Investment News

Monthly Bulletin from the Insurance & Investment Team

February 2018

Last Month in Brief

On 15th January Carillion, the UK's second biggest construction company, entered into liquidation. Carillion had run up large debts of around £1.5bn and accrued a pension scheme deficit of around £600m. Just two weeks after the collapse of Carillion, rival outsourcing firm Capita, one of the UK's largest employers providing public services, announced a profit warning and suspended its dividends to shareholders. This saw its share price fall to a 15-year low and its pension deficit stands at £381m.

Figures released in January 2018 showed sustained strong economic performance in the Eurozone over 2017 resulting in a 10-year high for growth. Eurostat revealed the Eurozone economy grew by 2.5% which is its strongest growth since 2007. This performance outstripped the US and UK economies, which expanded by 2.3% and 1.8% respectively in 2017. Measures of economic sentiment remained high, although fell slightly from record levels reached in 2017.

The Dow Jones Industrial Average fell to 23,860 after falls of more than 1,000 points twice in one week at the start of February. This decline followed the average having hit a record high level above 26,000 in January. The sharp fall has largely been attributed to investors' fear that inflation might rise more quickly than expected, leading policymakers to raise interest rates. Both Asian markets such as Japan's Nikkei 225 and the UK's FTSE 100 saw declines in response to the market movement seen in the US.

Chart 1: Equity Indices
Equity markets rose over January

Chart 2: Sterling Credit Spreads
Credit spreads fell over the month

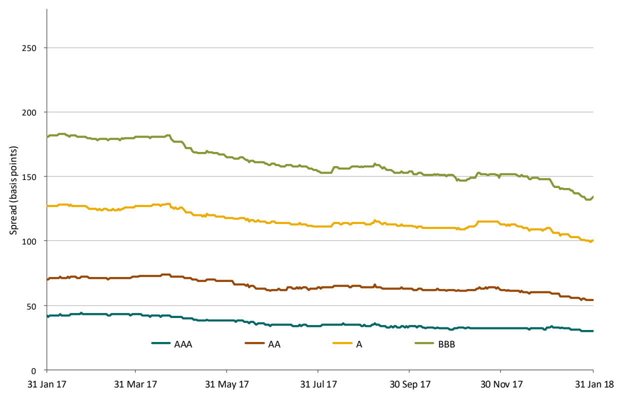


Chart 3: Gilt Yields
Short term gilt yields rose over the month

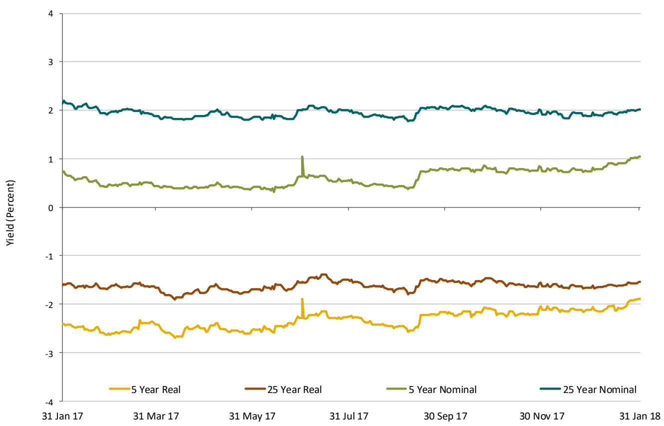
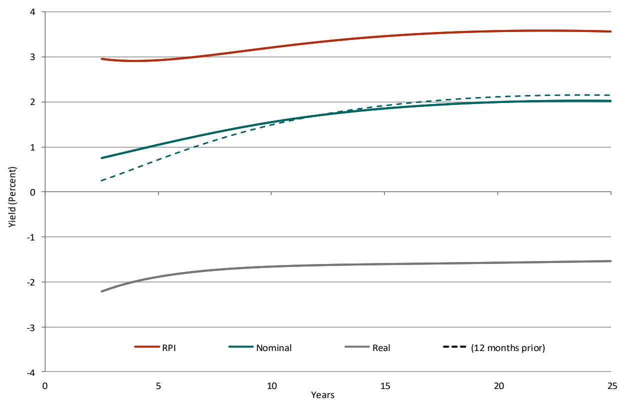


Chart 4: Gilt Spot Curves*
The yield curve was stable over the month



** Data for the real and inflation gilt spot curves prior to 1st January 2017 is temporarily unavailable from the Bank of England*

	Latest	Previous		Latest	Previous
CPI (annual change)	+3.0%	+3.1%	**Base rate**	0.5%	0.5%
PPF 7800 funding ratio	93.9%	94.7%	**$/£ exchange rate**	1.42	1.35
Halifax house prices (monthly change)*	-0.6%	-0.8%	**VIX (volatility) index**	13.54	11.04

** Halifax have recently changed their methodology for calculating the above figures so the figures may not be consistent with previous updates*

For monthly published indices "Latest" and "Previous" refers to the two most recently published statistics, otherwise numbers are quoted as at the month end.

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Barings Bank Collapse

In this article we look back at a historic event in the investment world and see how the lessons learnt at the time are still important today.

In February 1995, Barings Bank, the world's second-oldest merchant bank at the time, collapsed into administration in what was largely attributed to the actions of a single *rogue trader*. In this article we look back at how Barings collapsed and measures that have been put in place within the industry as a result of the collapse.

