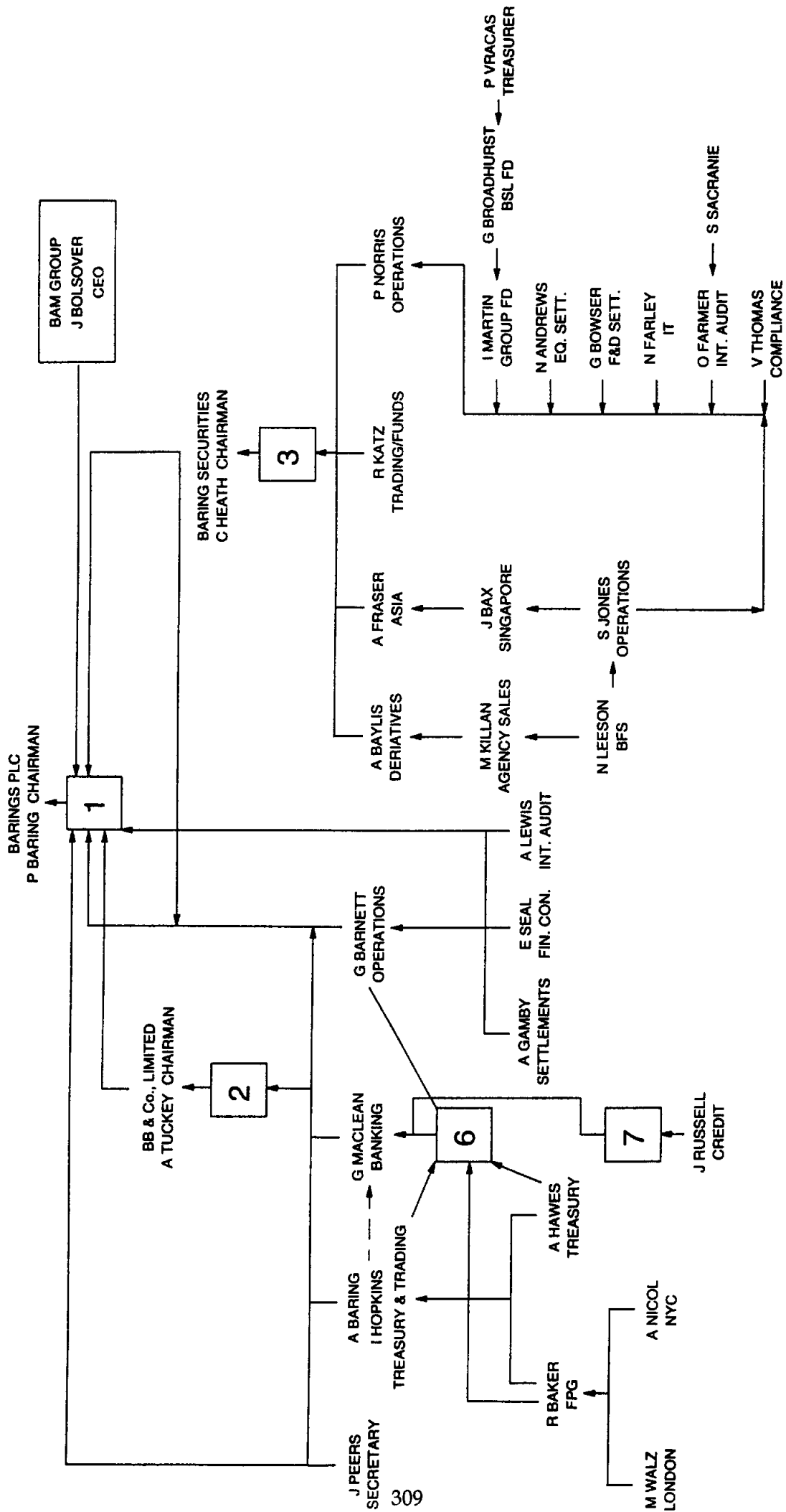
**MEMBERSHIP OF THE BOARD OF DIRECTORS
OF BFS AT 24 FEBRUARY 1995**

BARINGS GROUP

KEY COMMITTEES 1992 - 1995

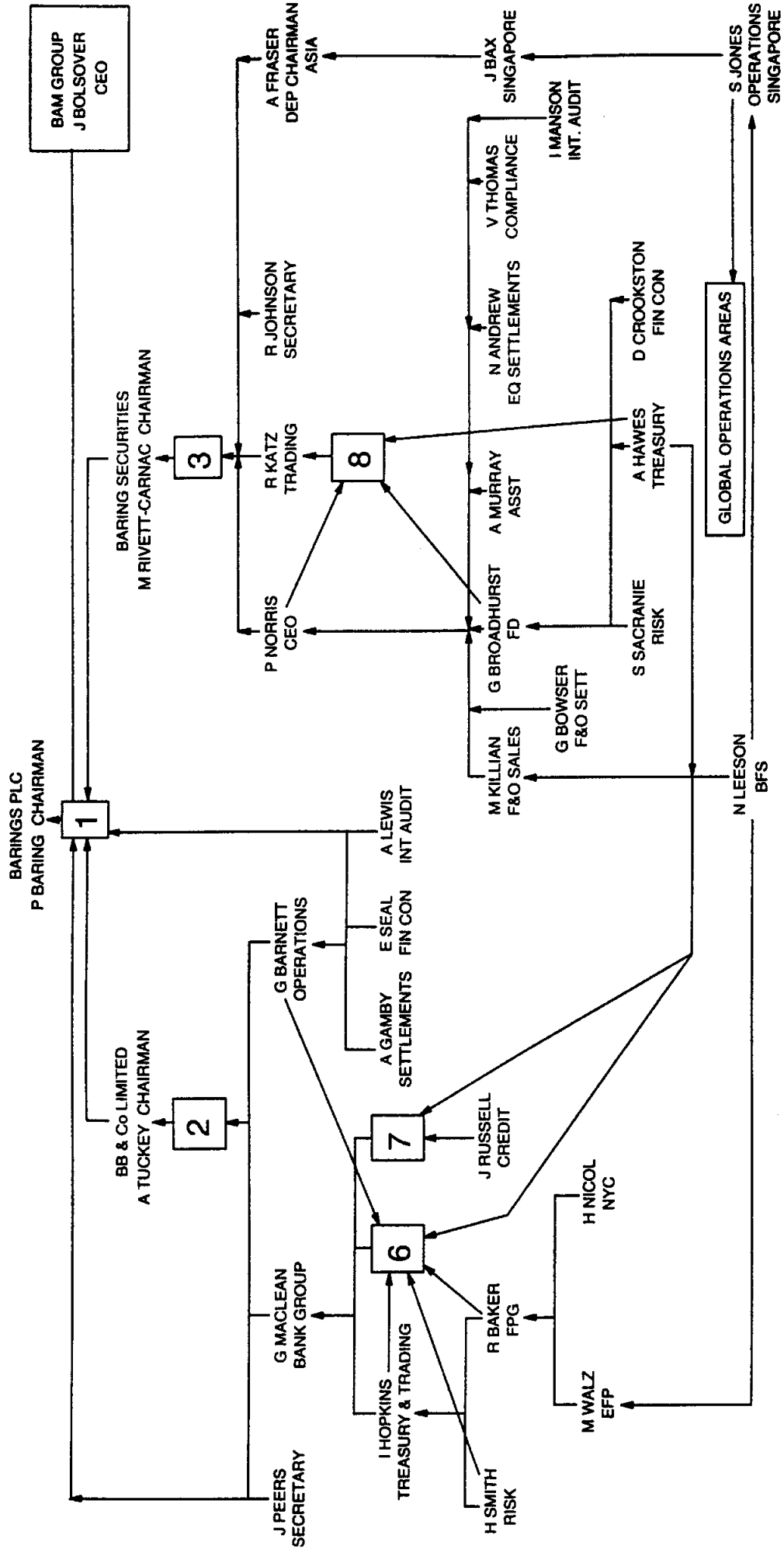
1. EXECUTIVE COMMITTEE, BARINGS PLC
2. MANAGEMENT COMMITTEE - BB&Co
(disbanded January 1994)
3. MANAGEMENT COMMITTEE - BSL
(became Equity Broking & Trading Management Committee in 1994)
4. MANAGEMENT COMMITTEE - IBG/BIB
(effective commencement as 'Liaison Group' - January 1994 and as a committee from May 1994)
5. ASIA PACIFIC MANAGEMENT COMMITTEE, BIB
(commenced June 1994)
(parallel committees for Tokyo, New York & Latin America)
6. TREASURY COMMITTEE, BB&CO
(disbanded November 1994)
7. CREDIT COMMITTEE, BIB
(originally BB&Co, from November 1993 BB&Co and BSL and for BIB from August 1994)
8. RISK COMMITTEE, BSL
(commenced June 1993, disbanded November 1994)
9. ALCO, BIB
(commenced November 1994)

