Fordham Law Review

Volume 64 | Issue 1 Article 1

1995

Lessons from the Barings Collapse

Sheila C. Bair

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Lessons from the Barings Collapse

Cover Page Footnote

Sheila C. Bair is Senior Vice President, Government Relations for the New York Stock Exchange (the "NYSE"). She was a member of the Commodity Futures Trading Commission (the "CFTC") from June 1991 to June 1995. The views expressed in these Remarks are the author's and are not necessarily those of the CFTC or the NYSE.

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Volume 64

1995-1996

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REMARKS

LESSONS FROM THE BARINGS COLLAPSE*

*SHEILA C. BAIR***

INTRODUCTION

THE February 1995 collapse of Barings PLC ("Barings") has, in many respects, produced far more questions than answers. This afternoon, I would like to explore some of those questions and such answers as we have to date. Perhaps the most frequent questions, especially among the general public, are "What caused the Barings collapse?" and "Could something similar happen in the United States?" I will try to answer both those questions in due course. First, however, given the fact that most of Barings' losses occurred through futures trading (albeit on overseas markets), it might be helpful to begin with some background about futures markets generally and how they function.

I. BACKGROUND ON THE FUTURES MARKETS

The traditional futures contract is simply a standardized agreement between a buyer and seller that requires the seller, called the short, to deliver to the buyer, called the long, a particular commodity at a future date, for a price agreed upon at the contract's inception.[1] Though many futures contracts require physical delivery of the underlying commodity, they are typically offset prior to delivery with the parties paying (or receiving) a cash amount equal to the difference between the initial contract price and the contract's value on the date their obligations are extinguished.[2] Many people still think of futures contracts in terms of agricultural commodities. In point of fact, however, the overwhelming majority of futures trading, both in the United States and internationally, involves financial instruments such as stock indices, government bonds, and foreign currencies.[3]

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* These Remarks are adapted from a speech presented on April 20, 1995, in connection with the 1994-1995 Fordham University Graduate Colloquium: Financial Services Regulation at Mid-Decade.

** Sheila C. Bair is Senior Vice President, Government Relations for the New York Stock Exchange (the "NYSE"). She was a member of the Commodity Futures Trading Commission (the "CFTC") from June 1991 to June 1995. The views expressed in these Remarks are the author's and are not necessarily those of the CFTC or the NYSE.

1. *See* Chicago Board of Trade, Commodity Trading Manual 8 (Lloyd Besant ed., 5th ed. 1982).
2. 1 Philip M. Johnson & Thomas L. Hazen, Commodities Regulation § 1.04 (2d ed. 1989).
3. *See* 1994 CFTC Ann. Rep. 99.

Futures contracts are highly leveraged instruments. Typically, the amount of performance bond or "margin" required to establish and maintain a futures position is less than five percent of the contract's notional value.[4] As a consequence, it is possible to make a great deal of money, or lose a great deal of money, very quickly on a relatively minimal initial investment. Leverage is not generally a problem for traders using futures for hedging purposes. Perfect hedges are risk neutral.[5] Losses on the futures position will be offset by gains on the underlying cash position being hedged, and vice versa.[6] Leverage can, however, pose significant dangers for speculators who intentionally assume risk in the hopes of profiting from future price movements.

Generally, futures trading, both in the United States and abroad, takes place on regulated exchange markets and is subject to some degree of governmental oversight.[7] In addition, futures transactions both here and overseas are supported by a clearinghouse guarantee.[8] A clearinghouse is the facility through which trades and the resulting financial obligations are settled.[9] The clearinghouse acts as the buyer to each seller and the seller to each buyer[10]—the universal counterparty guaranteeing performance for each transaction.

For traders on an exchange, the financial soundness of the clearinghouse is obviously of paramount importance. For this reason, both the Commodity Futures Trading Commission (the "CFTC" or the "Commission") and the exchanges the CFTC regulates take care to ensure that U.S. clearinghouses and their member firms are well capitalized and that accounts are adequately margined.[11] In the United States, all futures positions are "marked to the market" each day; that is, buyers and sellers must make daily settlements of all changes in contract value.[12] To date, the U.S. futures clearing system has been

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4. This figure represents a rough approximation of the margin required by most exchanges on most futures contracts.

5. *See* Johnson & Hazen, *supra* note 2, § 1.12, at 51-52.

6. *Id.*

7. Until the passage of the Futures Trading Practices Act of 1992, Pub. L. No. 102-546, 106 Stat. 3590 (codified in scattered sections of 7 U.S.C.), futures contracts in the United States were, with very few exceptions, required to be traded on a contract market designated by the CFTC to be legal. 7 U.S.C. § 6(a) (1988), *amended by* Futures Trading Practices Act § 502. The Futures Trading Practices Act empowered the CFTC to grant exemptions from the exchange trading requirement. Futures Trading Practices Act § 502 (codified at 7 U.S.C. § 6(c) (1994)).

8. Johnson & Hazen, *supra* note 2, § 2.50; *see* CFTC, International Regulation of Derivatives Markets, Products and Intermediaries 529 (1995) (reporting that numerous overseas regulatory agencies have rules pertaining to the scope, nature, and timing of clearinghouse guarantees).

