A Royal Mess

Britain's Barings PLC Bets on Derivatives —And the Cost Is Dear

Venerable Firm Collapses Under $800 Million Loss By Young Trader in Asia

Bank of England Rescue Fails

WSJ 2/28/95 A1

A WALL STREET JOURNAL *News Roundup*

LONDON – After a year in which the world saw a cascade of fiascoes in derivatives trading, Barings PLC disclosed one of the most astonishing disasters so far: a more than $800 million loss on derivatives trading that has driven the blue-blooded investment bank under.

Even more astonishing, the unauthorized trading apparently was masterminded by a 27-year-old Englishman in Barings's Singapore office.

The debacle is an ignominious end to an illustrious history for Barings, a 233-year-old bank that financed the Napoleonic Wars and the Louisiana Purchase and whose clients today include Queen Elizabeth II.

Ripple Effect?

The staggering loss from derivatives—complex financial products whose returns are linked to returns on such assets as stocks, bonds, currencies or commodities—dropped jaws from Singapore to New York to London and threatens to have a ripple effect in markets throughout the world. In Tokyo, where Nicholas William Leeson's trading of huge volumes of Japanese stock-index futures contracts led to the loss, market players braced themselves for a rocky start to trading. Authorities also worried that currency markets could be roiled, as the British pound fell against the dollar and the mark in early Monday morning trading in Asia.

In falling so far so fast, Barings joins a grim list of investors and institutions—Orange County, Calif., Procter & Gamble Co. and Metallgesellschaft AG of Germany—whose names have become synonymous with the pitfalls of high-risk investing.

"What is extraordinary is that Barings was widely regarded as one of the best-run houses in London. This came as a bolt from the blue," says a regulatory official.

As bad as the loss sounds, it could get even worse. The Bank of England threw in the towel last night in an attempt to fashion a rescue plan for Barings. The central bank noted that the loss could grow, saying the futures contracts on which the investment bank lost money "are still open, exposing Barings to unquantifiable further losses until the contracts expire or are otherwise closed out."

Legal Proceedings

Potential buyers, including U.K. and foreign institutions, pored over Barings's accounts to see if they would be interested in taking it over, but decided Barings was in "too big a mess," according to one potential bidder. After the Bank of England's bailout plan failed, Barings was forced into administration, a legal proceeding akin to Chapter 11 bankruptcy-court proceedings in the U.S. Under administration, a court-appointed administrator negotiates with creditors, evaluates the company's prospects and disposes of assets if appropriate.

Little is known yet about Mr. Leeson, who has disappeared since the scope of the loss was uncovered late last week. According to reports circulating within the bank, Mr. Leeson had a maverick's reputation. Some weeks ago, people familiar with Barings say, the merchant bank found itself in the embarrassing position of having to appeal to the Singapore authorities to release him from detention after he was accused of drunken and disorderly conduct.

In an interview with AP-Dow Jones News Service last week, before the crisis erupted, Mr. Leeson said he was heavily involved in trading futures contracts pegged to the Nikkei-225, a major index of Japanese stocks, on the Osaka futures market and on the Singapore International Monetary Exchange, or Simex. Such contracts allow buyers to bet on the level at which the market index will stand at specified dates; they can be used to hedge market positions or to speculate on the market's direction.

'A One-Way Bet'

Mr. Leeson told AP-Dow Jones he had been arbitraging – buying the contract on Simex and selling in Osaka in a strategy designed to take advantage of price differences between equivalent contracts listed on the two exchanges. However, the regulatory official says, Mr. Leeson appears to have "taken a one-way bet" that went wrong. The positions apparently were built up over a period of about a month.

There are different accounts of Mr. Leeson's trading strategy. Some Barings insiders say he apparently had extensive "long" positions, or contracts requiring him to buy stocks in the index at current prices, on the assumption that the index would rise and he could sell the contracts at a profit.

Barings had stood out for its bullishness in Japan's futures market, even though political scandals had marred many investors' confidence about Japanese stocks. "Barings was the most conspicuous purchaser [of futures] at these levels," says Alexander Kinmont, a strategist for Morgan Stanley & Co. in Tokyo. Indeed, worried Japanese institutional investors have asked other foreign firms about the reasons behind Barings's lonely bullishness,

Please Turn to Page A6, Column 1

A Royal Mess: Britain's Barings Collapses as Losses From Derivatives Top $800 Million; Rescue Bid Fails

Continued From First Page

Mr. Kinmont says.