BARING GROUP STRUCTURE: 31.12.92



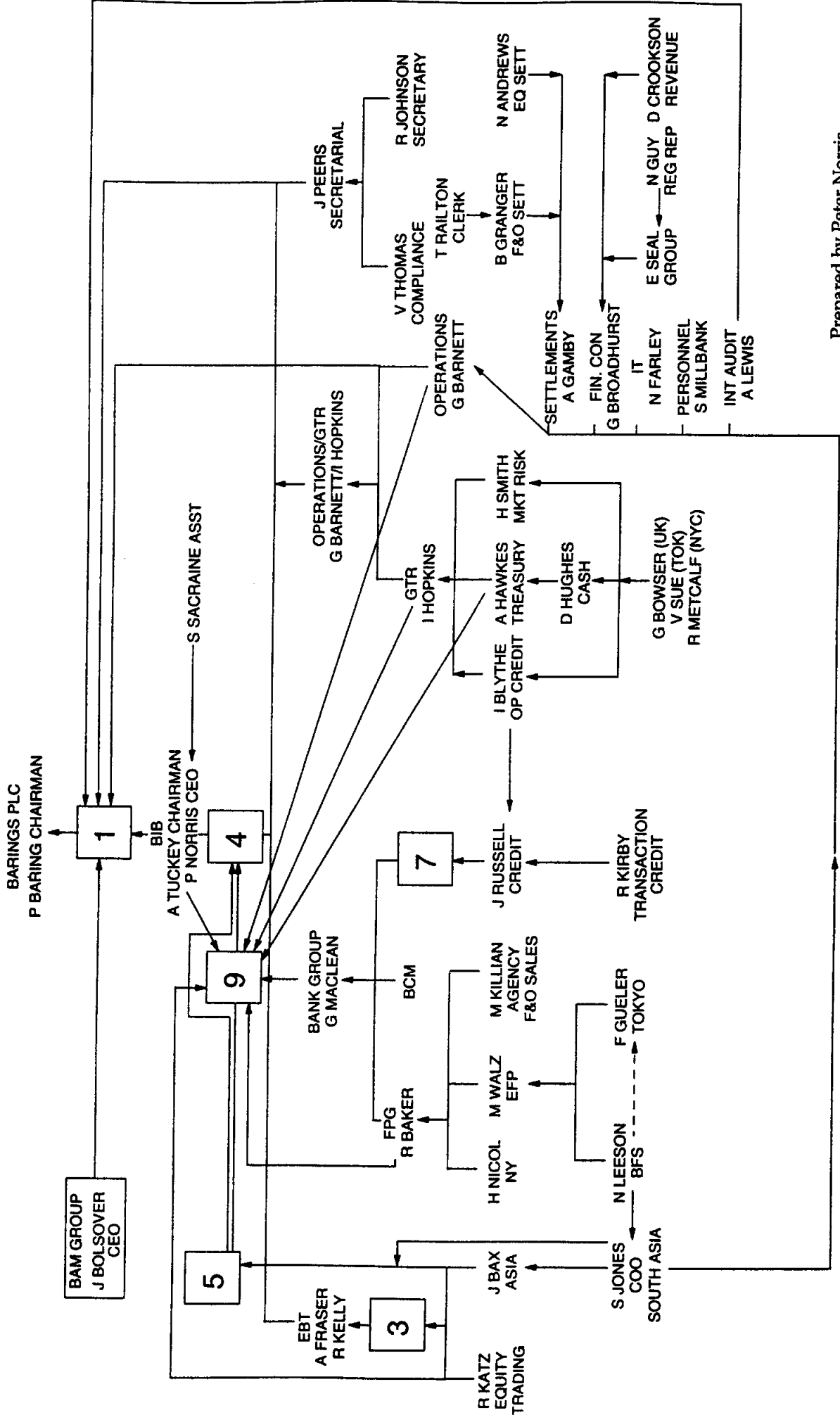
Prepared by Peter Norris

BARING GROUP STRUCTURE: 31.12.93



Prepared by Peter Norris

BARING GROUP STRUCTURE: 24.2.95



Prepared by Peter Norris

BARINGS: MEMBERSHIP OF BOARD AND KEY COMMITTEES

| | 31 December 1992 | 31 December 1993 | 24 February 1995 |
|-------------------------------------|---|---|---|
| 1. Board of Directors, Barings plc | <p>P. Baring (Chairman) A. Tuckey (Dep. Chairman) Lord Ashburton N. Baring J. Birkelund J. Bolsover R. Broadley J. Dare C. Heath R. Malpas H. Miles M. Rivett-Carnac</p> | <p>P. Baring (Chairman) A. Tuckey (Dep. Chairman) H. Miles (Dep. Chairman) Lord Ashburton N. Barber N. Baring J. Birkelund J. Bolsover R. Broadley J. Dare R. Malpas P. Norris J. Peyrelevade H. Rivett-Carnac Sir W Ryrie</p> | <p>P. Baring (Chairman) A. Tuckey (Dep. Chairman) H. Miles (Dep. Chairman) N. Barber J. Birkelund J. Bolsover R. Broadley R. Malpas P. Norris W. Ryrie</p> |
| 2. Executive Committee, Barings Plc | <p>P. Baring (Chairman) A. Tuckey (Dep. Chairman) J. Bolsover J. Dare C. Heath M. Rivett-Carnac J. Peers (Secretary)</p> | <p>P. Baring (Chairman) A. Tuckey (Dep. Chairman) H. Miles (Dep. Chairman) J. Bolsover J. Dare P. Norris W. Ryrie J. Peers (Secretary)</p> | <p>P. Baring (Chairman) A. Tuckey (Dep. Chairman) H. Miles (Dep. Chairman) J. Bolsover J. Dare P. Norris W. Ryrie J. Peers (Secretary)</p> |

Source: Barings

BARINGS: MEMBERSHIP OF BOARD AND KEY COMMITTEES (continued)

| | 31 December 1992 | 31 December 1993 | 24 February 1995 |
|--|--|---|--|
| 3. Management Committee, BB&Co | <p>A. Tuckey (Chairman) M. Baring G. Barnett N. Brown J. Dare I. Hopkins C. Irby G. Maclean N. Melville J. Peers (Secretary)</p> | <p>A. Tuckey (Chairman) G. Barnett N. Brown J. Dare I. Hopkins C. Irby A. McGrath G. Maclean P. Norris J. Peers (Secretary)</p> | N/A |
| 4. Management Committee, BSL (became EBT Management Committee post 31 December 1994) | <p>C. Heath (Chairman) S. Aldridge H. Anstey M. Baring G. Barnett J. Bax A. Baylis (MD) A. Fraser (MD) V. Gibson R. Greer (MD) R. Katz R. Kelly (MD) I. Martin A. Murray W. Murray P. Norris (COO) J Reed (MD) J. Remington-Hobbs C. Strutt A. Tuckey R. Johnson (Secretary)</p> | <p>M. Rivett-Carnac (Chairman) A. Fraser (Dep. Chairman) R. Kelly (Dep. Chairman) P. Norris (CEO) H. Anstey M. Baring G. Barnett J. Bax R. Greer M. Howell B. Johnson R. Katz C. Kemball A. Murray J. Remington-Hobbs C. Strutt A. Tuckey R. Johnson (Secretary)</p> | <p>A. Fraser (CEO) H. Anstey J. Bax J. Beatson Hird W. Daniel R. Greer W. Holman M. Howell B. Johnson P. Johnson R. Katz R. Kelly F. Kirkpatrick A. Murray P. Norris A. Norris J. Palmer J. Remington-Hobbs C. Strutt W. Murray R. Johnson (Secretary)</p> |

