Barings Collapses; Financial System Bears Up Well

WSJ 2/28/95 A14

By Gregory J. Millman

How did a young trader from a working-class background topple Barings, banker to the queen? The answer leapt boldly into yesterday's headlines: derivatives, the new, complex and risky financial instruments that hardly anyone understands.

Yet three things are wrong with that answer. First, the derivatives blamed for the Barings disaster are not that complex—they are straightforward futures contracts. Second, they aren't that new—futures contracts have been around for more than 100 years, stock-index futures for more than a decade. Third, they aren't that risky, either, insofar as risk means the possibility of unexpected things happening. The general relationship between financial futures contracts and the underlying stocks is even taught in business schools. There's been no suggestion that the relationship broke down in Singapore and took Barings with it.

In fact, Barings fell because of simple trades in rather old-fashioned financial instruments. A 20-something trader, Nick Leeson, put on enough of these trades to wipe out the capital of a 200-year-old pillar of the establishment. How did this trader manage to put the firm's existence at risk? And what does it mean to the safety of the international financial system?

The answer to the first question is bad management. The answer to the second is that the collapse of Barings is a symptom of a healthy financial system.

Based on reports to date, upper management knew that Mr. Leeson was taking huge positions in Japanese stock index futures but assumed that the trades were made on behalf of a customer. If that is true, the Barings scenario follows the script to which we have become accustomed in a new genre of business theater, the derivatives-disaster play.

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It is a rule of the form that upper management not be completely in the dark, but also not trouble to enlighten itself about the source of profits being earned by eager speculators in its employ. In Orange County, although state law had been changed to permit speculation by a county official, no one really seemed to know what the official was doing—including, by his own account, himself—when disaster struck. Metallgesellschaft, like Barings, foundered in the futures market, under supervisors willing to ask few questions when the ink was black. The losses that ensue in these cases are an appropriate penalty for careless management.

True, people who gained little from the speculation are sometimes injured. In Britain, people far from the financial markets are wondering how they will pay their floating-rate mortgages. In Orange County, taxes are going up and some county employees will be looking for new jobs. Still, those who stood to gain the most are generally the ones to lose the most.

This is rough justice. It is better than the alternative, in which governments bail out bad managers and people who stood to gain absolutely nothing from the speculation are compelled to pay for the losses. Not better because it is more moral, but better because it is more useful.

Although the Barings collapse is a disaster for the management of Barings, it shows that the international financial system is basically in good shape. The capital of Barings has been wiped out, and no doubt the membership of the Singapore and Osaka exchanges will also bear losses, but there's no sign that the collapse will lead to the kind of chained bankruptcies that helped usher in the Depression.

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In fact, the containment of the collapse of Barings is a tribute to the derivatives markets, and to the new international financial system that has evolved over the past two decades. The derivatives markets got their start in 1972, when the Chicago Mercantile Exchange began to trade currency futures contracts. The collapse of the Bretton Woods international monetary system had proved that governments were incapable of providing a safe, sound and stable financial environment. Traders took the law into their own hands and sold protection at a price.

Currency futures were followed by interest rate futures, equity options, currency options and a host of other financial instruments traded over the counter, confidentially, beyond the reach of regulatory authorities. The first swap contract, for example, came about because the World Bank wanted to borrow Swiss francs and German marks when the Swiss and German financial regulators were unwilling to allow it to borrow on their markets. The Singapore International Monetary Exchange began to trade futures on the Nikkei index at a time when the Japanese authorities did not allow Nikkei index futures trading in Japan. Later, when the Japanese stock market began to slide in 1990, the Ministry of Finance tried to stop the trading of Nikkei index futures in Singapore and Nikkei options at the American Stock Exchange, to no avail.

The new international financial system is a truly private market that is difficult if not impossible for governments to control. Participants in this system survive or die by their ability to assess and manage risk. Yet despite the fact that it functions largely without the benefit of government protection and regulation, this international system has been flexible enough and strong enough to weather the collapse of the Japanese stock market in 1990, the disintegration of the European Exchange Rate Mechanism in 1992, the crisis at Metallgesellschaft in 1993, the corporate derivatives losses and Orange County crisis of 1994, and would no doubt have absorbed the collapse of Mexico's peso in 1995 even without a rescue package.

The Bank of England's decision to allow Barings to enter bankruptcy may be the strongest signal yet that the free markets are, in fact, their own best regulator.

Mr. Millman is the author of "The Vandals' Crown: How Rebel Currency Traders Overthrew the World's Central Banks," due from The Free Press in May.

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