How to Prevent Future Nick Leesons

Blame for the collapse of Barings PLC cannot be pinned solely on a mischievous trader named Nick Leeson and financial products called derivatives. That's the conclusion of last month's report by Britain's Board of Banking Supervision.

Rather, the report exposes a fatal rift at Barings that should concern every bank and corporation: a rift in the corporate culture. Three months before the bank's collapse, the head of the Barings group treasury complained to his chief executive that it was "a struggle to get hard information" about the bank's control systems, and that "it is becoming much clearer that our systems and control culture are distinctly flaky." Subsequent events proved a fundamental breakdown in shared institutional ethos. This "culture" failure deserves reflection.

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By Charles M. Seeger

At the broadest level, national regulators, with cooperation on the international level, can take important steps to promote procedures for risk management. They can use their authority to ensure that financial market participants act responsibly and have sufficient capital to support their activities. But they can only do so much. Governments have quite properly recognized that most of the responsibility for regulating the extensive derivatives markets rests with those who use them.

Self-regulation, in fact, has been the emphasis of recently published international recommendations for derivatives users. Self-regulation in these markets is synonymous with self-interest, and that is a powerful engine. The triple-A rating that can be achieved only through a high internal standard of credit-worthiness is a valuable competitive advantage, whether it be for a dealer bank, a corporate counterparty or the Options Clearing Corporation in Chicago. A 1993 study by the Group of Thirty on global derivatives issued 24 recommendations for managing the risks associated with derivatives use. Had the recommendations been followed at Barings, it would not now be owned by a Dutch insurance and banking firm.

Cultivating a culture of risk management at banks and corporations does not mean overhauling the way they do business. Rather, it means fostering what the best institutions have historically done well: manage their diverse risks to a competitive advantage. From investing deposits to guaranteeing loans, risk management has been the business of banks.

The concept of an internal risk management culture guiding the use of derivatives is indispensable for banks and large corporations. Today the talk is about OTC swaps, binomial trees and Monte Carlo simulation. The heightened notoriety of derivatives, as a result of the losses suffered by Metallgesellschaft, Procter & Gamble, Gibson Greetings, Orange County, Barings and others, has had a truly positive impact on risk management. But a successful risk management culture is greater than the sum of careful procedures for managing separate risks.

Beyond procedures for managing individual risk areas, management and traders, board members and the corporate treasurer must share the same understanding of their firm's appetite for risk; they must, in short, convey a "risk" culture. This is easier said than done, but corporate and bank managers might begin by asking the following questions:

- Do we have our risk management philosophies and procedures clearly codified and distributed?
- Do compensation policies include incentives that skew behavior toward or away from the desired risk appetite?
- Are sanctions for violating the controls understood and enforced?
- Are there educational and training techniques in place that reinforce the corporate risk management culture?
- Do we prudently minimize operational risks by having fully trained front-office and back-office personnel?
- Do we assign and monitor market risk and trading, or do we position limits by properly measuring volatility, pricing derivative instruments, and valuing revenue at risk?
- Do we assign and monitor credit risk according to counterparty rating, instrument, currency, etc.; and do we have effective means for handling exceptions to credit risk limits?

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- Do we protect against legal risks by securing and tracking all documents, regularly updating contracts and quickly responding to legal problems?
- Do we have reliable technical systems for daily processing of our contracts and for possible disaster recovery?

One of the above questions deserves special comment. Bank policies that provide compensation incentives that fail to include a comparison of profit made with risks taken can—as it did with Barings—jeopardize the institution. Profit enhancement and risk management need not be conflicting objectives, but they can be. Banks that consciously pursue a culture of risk management should look for ways to build incentives for the effective use of derivatives to control financial risks.

One valuable tool for management that has begun to receive some attention is the VAR, or value-at-risk method. VAR measures how much of a firm's money is at risk each day in its various derivatives contracts and other investment strategies. The chief virtue of VAR is its simplicity. Using rudimentary probability analysis, it generates a single number to quantify with high probability the outer limits of what could be lost on any given trading day. The Basel Committee on Banking Supervision has suggested a regulatory framework that allows banks to use internal capital adequacy models such as VAR, and the Bank of England has recently allowed British banks to use their own in-house risk management systems to calculate capital reserves. Five U.S. banks—J.P. Morgan, Chase Manhattan, Bankers Trust, Chemical Bank and Citicorp—use VAR for measuring market risk, but few end-user corporations have begun using VAR.

The effort required to institute a variety of risk-control measures (no one technique will do the job) may discourage management at banks and corporations from instituting such measures. The fact that former physicists design many of the financial instruments may further dissuade management. But for each of the institutions that has suffered derivatives losses in the past few years, there have been hundreds of unheralded companies that have successfully and profitably managed their financial risks.

The "corporate culture" of risk management will be emphasized because it is in each company's self-interest to do so. The fact is, hard falls teach hard lessons. Barings failed—and it was Barings's fault. What could be more instructive?

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