Source: Barings

BARINGS: MEMBERSHIP OF BOARD AND KEY COMMITTEES (continued)

| | 31 December 1992 | 31 December 1993 | 24 February 1995 |
|---|------------------|------------------|--|
| 5. Management Committee, IBC/BIB | N/A | N/A | <p>A. Tuckey (Chairman) P. Norris (CEO) G. Barnett (COO) A. Fraser (EBT) I. Hopkins (GTR) C. Irby (CF (Dev.)) R. Kelly (EBT) C. Kemball (CR (EM)) G. Maclean (Bank) M. Baring (Strategy) [A. McGrath - Alt. to Irby] J. Peers (Secretary)</p> |
| 6. Asia Pacific Management Committee, BIB | N/A | N/A | <p>J. Bax (Chairman) J. Palmer (Deputy) P. Kurz (EBT) C. Strutt (EBT) B. Cho (EBT) S. Drake-Brookman (Bank) R. Orders (CF (EM)) S. Jones (COO (South)) S. Leonard (COO (North)) [P. Bugge - Alt to Orders]</p> |

Source: Barings

BARINGS: MEMBERSHIP OF BOARD AND KEY COMMITTEES (continued)

| | 31 December 1992 | 31 December 1993 | 24 February 1995 |
|---|--|--|---|
| 7. Treasury Committee, BB&Co | <p>G. Maclean (Chairman)</p> <p>R. Baker M. Baring G. Barnett A. Hawes I. Hopkins</p> <p>+ attended by heads of desks</p> <p>J. Cameron G. Bird J. Warman S. Best</p> | <p>G. Maclean (Chairman)</p> <p>R. Baker G. Barnett G. Bird J. Cameron J. Warman I. Hopkins</p> <p>+ attended by heads of desks</p> <p>M. Fisher</p> <p>+ attended by BSGT</p> <p>A. Hawes</p> | N/A |
| 8. Credit Committee, BIB (originally BB&Co, and BSL from November 1993, BIB from August 1994) | <p>G. Maclean (Chairman)</p> <p>N. Brown K. Cox M. Packman J. Russell C. Steane A. Swann</p> <p>+ Assistant Directors</p> <p>F. Burkitt N. Coates S. Hollis R. Kirby P. Loribond</p> | <p>G. Maclean (Chairman)</p> <p>S. Best K. Cox I. Hopkins M. Packman J. Russell C. Steane A. Swann</p> <p>+ BSGT</p> <p>A. Hawes D O'Donaghue</p> <p>+ Assistant Directors</p> <p>D. Clements N. Coates R. Kirby</p> | <p>G. Maclean (Chairman)</p> <p>S. Best K. Cox M. Packman J. Russell C. Steane A. Swann M. Thomas</p> <p>+ GTR</p> <p>I. Hopkins I. Blythe D. O'Donaghue</p> <p>+ Assistant Directors</p> <p>D. Clements N. Coates R. Kirby</p> |

Source: Barings

BARINGS: MEMBERSHIP OF BOARD AND KEY COMMITTEES (continued)

| | 31 December 1992 | 31 December 1993 | 24 February 1995 |
|------------------------|------------------|--|--|
| 9. Risk Committee, BSL | N/A | [G. Broadhurst] [A. Hawes] P. Norris R. Katz S. Sacranie (Secretary) | N/A |
| 10. ALCO, BIB | N/A | N/A | G. Maclean (Chairman) R. Baker (Bank/FPG) G. Barnett (COO) G. Broadhurst (FD) A. Hawes (Treasurer) I. Hopkins (GTR) R. Katz (EBI) P. Norris (CEO) |

Source: Barings

**MEMBERSHIP OF BOARD AND KEY COMMITTEES
FROM 1 JANUARY 1993 TO 24 FEBRUARY 1995**

| Name | Board | EXCO | MANCO IBG | ALCO | Risk | Treasury (Note 1) | EBT/ BSL Man | Credit | Audit |
|--------------------|-------|---------|--------------|------|------|----------------------|-----------------|---------|-------|
| P. Baring | ◆,◆* | ◆,◆*,◆* | | | | | | | |
| A. Tuckey | ◆,◆ | ◆,◆,◆ | ◆,◆*,◆* | | | | ◆ | | |
| J. Bolsover | ◆,◆ | ◆,◆,◆ | | | | | | | |
| H. Miles | ◆,◆ | ◆,◆,◆ | | | | | | | |
| J. Dare | ◆,◆ | ◆,◆,◆ | ◆,◆ | | | | | | |
| C. Heath | ◆ | ◆ | | | | | ◆* | | |
| Lord Ashburton | ◆,◆ | | | | | | | | |
| N. Barber | ◆ | | | | | | | | ◆ |
| N. Baring | ◆,◆ | | | | | | | | |
| J. Birkelund | ◆,◆ | | | | | | | | |
| R. Broadley | ◆,◆ | | | | | | | | ◆* |
| R. Malpas | ◆,◆ | | | | | | | | ◆ |
| J. Peyrelevade | ◆ | | | | | | | | |
| M. Rivett-Carnac | ◆,◆ | ◆ | | | | | ◆,◆* | | |
| N. Melville | | | ◆ | | | | | | |
| W. Rylie | ◆ | ◆,◆ | | | | | | | |
| P. Norris | ◆ | ◆,◆ | ◆,◆ | ◆ | ◆ | | ◆,◆,◆ | | |
| M. Baring | | | ◆,◆ | | | ◆ | ◆,◆ | | |
| G. Barnett | | | ◆,◆,◆ | ◆ | | ◆,◆ | ◆ | | |
| N. Brown | | | ◆,◆ | | | | | ◆ | |
| A. Fraser | | | ◆,◆ | | | | ◆,◆,◆* | | |
| I. Hopkins | | | ◆,◆,◆ | ◆ | | ◆,◆ | | ◆◆ | |
| C. Irby | | | ◆,◆,◆ | | | | | | |
| R. Kelly | | | ◆ | | | | ◆,◆,◆ | | |
| C. Kemball | | | ◆ | | | | ◆ | | |
| G. Maclean | | | ◆,◆,◆ | ◆* | | ◆,◆* | | ◆,◆*,◆* | |
| R. Baker | | | | ◆ | | ◆,◆ | | | |
| G. Broadhurst | | | | ◆ | ◆* | | | | |
| A. Hawes | | | | ◆ | ◆ | ◆,◆ | | ◆ | |
| R. Katz | | | | ◆ | ◆ | | ◆,◆,◆ | | |
| G. Bird | | | | | | ◆,◆ | | | |
| J. Cameron | | | | | | ◆,◆ | | | |
| J. Warman | | | | | | ◆,◆ | | | |
| S. Aldridge | | | | | | | ◆ | | |
| H. Anstey | | | | | | | ◆,◆,◆ | | |
| A. Bayliss | | | | | | | ◆ | | |
| V. Gibson | | | | | | | ◆ | | |
| R. Greer | | | | | | | ◆,◆,◆ | | |
| I. Martin | | | | | | | ◆ | | |
| A. Murray | | | | | | | ◆,◆,◆ | | |
| J. Reed | | | | | | | ◆ | | |
| J. Remington-Hobbs | | | | | | | ◆,◆,◆ | | |

Note 1: The Treasury Committee was also attended by the desk heads.