But others familiar with Mr. Leeson's trading say his futures trades represented a more complex wager that the market wouldn't break out strongly in either direction. Such a gamble, which would have made money only if the market remained stable, would produce the same kinds of losses in a tumbling market as an outright bet on the market's direction.

Either way, he lost as the Nikkei-225 declined 3.5% in the final two trading days of last week. The index is down a total of 4.5% since Feb. 10.

A person familiar with Barings insisted that senior officials in London only learned of the heavy loss on Thursday night. Indeed, this person says executives assumed that the trading was on behalf a client or clients and that the bank itself wasn't exposed to any potential trading losses. "We heard rumors of a huge [derivatives] position, but we believed it was a client and [that] we were just a acting for them," said the board member.

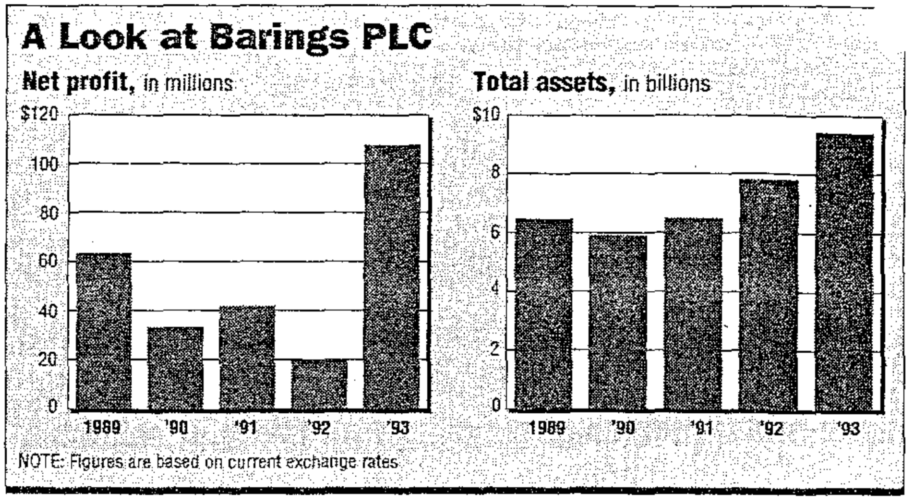
Barings's loss is likely to renew calls for greater regulation of derivatives. Although Barings maintains that it did have adequate controls on derivatives trading, critics wonder how strict they were if they were so easily circumvented by Mr. Leeson. Indeed, they add that the debacle raises serious questions about risk-management controls and oversight of trading operations. Specialists at other firms expressed surprise that Barings's internal checks and controls hadn't switched on alarm bells sooner. "There's widely available software for this type of risk management," a Hong Kong-based regional fund manager says. "The head [of the Singapore futures arm] should be able to get up on a Saturday morning, dial in and see exactly what their exposure is." Moreover, Barings's aggressive buying of futures "has been very solidly rumored for a month," adds a futures trader in Tokyo.

Acting With Others?

Some Barings executives were equally surprised by the apparent breakdown of internal controls. "The great shame is we're very conservatively run," one executive says. "The one thing that we were trying to minimize – proprietary risk taking – is what blew us out of the water."

Indeed, the fear that the 233-year old firm might fold has already resulted in finger-pointing. One senior executive at the securities company subsidiary stressed that Mr. Leeson's trading had occurred in a financial products unit that, although 50% owned by the securities unit, was managed by Barings's banking subsidiary.

Officials also are looking at the possibility that Mr. Leeson may have been acting with others. Noting apparent attempts to disguise trading activity at the Singapore futures subsidiary, he added: "There's an appearance that this person wasn't doing what the company thought he was doing. It's more than just a trader exceeding limits." Another Barings's official said, "It's not just sloppy trading; it's too big to be that."



Despite some concern that Barings's problem could trigger panic selling in global securities markets, a former senior Western central banker was more sanguine. "If this thing is contained mainly on the Simex and Osaka exchanges, the immediate effects would be limited on other institutions," he says. That is because the two futures exchanges could control the damage in a way that would "distribute the immediate losses among their members."

He added: "From a systemic point of view, this isn't a problem."

Meanwhile, executives at other financial institutions throughout the world were scrambling over the weekend to calculate what their own exposure is to Barings.

"What I'm working on very provisionally is my exposure to them; so far, everything we've turned up indicates that we owe them money. So we're all right unless there is some long-dated derivatives contract we don't know yet," said the head of risk management at a U.S. commercial bank in New York. "I'm sure there are a l of institutions doing a lot of things we are looking at their own exposures and contracts due to settle in the next few days."

24