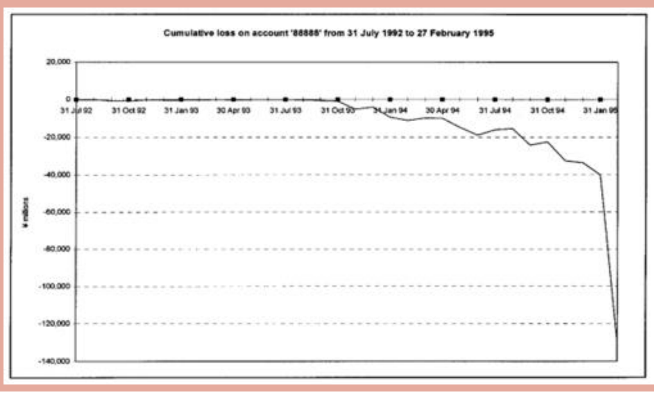
What happened?

When an earthquake shook Kobe, Japan in 1995 it broke open an ongoing scandal within the walls of Barings Bank. At the centre of the scandal was Nick Leeson, a derivatives trader who, by the age of 28, had risen through the ranks of Barings to head its operations on the Singapore International Monetary Exchange (SGX).

Nick Leeson joined Barings at the age of 22 and initially made huge profits in his speculative trades. He was given full authority to seek out temporary price differences that existed between the Singaporean and Osaka futures exchanges to make a "risk–free" profit. He was further entrusted with the responsibility of Barings Futures Singapore Exchanges settlement operations, allowing him to check his own trades and enabling him to utilise the now infamous 88888 error account which was used to settle errors in trades. Barings recognised the risk of having Leeson in charge of both the dealing and settlement operations, however, as a result of the substantial profits Leeson was viewed to be generating in his role, management were reluctant to upset the 'applecart'.

Figure 1: Cumulative Losses on the 88888 Account from 31/07/1992 to 27/02/1995

Data Source: Board of Banking Supervision Investigation into the Failure of Barings



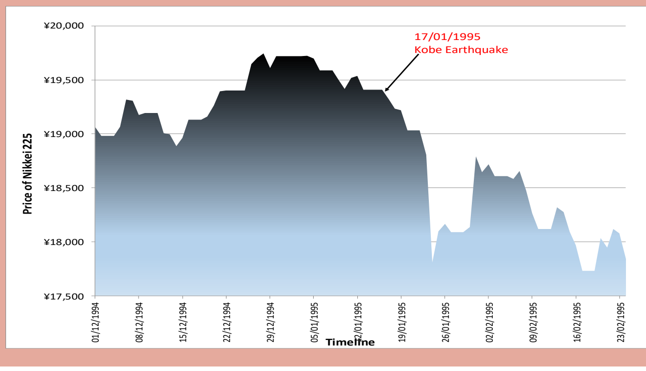
By the end of 1994 Leeson had racked up losses in the 88888 account of over £200 million from unauthorised transactions.

Prior to Leeson's involvement, Barings had been taking advantage of an arbitrage opportunity that existed due to temporary price differences in the Nikkei 225 futures on the SIMEX and OSE. Shortly after his appointment, Leeson began trading Nikkei 225 futures and Japanese Government Bond (JGB) futures.

Leeson continued to trade in Nikkei 225 and JGB futures at the start of 1995 but the markets started to turn against him. The trade that undid Leeson and Baring was a 'short straddle' on the Nikkei, a sale of both call and put options designed to benefit from limited price movements. These options give the holder the right to buy (call) and sell (put) an underlying asset at a specified strike price, for a certain period of time. However, On January 17th an earthquake hit Kobe in Japan, causing $100bn in damage, sending shockwaves through the Japanese futures markets. Leeson continued to invest heavily and attempted to offset the losses with increasingly desperate, short -term gambles that were based on the rate of recovery of the Nikkei. However the market continued to decline into February. Leeson called it quits at the end of February leaving a note reading "I'm Sorry" and fled to Malaysia with his wife on 23 February.

Figure 2: Price Of Nikkei 225 from 01/12/94 to 23/02/95

Data Source: finance.yahoo.com



With insufficient funds to continue trading, Barings Bank went into administration on 26 February 1995, despite the Bank of England's best efforts to bail it out. Leeson was apprehended at Frankfurt airport on 2 March and extradited back to Singapore where he received a prison sentence of six-and-a-half years.

Preventative measures put in place

The following measures have arisen from the findings of the Board of Banking supervision into the failures that led to the collapse of Barings:

> Management teams have the duty to understand fully the business they manage;

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

> Clear separation of front and back office operations;

> Relevant internal controls, including independent risk management, have to be established for all business activities; and

> Senior management and the Audit Committee have to ensure that significant weaknesses, identified to them by internal audit or otherwise, are resolved quickly.

Barings' losses of over £820 million caused the bank to collapse catastrophically, largely attributed to the actions of a single *rogue trader*. However, the situation wasn't entirely out of Barings' control. Senior management failed to implement fundamental processes that are crucial to preventing fraudulent activity from taking place.

The lessons arising from Barings' collapse are very much relevant today. In 2012 JP Morgan suffered large trading losses of $6.2bn after a trader nicknamed *the London Whale* entered into complex derivative trades which senior management did not fully understand nor appropriately control with risk limits breached over 300 times before the bank took action. These events show the importance of companies today remaining vigilant and learning from the lessons of the past to ensure they are not repeated again in the future.

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