Note 2: The table includes all those who have served on the committees at any time from 1 January 1993 to 24 February 1995

Legend: ◆ as at 31 December 1992
 ◆ as at 31 December 1993
 ◆ as at 24 February 1995
 * Chairman of committee
 + Secretary of committee

**MEMBERSHIP OF BOARD AND KEY COMMITTEES
FROM 1 JANUARY 1993 TO 24 FEBRUARY 1995**

| Name | Board | EXCO | MANCO IBG | ALCO | Risk | Treasury (Note 1) | EBT/ BSL Man | Credit | Audit |
|-----------------|-------|----------|--------------|------|------|----------------------|-----------------|--------|-------|
| C. Strutt | | | | | | | ♠,♥ | | |
| J. Bax | | | | | | | ♠,♥ | | |
| W. Murray | | | | | | | ♠,♥ | | |
| W. Holman | | | | | | | ♠,♥ | | |
| M. Howell | | | | | | | ♠,♥ | | |
| B. Johnson | | | | | | | ♠,♥ | | |
| J. Beatson Hird | | | | | | | ♥ | | |
| W. Daniel | | | | | | | ♥ | | |
| P. Johnson | | | | | | | ♥ | | |
| F. Kirkpatrick | | | | | | | ♥ | | |
| J. Palmer | | | | | | | ♥ | | |
| S. Best | | | | | | ♦ | | ♠,♥ | |
| K. Cox | | | | | | | | ♦,♠,♥ | |
| M. Packman | | | | | | | | ♦,♠,♥ | |
| J. Russell | | | | | | | | ♦,♠,♥ | |
| C. Steane | | | | | | | | ♦,♠,♥ | |
| A. Swann | | | | | | | | ♦,♠,♥ | |
| I. Blyth | | | | | | | | ♥ | |
| D. Clements | | | | | | | | ♠,♥ | |
| N. Coates | | | | | | | | ♦,♠,♥ | |
| R. Kirby | | | | | | | | ♦,♠,♥ | |
| F. Burkitt | | | | | | | | ♦ | |
| S. Hollis | | | | | | | | ♦ | |
| D. O'Donaghue | | | | | | | | ♠,♥ | |
| M. Thomas | | | | | | | | ♥ | |
| P. Loribond | | | | | | | | ♦ | |
| J. Peers | | ♦+,♠+,♥+ | ♦+,♠+,♥+ | | | | | | |
| M. Fisher | | | | | | ♠ | | | |
| S. Sacranie | | | | | ♠+ | | | | |

Note 1: The Treasury Committee was also attended by the desk heads.

Note 2: The table includes all those who have served on the committees at any time from 1 January 1993 to 24 February 1995

Legend: ♦ as at 31 December 1992
♠ as at 31 December 1993
♥ as at 24 February 1995
* Chairman of committee
+ Secretary of committee

**MEMBERSHIP OF THE BOARD OF DIRECTORS
OF BFS AT 24 FEBRUARY 1995**

| Name | Location | Reporting line | Main executive responsibilities in Barings |
|-------------|-----------------|--|--|
| Bax | Singapore | Fraser, Director of Equity Broking & Trading Group | Regional Manager South East Asia Chairman of the Asia Pacific Management Committee |
| Jones | Singapore | Bax | Regional Operations Manager South East Asia Member of the Asia Pacific Management Committee Operations Director, BSS Director of Finance, BFS |
| Fu Ya-Yin | Singapore | Bax | Head of Institutional Sales Team, BSS |
| Killian | USA/ Tokyo | Baker - from 1 January 1995, previously to Norris | Head of Global Equity Futures and Options sales |
| Johnson | London | Peers | Company Secretary, BSL |
| Norris | London | Tuckey | Chief Executive Officer BIB (and formerly of BSL) and member of BIB Management Committee and ALCO Member of the Barings Plc Board and Executive Committee |

**APPENDIX XI TITLE AND PURPOSE OF MARKET RISK REPORTS
SHOWING BARING INVESTMENT BANK'S
EXPOSURE TO MARKET RISK**

| Title of report | Purpose of report |
|-----------------------------------|---|
| Daily Income Report | Gave the daily, week to date and month to date profit by trading strategy. |
| Equity Value at Risk | Gave the net delta for all equity positions held on markets world-wide. Market risk is calculated according to a new Value at Risk model which calculated historic volatilities on exposures to determine a "worst case scenario" loss. |
| Equity Derivative Risk Report | Gave the position, net delta and maximum loss by equity derivative trading strategy. |
| Treasury and Trading Risk Report | Gave the interest rate risk positions and mismatches using Barings' old 'risk points' system (a measure of the sensitivity of a trading strategy's profit and loss to changes in interest rates over particular time periods). |
| Interest Rate Risk | Gave the interest rate risk calculated by the new Value at Risk model. |
| Currency Risk | Gave all currency exposures using the Value at Risk model. |
| ANBD - Position and Limit Summary | Gave delta positions and trading limits on the Abbey National Baring Derivatives Joint Venture. We are not aware of any connection between ANBD and the events leading to the collapse of Barings. |
| Emerging Markets Risk Report | Gave cash values and value at risk by area. |

All these reports were received by ALCO.

APPENDIX XII LEESON'S HANDWRITTEN NOTES EXPLAINING THE PURPORTED SLK RECEIVABLE

When?

Letter often says put through the system between J&K (S&K leg: Kellogg) and Banque Nationale de Paris. Letter rate was equal: NIL CREDIT RISK

Proves via the system between J&K and BNP - with premium to hit at maturity. At this stage no impact on system because

Customer side to hit at maturity

Dramatic

Bank side: no movement because holding both sides (J&K)

Impact zero. - PFS were not to be involved at all. Payment would be between J&K + BNP.

Profit to AP2 ??? NIL

Error

ERROR in maturity of maturity dates. True maturity = 30/12, maturity for BNP leg ⁽⁰³⁾ 1/12.

Subsequently, ~~reversal of~~ BNP have received value for the funds ^(3/12) and funds have been returned to them effectively over a period during the normal course of business ^{is clear not all} up

Therefore reversal of entries 30/12 has left us with

A receivable of JPY 7,778,000 -

As the trade was to have no impact, reversal was not made - so blame me!

RECENTLY RECEIVED VERBAL COMMUNICATION THAT FUND
WILL BE PAID 2-2-95 EXPECTING WRITTEN CONFIRMATION
THIS EVENING CIRCA 10 PM

THERE ARE OBVIOUSLY A LOT OF ERRORS THAT I CAN BE
HUNG ON, TO WHICH I WILL TAKE FULL RESPONSIBILITY
BUT SUGGEST THAT WE TACKLE THE MATTER WITH THE
AUDITOR, SHOW HIM RECEIPT OF FUNDS VALUE 2-2-95
AND CONFIRMATIONS THAT WE WILL RECEIVE THIS EVENING
OF BALANCES. AND HOPEFULLY THEN HE WILL MAKE LONDON
HAPPY.

SEE YOU AT 7.30

Nick.

BFS out of pocket 30/11/95
for 2 mths !!

**APPENDIX XIII OPEN INTEREST AS REPORTED ON THE OSAKA
SECURITIES EXCHANGE**

Open Interest Report for March 1995 Nikkei 225 Contract

| Date | BSJ Net long position (no. of contracts) | Total number of open contracts | BSJ's percentage of open contracts |
|------------------|---|---|---|
| 30 December 1994 | 5,400 | 104,712 | 5.16% |
| 6 January 1995 | 4,939 | 106,073 | 4.66% |
| 13 January 1995 | 3,024 | 111,353 | 2.72% |
| 20 January 1995 | 7,135 | 117,889 | 6.05% |
| 27 January 1995 | 16,852 | 128,048 | 13.16% |
| 3 February 1995 | 14,399 | 123,975 | 11.61% |
| 10 February 1995 | 14,975 | 125,220 | 11.96% |
| 17 February 1995 | 20,076 | 128,749 | 15.59% |
| 24 February 1995 | 15,928 | 119,850 | 13.29% |

Source: OSE data that is made publicly available every Tuesday for close of business the previous Friday.

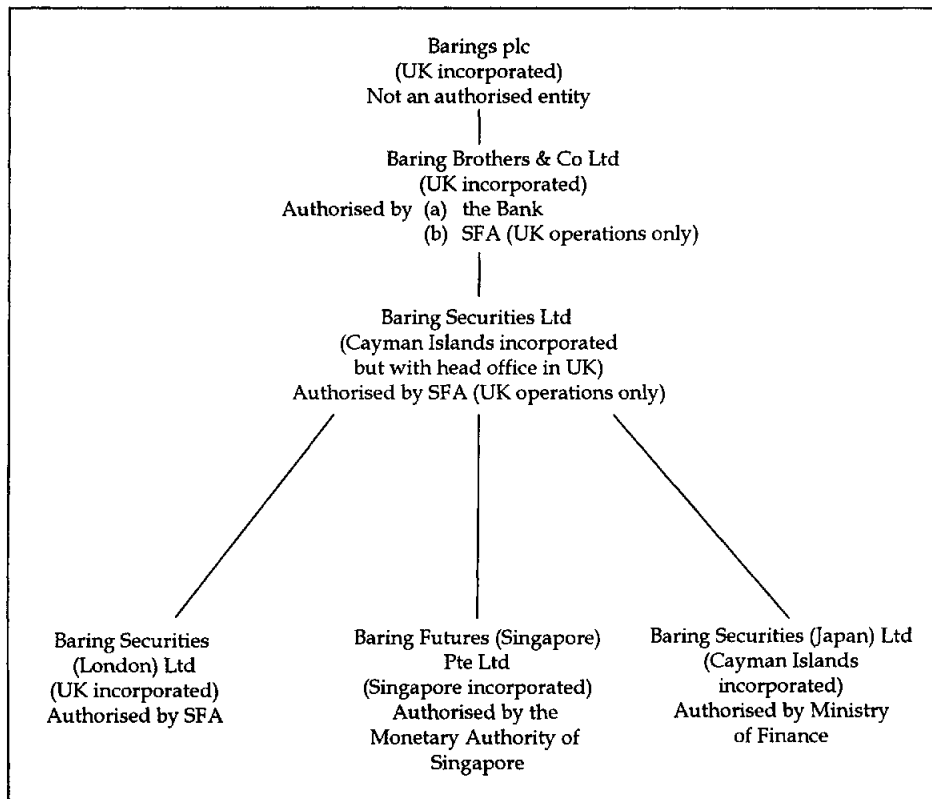
For every week reported in January and February 1995, BSJ had the largest outstanding position of any of the members of the OSE.

APPENDIX XIV SUPERVISION AND REGULATION

General framework

- XIV.1 The following will provide a brief description of the regulatory framework within which Barings operated in the United Kingdom, Singapore and Japan. It will then focus on each regulator with responsibilities covering one or more of Barings' entities involved in the events leading up to the collapse. This will be in the form of an overview of such regulator's powers and responsibilities, together with a description of the methods of regulation employed.
- XIV.2 The Barings Group companies and regulatory authorities most closely involved in the events leading up to the collapse are shown in summary form in Figure XIV.1:

Figure: XIV.1



Source: Inquiry team

It should be borne in mind, however, that the Barings Group comprised over 100 companies and that a number of other regulatory authorities (both in the United Kingdom and overseas) had responsibilities with respect to various Group members.

- XIV.3 The Bank authorised BB&Co under the Banking Act 1987 (the 'Act') and was responsible for the consolidated supervision of the Barings Group, as explained in paragraphs 12.6 and 12.7. It was also Barings' lead regulator.

Powers and responsibilities of the Bank

- XIV.4 The legal basis for the Bank's supervision is the Act, which sets out the requirements for the initial and continued authorisation of banking institutions in the UK. (Although not relevant for the purposes of this report, it should be noted that, following the implementation of the EU Second Banking Coordination Directive in the UK on 1 January 1993, the Bank no longer 'authorises' EU banks which establish UK branches.) The minimum authorisation criteria (which are set out in full in Schedule 3 to the Act) include requirements that:
- (a) directors, controllers and managers of the institution should be fit and proper persons for the positions they hold;
 - (b) the business of the institution should be carried on with integrity and the appropriate professional skills;
 - (c) the business of the institution should be conducted in a prudent manner; in particular there must be adequate capital, liquidity, provisions and accounting and other records and systems of control of the business and records.
- XIV.5 Also relevant are the statements made by the Basle Committee and a number of EU Directives. One means by which such statements and Directives have been implemented in the United Kingdom has been by way of Bank Policy Notices: these have covered a number of matters, including capital adequacy, consolidated supervision and large exposures. An institution which fails to comply with such Notices may be found to be failing to conduct its business 'in a prudent manner' and therefore liable to have its authorisation revoked.
- XIV.6 The Bank was responsible under the Act for monitoring whether BB&Co continued to meet the minimum criteria for authorisation set out in Schedule 3 to the Act.
- XIV.7 The Bank may revoke an authorisation if (among other things) it appears to it that:
- (a) any of the criteria for authorisation "is not or has not been fulfilled, or may not be or may not have been fulfilled, in respect of the institution", or
 - (b) "the interests of depositors or potential depositors of the institution are in any other way threatened, whether by the manner in which the institution is conducting or proposes to conduct its affairs or for any other reason".
- XIV.8 The Bank may, instead of revoking an authorisation, restrict it in duration (up to a maximum of three years) or impose such conditions as the Bank thinks desirable for the protection of the institution's depositors or potential depositors, or both, if it appears to the Bank that there are grounds on which the Bank can exercise its power to revoke, but that the circumstances are not such as to justify revocation.
- XIV.9 Among the powers conferred on the Bank by the Act, two have particular relevance to the provision of information to the Bank:
- (a) under Section 39 the Bank can require an authorised institution to provide such information or documents as the Bank may reasonably require for the performance of its supervisory functions or to commission a report by an

accountant nominated or approved by the Bank on any matter about which the Bank can require information for the performance of such functions. It can also require production of documents by a third party. In addition, if it appears to the Bank to be desirable in the interests of depositors of an authorised institution so to do, it can also exercise these powers in relation to a parent company, subsidiary or related company of the institution. This power is reinforced by a right of entry and criminal penalties for non-compliance.

- (b) Section 41 of the Act provides that the Bank can, if it appears to it to be desirable in the interests of depositors of an authorised institution, appoint persons to investigate and report to the Bank on the nature, conduct or state of the institution's business or any particular aspect of it or the ownership or control of the institution. A person so appointed can if necessary investigate parent, subsidiary and related companies, require the production of documents and the attendance of relevant persons and enter the institution's premises.

- XIV.10 Whereas under Section 39 the reporting accountant is formally instructed by and reports to the institution, his report being provided to the Bank, under Section 41 it is the Bank itself which gives the instructions and receives the report. This invasive power is reinforced by criminal penalties.
- XIV.11 These powers are derived from the Act and therefore are only directly enforceable in the UK (although a failure on the part of an authorised institution or any of its parent, subsidiary or related companies to respect these powers may have repercussions as regards the continuing authorisation of the institution under the Act). In practice the Bank may seek co-operation, from the authorised institution and the relevant overseas supervisory authority, if it wishes to commission reports on operations or legal entities outside the UK.
- XIV.12 Prior to the collapse, Section 41 powers were not used by the Bank in respect of any company in the Barings Group and Section 39 powers were only used in the manner described in paragraph XIV.33.
- XIV.13 UK auditors and reporting accountants have a statutory duty (under the Accountants (Banking Act 1987) Regulations 1994 which came into force on 1 May 1994) to report to the Bank if (among other things) they become aware of matters which give them reasonable cause to believe that any of the minimum criteria for authorisation may not be or may not have been fulfilled and such matters are likely to be of material significance for the exercise of the Bank's supervisory functions. The auditors and reporting accountants of Barings did not report to the Bank under this requirement.
- XIV.14 Section 47 of the Act relaxes the ordinary duty of confidentiality owed by an auditor to his client, the company subject to the audit. It provides that no duty to which the auditor of an authorised institution or a reporting accountant is subject shall be regarded as contravened by his communicating in good faith to the Bank any information or opinion on a matter relevant to the Bank's functions under the Act of which the auditor or reporting accountant has become aware in his capacity as such. We understand that in practice this means that auditors and reporting accountants can discuss matters freely in trilateral meetings involving the Bank, the auditors or reporting accountants and the institution.

Relations between the Bank and supervisors abroad

- XIV.15 Mention has been made in Section 12 of the Basle Concordat and other international supervisory agreements to which the Bank, MAS and MoF subscribe. These agreements lay down a number of supervisory principles which are relevant to the report; these are set out in the following paragraphs.
- XIV.16 Adequate supervision of banks' foreign establishments calls not only for an appropriate allocation of responsibilities between parent and host supervisory authorities, but also for contact and co-operation between them.
- XIV.17 The principal requirement of the parent authority is to ensure that a routine is laid down for the regular flow of information to the parent bank and from the parent bank in consolidated form to the parent authority. This calls for a sound system of reporting from foreign establishment to parent bank, for the host and parent authorities to have knowledge of that system and for the adequate working of the system to be capable of verification. Host and parent authorities should seek to satisfy themselves that banks' internal controls include comprehensive and regular reporting between a bank's foreign establishment and its head office.
- XIV.18 If a host authority identifies, or has reason to suspect, problems of a material nature in a foreign establishment, it should take the initiative to inform the parent authority. The level of materiality will vary according to the nature of the problem. Because the level of materiality is principally a matter for the parent authority's judgement, it may wish to inform the host authority of the precise level which would trigger concern, but the host authority is often in the best position to detect problems and should therefore be ready to act on its own initiative. Host authorities should ensure that parent authorities are informed immediately of any serious problems which arise in a foreign establishment and should consult with them in order to seek possible remedies.
- XIV.19 Host authorities should ensure that adequate data can flow to parent authorities, particularly in relation to large exposures.
- XIV.20 Where a host authority discovers an exposure which it considers should be drawn to the attention of the parent authority the host authority should take the initiative in doing so. Where secrecy laws prevent the passage of information to another supervisor which may identify specific accounts, host authorities are nonetheless encouraged to inform the parent authority if it comes to their notice that a foreign establishment has a large exposure which may threaten the soundness of the establishment.
- XIV.21 Where groups contain both banks and non-bank organisations, there should, where possible, be liaison between the banking supervisory authorities and those authorities which have responsibilities for supervising the non-banking organisations, particularly where the non-banking activities are of a financial character. Banking supervisors, in their overall supervision of banking groups, should take account of these groups' non-banking activities; and if these activities cannot be adequately supervised, banking supervisors should aim at minimising the risks to the banking business from the non-banking activities of such groups.

- XIV.22 Host authorities are responsible for the foreign bank establishments operating in their territories as individual institutions, while parent authorities are responsible for them as parts of larger banking groups where a general supervisory responsibility exists in respect of their worldwide consolidated activities. These responsibilities of host and parent authorities are both complementary and overlapping.
- XIV.23 The principle of consolidated supervision does not imply any lessening of host authorities' responsibilities for supervising foreign bank establishments that operate in their territories. Consolidated supervision should not be applied to the exclusion of supervision of individual banking establishments on an unconsolidated basis by parent and host authorities.
- XIV.24 The supervision of solvency of foreign subsidiaries is a joint responsibility of host and parent authorities. Host authorities have responsibility for supervising the solvency of all foreign subsidiaries operating in their territories. Parent authorities, in the context of consolidated supervision of the parent banks, need to assess whether the parent institutions' solvency is being affected by the operations of their foreign subsidiaries.
- XIV.25 Primary responsibility for supervising liquidity of foreign subsidiaries should rest with the host authority. Parent authorities should take account of any commitments (including comfort letters) granted by parent banks to such subsidiaries. Host authorities should inform parent authorities of the importance they attach to such commitments, to ensure that full account is taken of them in the supervision of the parent bank. Parent authorities have a general responsibility for overseeing the liquidity control systems employed by the banking groups they supervise and for ensuring that these systems and the overall liquidity position of such groups are adequate.
- XIV.26 The supervision of foreign exchange operations and positions is the joint responsibility of parent and host authorities. Parent authorities should monitor the parent bank's systems for assessing the group's overall foreign exchange exposure and host authorities should monitor the foreign exchange exposure of foreign establishments in their territories.
- XIV.27 The Bank's direct contacts with overseas securities regulators are on a lesser scale than those with banking regulators and are not formalised in the same manner as the Basle arrangements. Typically these contacts are conducted via the local banking regulator and then only if there are known issues of concern. The Basle Committee has had occasional discussions with the International Organisation of Securities Commissions (an "umbrella" body for securities regulators which is the closest equivalent to the Basle Committee). There are also various conferences and groupings which bring individual banking and securities regulators together.

Methods of supervision by the Bank

- XIV.28 Supervision is carried out by the Bank in its Financial Stability Wing. S&S is the division within the Financial Stability Wing which has primary responsibility for the supervision of banks. It comprises five divisions, two dealing with UK institutions, two with overseas banks and surveillance, and one with banking supervisory policy. For the year ended February 1995 there were a total of 322 staff in S&S. This number included 41 senior managers, 199 managers, analysts and assistants, 10 inward

secondes and 72 support staff. The Major UK Banks Supervision Division within S&S, which was responsible for the supervision of Barings, as at February 1995 was divided into four groups. It has a total of 31 staff and is responsible for 71 institutions. Bank staff also have access to the separate Legal Unit which comprises legally qualified staff employed by the Bank, supplemented by inward secondes from outside law firms.

- XIV.29 To ensure consistency in its approach to supervision, the Bank has issued internal guidelines to the members of S&S which deal with various aspects of supervision including: administration matters; Banking Act issues; policy issues; and relations with other regulators. As well as providing guidance on the implementation of Bank policy, the guidelines provide checklists of matters which should be reported by the analyst to the senior manager or by the senior manager to the Head of Division.
- XIV.30 In fulfilling its responsibility to monitor whether UK incorporated authorised institutions continue to meet the minimum authorisation criteria the Bank presently uses a number of methods and techniques. Those of particular relevance to the inquiry are discussed below.
- XIV.31 The Bank regularly meets with an institution's management to discuss matters of a prudential nature. Matters discussed can vary widely but often include matters such as strategy, performance, provisions, systems and controls, etc. There is a presumption that the information and comments provided by management are accurate and portray a fair view of the matters being discussed. The Bank is therefore unlikely to question matters unless it has reason to be suspicious or the information provided is inconsistent with its knowledge or other available data. We understand that in recent years there has been a trend for the Bank to be more probing in its discussions with management.
- XIV.32 The Bank requires institutions to complete financial (or 'prudential') returns on a regular basis. For Barings the following returns are of particular interest to the inquiry: BSD 1 (which was completed on three bases and is concerned with the adequacy of an institution's capital to support the assets which it holds) and the large exposures return (which was compiled on two bases). (The large exposures return is discussed and explained in Section 12 of the report.) The S&S analyst supervising the institution is responsible for reviewing the returns and highlighting any inconsistencies or unexpected trends which require explanation. The Bank has informed us that it also received quarterly management information (which included source of profit against budget) and published annual accounts from Barings, which it used to analyse the profitability of particular areas of activity; however, it did not, we were informed, receive information specifically about Barings' Singapore operations.
- XIV.33 In order to satisfy itself that an institution is maintaining adequate records and systems and controls and is accurately reporting its position to the Bank, the Bank usually requires the institution to commission annual reports under Section 39 of the Act from reporting accountants (who are generally the auditors, as was the case with BB&Co) on the adequacy of its systems and controls and the preparation of specified prudential returns. The scope of each report is set by the Bank and the report itself and the annual audit of the bank are discussed in the annual trilateral meeting between the Bank, the institution and the auditors/reporting accountants. For Barings these meetings could have included matters arising from any entity within the group.

XIV.34 The Bank has a number of commercial bankers and accountants on its staff, many of whom are on secondment from clearing banks and accountancy firms. An accountant, a banker and the relevant S&S analyst (together the 'review team') visit institutions to undertake a programme of work which is agreed in advance with the relevant S&S senior manager. The work programme varies from institution to institution. A visit generally lasts between two and five days and tends to be conducted by means of discussion with management and staff. It is not intended to perform detailed checking or testing.

Powers and responsibilities of the SFA

XIV.35 The SFA is an SRO approved by the SIB (which itself has been delegated certain regulatory powers under the FSA by the Secretary of State). The SFA has responsibility for authorising and monitoring firms which carry out investment business, as described in the FSA. The SIB's statement of principles is intended to form a universal statement of the standards expected of a member firm. The principles include requirements in respect of a member firm's integrity, skill, care and diligence, standards of market practice, knowledge of customers, the need for internal controls, etc. The SFA requires that a firm should ensure it maintains adequate financial resources to meet its investment business commitments.

XIV.36 BSL and BSLL were both authorised by the SFA to carry out certain types of investment business in the United Kingdom. They were both classified as 'broadscope' firms for SFA purposes. They were both required to provide to the SFA on a monthly basis, a full balance sheet, profit and loss account, calculation of financial resources and client money calculation. On a quarterly basis they reported CRRs and PRRs. They were also required to provide the SFA with audited annual financial statements, annual reporting statements, auditors' reports and internal control letters.

XIV.37 BB&Co was (as referred to above) lead regulated by the Bank, but it was also a member of the SFA. The relevant financial regulation of BB&Co was performed by the Bank as agreed within the MoU between the SFA and the Bank. However, the SFA continued to monitor compliance with its own Conduct of Business Rules. The SFA received quarterly reports from the Bank in respect of BB&Co. Any inspection visits (see paragraph XIV.41) carried out by the SFA into BB&Co were only in connection with compliance by BB&Co with the SFA's Conduct of Business Rules. In practice this only involved review of BB&Co's corporate finance activities in London.

XIV.38 BSB was a gilt edged market maker and, as such, was a member of the SFA, but was in the process of being closed down at the time of the collapse.

Methods of supervision by the SFA

XIV.39 There are four principal ways through which the SFA conducts its supervision. These are explained in the following paragraphs.

XIV.40 As noted above, firms are required to submit a number of regular returns to the SFA. The SFA reviews returns and follows up unusual or inconsistent data with the member firm.

- XIV.41 Inspection visits for broadscope firms generally take place approximately once a year. The relevant surveillance team (see Section 12 of the report for an overview of the structure of the SFA) is responsible for agreeing the purpose of a visit and the issues to be covered. The length of the visits is dependent on the size of the member and the risks associated with it and typically last 2 to 3 days and are performed by a team of 3 or 4 from the SFA, which may or may not include the team manager. They are generally predominantly discussion based. At the end of each visit there will be a 'close out' meeting at which key findings are discussed. A follow-up letter will be sent after the visit, summarising the key issues arising and requesting a response to the issues raised.
- XIV.42 The SFA's Transaction Monitoring Unit monitors transactions via Cedel, Euroclear, the LSE etc. on a daily basis. Parameters are established for review purposes. Any exceptions noted are known as referrals and are passed to the surveillance team.
- XIV.43 The fourth principal method of surveillance is through maintaining dialogue. There are no pre-set formal meetings and no equivalent of the Bank's regular prudential and trilateral meetings. Meetings are only arranged on an ad hoc basis or in conjunction with inspection visits. Meetings therefore tend to be arranged for a specific purpose.
- XIV.44 In addition to the methods of surveillance employed by the SFA and referred to in the four preceding paragraphs, UK auditors and reporting accountants have a statutory duty to report to the SFA if they become aware of matters which, in their opinion, would be materially significant to the SFA in exercising its responsibilities under the FSA.

Liaison by the SFA with other supervisors

- XIV.45 In the UK the SFA has entered into a series of MoUs with other supervisors (see the Bank/SFA MoU in Appendix VIII) and attends College of Regulators meetings relating to the institutions which it supervises (where applicable).
- XIV.46 At an international level, the SFA has some bilateral liaison with North American and European regulators, but has found the Far East "somewhat impenetrable". In respect of Europe and North America, the bilateral liaison is only on a case-by-case basis and is not regular.

Background on SIMEX

- XIV.47 The information on SIMEX in the following paragraphs is derived from a SIMEX publicity brochure.
- XIV.48 SIMEX is governed by the Singapore Futures Trading Act 1986 and is regulated by the MAS.
- XIV.49 SIMEX has various departments with regulatory duties as follows: Clearing House Department, Trading Floor and Compliance Department, Audit and Review Department and the Market Surveillance Department.
- XIV.50 The Clearing House is part of the Exchange itself and is liable for all trades that are cleared on the Exchange. It deals exclusively with 'Corporate Clearing Members and inserts itself into every cleared trade, thereby assuming the opposite side of all open

positions. All Corporate Clearing Members are shareholders of the Exchange and are jointly and severally liable for the obligations of the Clearing House via the 'Common Bond System'. Since this responsibility on the shareholders may eventuate in the contribution of funds in the event of a default, the financial stability of these Members is important and is intended to be ensured via the financial requirements imposed by the Exchange. Members must maintain an adjusted net capital of an amount that the Exchange determines to be adequate to serve the needs of the market.

- XIV.51 The Clearing House administers the collection of margins from Member firms and oversees the transfer of funds on a daily basis to settle all closed losses and gains. It also coordinates the delivery process for all contracts at the time of maturity.
- XIV.52 The Clearing House uses the SPAN margin system. The system is set up to simulate the reaction of the portfolio to a range of possible market changes and then covers the largest reasonable overnight loss. All SIMEX contracts are margined on the basis of SPAN.
- XIV.53 SIMEX margins all open positions on a gross, and not on a net, basis. The collection of margins for all positions, long and short, is intended to ensure that there are adequate funds to support existing open positions against adverse market movements. The Clearing House margins Clearing Members separately for house positions and customers' positions. Margin levels will vary for each contract.
- XIV.54 If a Corporate Clearing Member defaults the Clearing House will take steps to protect the customers of the defaulting Member, as well as to satisfy the Member's obligations to the Clearing House.
- XIV.55 If, after attaching and applying all available funds of the Corporate Clearing Member, further funds are still required to fully discharge the Member's obligations to the Clearing House, the Clearing House can resort to the Common Bond System to access additional sources of funds to meet all its obligations.

Methods of supervision by SIMEX

- XIV.56 The Audit and Review Department is responsible for regularly checking and monitoring the Exchange's membership to ensure that Members are financially sound as well as professional in their practice and dealings with customers. In carrying out its tasks, the department conducts regular audits to ensure that all rules and regulations are complied with and that comprehensive internal controls are in place.
- XIV.57 To achieve its objectives, the department carries out a daily financial surveillance before the SIMEX market opens in order to assess the impact of market movements on a Member's financial condition. In carrying out such surveillance, the department monitors the market and the activities of the Members especially during times of increased volatility. Sustained losses by Members are closely examined and checks are made to ensure that proper and sufficient margins are in place. The capital requirements of Members may be reassessed during substantial market movements to determine if they are sufficiently capitalised. The department will identify any concentrated high-risk positions and will monitor them to ensure that SIMEX is able to respond to any situation that may adversely affect the stability of a Member and that of the Exchange.

- XIV.58 In addition, the department also carries out random, on-site spot audits as well as inspections of the books, accounts and the procedures of Members. The objectives of these surprise audits, which may be full or limited scope audits, include the following:
- (a) to determine that proper internal controls are in place;
 - (b) to determine that account balances used in computing financial and capital requirements are properly stated and classified;
 - (c) to ensure that all rules and regulations are complied with.
- XIV.59 The department also regularly reviews the financial statements of Member firms. Corporate Members must submit financial statements quarterly and certified financial statements annually. Quarterly reviews are carried out every calendar quarter to ascertain that Members are complying with the minimum financial and segregation requirements.
- XIV.60 The Market Surveillance Department oversees the activity of the marketplace to seek to ensure that no situation exists which could adversely affect the market. The department conducts regular programmes which study and analyse the market activity for indications of possible congestion and/or other market situations which are conducive to possible price distortions, such as manipulation and cornering. As part of its activities, the department monitors the expiry/maturity of all contracts to seek to ensure the proper liquidation of the same. Furthermore, it monitors the delivery procedure and provides assistance to ensure that the deliveries proceed smoothly. The department also monitors speculative position limits, as well as price levels and large account positions to ascertain any potential financial problems of the Members and/or their customers.
- XIV.61 The Market Surveillance Department conducts its activities so as to prevent any market disruption and, in the event of it, to react to it. In addition to this, the department works to ensure that market participants at all times comply with all the rules and regulations governing their operations.
- XIV.62 The Trading Floor and Compliance Department oversees the activity on the SIMEX trading floor and ensures Exchange rules are abided by. (Trading on SIMEX is via the open outcry system.)
- XIV.63 The Trading Floor and Compliance Department monitors the trading activity to try to ensure that no prohibited or any other illegal and/or unethical practices are carried out. It also seeks to ensure that all trading floor practices are complied with. In carrying out its task, the department maintains a number of pit observers who are attached to each pit. Each pit also has its own committee which seeks to resolve any trading disputes that may arise. In addition to this, the trading floor is constantly under video-camera surveillance and all activities are taped. These video tape recordings are reviewed to spot any trading infractions and rule violations and are kept as a record.
- XIV.64 The Exchange requires that all customer funds in the hands of the Corporate Members be maintained separately. Such funds cannot be commingled with house funds and

have to be segregated and separately accounted for. SIMEX Members have to maintain books and records on all transactions relating to customers' funds.

- XIV.65 SIMEX requires that all its Corporate Members submit to the Exchange a daily report of customers with large positions (whether entered into on the Exchange or elsewhere). For this purpose, the Exchange has specified reportable levels for SIMEX contracts as well as for non-SIMEX contracts. The Exchange may require such reports from its Corporate Members even if the number of positions owned or controlled is below reportable levels. This practice allows SIMEX to better monitor and administer the market and helps to preserve the integrity of the Exchange.

Background on regulation in Japan

- XIV.66 BSJ was a company which was incorporated in the Cayman Islands. Its operations were conducted entirely in Japan through branches.
- XIV.67 In Japan a branch of a foreign securities firm is subject to the law on Foreign Securities Firms (1971), related laws, Cabinet orders and ministerial ordinances, official notices and rules and regulations of the self-regulatory organisations.
- XIV.68 The persons and authorities in Japan with regulatory responsibility for branches of foreign securities firms operating in Japan may be summarised as in Figure XIV.2.

Figure: XIV.2

| Person or Authority | Nature of their interest |
|---|---|
| Minister of Finance (Securities Bureau) | Overall regulation and supervision (excluding inspection) |
| Minister of Finance (Financial Inspection Department, Minister's Secretariat) | Inspection to ensure financial soundness |
| Minister of Finance (whose authority is delegated to Securities and Exchange Surveillance Commission) | Inspection to ensure fairness in securities transactions |
| Japan Securities Dealers Association | Self-regulation based on Rules and Regulations |
| Securities Exchanges | Self-regulation based on Articles of Association and Business Regulations |

Source: MoF

Methods of regulation in Japan

- XIV.69 The Minister of Finance grants a licence to a foreign securities company on a branch-by-branch basis. The essence of the screening criteria for a licence are that the applicant (a) has financial resources sufficient to carry out the business on a sound basis, and has good prospects for generating sufficient revenues to cover expenses, and (b) in the light of the composition of its personnel, has adequate knowledge and

experience for carrying out the business fairly and correctly and enjoys sufficient social credibility.

- XIV.70 When a foreign securities company, among other things, (a) has violated any law or regulation or any action has been taken by an administrative agency, and it is deemed necessary and appropriate in the public interest or for the protection of investors, or (b) seems to be in danger of becoming insolvent, and it is deemed unavoidable in order to prevent investors from sustaining damage, the Minister of Finance may revoke the licence granted to the branch of that foreign securities company or order the suspension of its business, in whole or in part, for a fixed period of not more than six months.
- XIV.71 Self regulation in effect includes regulation of, among others, employees of securities companies and internal administrators based on the rules and regulations of the Japan Securities Dealers Association.
- XIV.72 A foreign securities company is required to report to the Minister of Finance its capital adequacy ratio at the end of every month, or without delay in any case where the ratio falls to or below 120%. There is a requirement to set aside adequate reserves for losses. A foreign securities company is in addition required to hold within Japan assets equivalent to the sum of (a) its branch's liabilities to persons other than non-residents and (b) the legally required reserves mentioned above, and to deposit a performance bond of a certain amount.
- XIV.73 There is a requirement to prepare certain documents and to submit reports concerning the company's business and financial status, such as business reports (annually), balance sheet and profit and loss reports (monthly) and the above mentioned capital adequacy reports.
- XIV.74 Inspection to ensure fairness in securities transactions is conducted by the Securities and Exchange Surveillance Commission. Inspection to ensure financial soundness is conducted by the Financial Inspection Department, Minister's Secretariat, Ministry of Finance.
- XIV.75 When the financial position of a foreign securities company deteriorates to a certain level, e.g. its capital adequacy ratio falls to or below 120%, and when, in such cases, the Minister of Finance deems it necessary and appropriate in the public interest or for the protection of investors, the Minister may order such foreign securities company to change its method of business, or to suspend its business, in whole or in part, for a fixed period not exceeding three months, or may make other necessary orders.

Other UK regulators

- XIV.76 IMRO (an SRO) regulated a number of Barings companies, most of which were within the BAM group: Baring Asset Management Limited, Baring International Investment Limited, Baring Private Investment Management Limited, Baring Fund Managers Limited, Baring International Investment Management Limited and Ravensbourne Registration Services Limited. BB&Co also had three IMRO regulated subsidiary companies: Baring Venture Partners Limited, BHB Management Limited and Baring Capital Investors Limited. Baring Houston & Saunders Limited is also IMRO regulated and is one third owned by Houston. There were also three Barings unit

trusts regulated by IMRO: Abbotstone Agriculture Property Unit Trust, Gulliver Development Property Unit Trust and Lilliput Property Unit Trust.

- XIV.77 IMRO's method of supervision is carried out in a number of ways, including inspection visits, reporting procedures, complaints reporting and financial returns. IMRO also requires annual statements of representation signed by the chief executive.
- XIV.78 IMRO representatives attended College of Regulators Meetings in respect of Barings. IMRO relied on the Bank to monitor the financial soundness of the Group as a whole. IMRO has liaised with the SFA over specific issues. In respect of overseas liaison, the only example mentioned was significant past liaison with the US Securities and Exchange Commission.
- XIV.79 BSL and BSB were both members of the LSE and BB&Co was a participant in the institutional net settlement service. The LSE only regulated BSL and BSB in terms of their competence as market participants. The arrangement with BB&Co was commercial and involved no regulatory responsibility. The SIB supervises the LSE in respect of its position as a recognised investment exchange under the FSA. The LSE has an MoU with the SFA and receives quarterly reports from the SFA in respect of member firms. There are also six-weekly bilateral meetings with the SFA. The LSE has little liaison with the Bank and is not a member of the College of Regulators. The LSE has overseas liaison via the International Market Surveillance Group, but this does not include SIMEX or OSE.
- XIV.80 BSL was a member of the OMLX, an exchange which deals in financial futures and equity derivatives. Within the UK the OMLX would be most likely to liaise with the SFA if concerns arose with a member. There is little liaison with overseas supervisors.
- XIV.81 BB&Co was a principal at the LCH. BSL had been a member but had resigned approximately six months before the collapse.
- XIV.82 The LCH reports to the SIB in respect of membership and rule changes and also reports market information in respect of large positions. In practice the reporting is informal and not frequent. The LCH also holds monthly meetings with the SFA which are again relatively informal. There is also an electronic link into the SFA which provides financial information to the LCH on its members. Liaison with the SFA over BSL ceased when BSL resigned. The LCH has discussed with the Bank the question of regular liaison but at present there are no formal links. The LCH has recently been in close discussion with SIMEX on a specific project. SIMEX has been considering establishing MoUs with both the LCH and the International Petroleum Exchange.

APPENDIX XV MATTERS FOR CONSIDERATION BY THE SECURITIES AND FUTURES AUTHORITY

In addition to the matters referred to in paragraph 14.63 we set out below a number of further matters which the SFA should take in to account in considering their own regulatory arrangements.

- (a) Assessing the extent to which the SFA communicates with overseas regulators of companies related to member firms;
- (b) Adopting the recommendations we have made in respect of the Bank concerning communications with internal auditors and Audit Committees;
- (c) Instituting a system of regular meetings with management of member firms;
- (d) Instituting a system of reviews by reporting accountants along the lines of those under section 39 of the Act and meeting regularly with auditors;
- (e) Clarifying rules concerning guarantees and comfort letters;
- (f) Establishing clear procedures concerning the hand-over from one surveillance officer to another;
- (g) Re-evaluating the aims and objectives of inspection visits to member firms.



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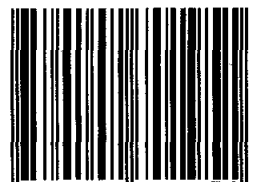
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