9. Johnson & Hazen, *supra* note 2, § 1.31.

10. *Id.*

11. *See id.*

12. Mark J. Powers & David J. Vogel, Inside the Financial Futures Markets 26-27 (2d ed. 1984).

extremely successful. No customer has ever lost money due to an exchange member default.[13]

II. The Barings Collapse: What Happened?

While details of some of the events surrounding the collapse of Barings remain hazy, the essential facts, according to published reports, appear to be the following. Keep in mind, however, that investigations by the Bank of England, the relevant exchanges, and the criminal authorities in Singapore and England are continuing. In late 1994, Nicholas Leeson, Barings' twenty-seven year old head arbitrage trader in Singapore,[14] began to implement an options trading strategy premised on the assumption that the Nikkei 225, an index of leading Japanese stocks, would remain in a narrow trading range.[15] His trading strategy went awry shortly after the January seventeenth Kobe earthquake.[16] The Nikkei fell substantially and large losses began to accrue on his position.[17]

In late January of this year, in an apparent attempt to cover these large losses, Leeson abandoned his arbitrage strategy of buying futures contracts on one exchange and selling the same number at a slightly higher price on another exchange.[18] Instead, he started buying Nikkei 225 futures on both the Singapore International Monetary Exchange, or SIMEX, and the Osaka Securities Exchange.[19] This position would turn a profit if Japanese stock prices rose.[20] Leeson eventually built up futures positions on the two exchanges with a total notional value of over $7 billion.[21] At about the same time, Leeson started selling futures on long- and short-term Japanese government debt.[22] Because interest rates move inversely to the price of debt issues, the positions would profit if Japanese interest rates rose. These positions eventually grew to a notional value of $22 billion.[23]

Unfortunately for Leeson and Barings, both the Japanese stock market and Japanese interest rates fell, and all of Leeson's positions began to experience large losses.[24] Between late January and late February, Barings met margin calls[25] that totaled over $400 mil-

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13. Andrea M. Corcoran, Bankruptcy Pitfalls for Dually-Licensed Brokerage Firms, 12 Futures Int'l L. Letter 1 (Jan. 1993).

14. Leeson turned 28 on February 25, 1995. *See* Richard W. Stevenson, *Big Gambles, Lost Bets Sank a Venerable Firm*, N.Y. Times, Mar. 3, 1995, at A1.

15. *Id.* at D15.

16. *Id.*

17. *See id.*

18. *Id.*

19. *Id.*

20. *See id.*

21. Tony Shale, *Why Barings Was Doomed*, Euromoney, Mar. 1995, at 40.

22. *See* Stevenson, *supra* note 14, at D15.

23. *Id.*

24. *Id.*

25. *Id.*

lion.[26] On February twenty-third, Leeson left Singapore.[27] The next day, Peter Baring, the chairman of Barings, was informed of the situation.[28] At that point, the open positions established by Leeson had unrealized losses of nearly $1 billion.[29]

Barings informed the Bank of England of the situation on that same day.[30] Over the ensuing weekend, the Bank of England tried to formulate a rescue package for Barings.[31] This proved impossible because Barings' futures positions remained open, and thus the full extent of the losses on these positions was unknown.[32] On Sunday, February twenty-sixth, Barings was placed into administration, the British equivalent of bankruptcy.[33] Soon thereafter, Barings' proprietary positions on SIMEX, the Osaka Securities Exchange, the Tokyo International Financial Futures Exchange and the Tokyo Stock Exchange were liquidated.[34] Though the liquidation was orderly, total losses on the positions approximated $1.4 billion.[35] In early March, ING, a Dutch bank and insurance firm,[36] purchased Barings' entire business for one British pound.[37]

III. What Caused the Barings Collapse?

In sum, over a period of approximately two months, futures and options trading by a single trader in the Singapore office of Barings triggered the collapse of a financial institution that had endured for 233 years. What was the underlying cause of this disaster? There is no doubt in my mind concerning the answer to that question: a profound and fundamental breakdown of Barings' internal controls. According to published reports, Leeson was allowed to oversee *both* the trading activities of the Singapore office and its "back office systems"—those systems which provide for the settlement and accounting of transactions.[38] In other words, there apparently was no independent Barings official looking over Leeson's shoulder to review

26. *See* Frances Maguire, *Can You Manage It?*, Futures & Options World, Apr. 1995, at 25.
27. *See* Stevenson, *supra* note 14, at D15.
28. *Id.* at A1.
29. *See id.*
30. *See* Ginger Szala et al., *Barings Abyss*, Futures, May 1995, at 68.
31. Richard S. Grossman, *Barings' Failure, Then and Now*, J. Com., Mar. 27, 1995, at 9A.
32. *Id.*
33. Stevenson, *supra* note 14, at A1.
34. Jane Blennerhassett, *Barings' Singapore Losses Remain Mystery*, Reuters, Feb. 28, 1995, *available in* WESTLAW, REUTERNEWS Database; Velisarios Kattoulas, *Barings' Japan Positions Squared, But Worries Linger*, Reuters, Mar. 2, 1995, *available in* WESTLAW, REUTERNEWS Database; *see* Shale, *supra* note 21, at 40.
35. Shale, *supra* note 21, at 40.
36. Peter Truell, *Sale of Baring Assets to ING Group is Likely*, N.Y. Times, Mar. 3, 1995, at D15.
37. Shale, *supra* note 21, at 40.
38. Maguire, *supra* note 26, at 25.

and verify his transactions and ensure that his trading activity was kept within acceptable levels of risk.

In my view, any firm engaged in significant derivatives trading should have risk management systems which are kept separate and distinct from its trading functions and which have independent lines of reporting authority reaching to the highest levels of senior management. Virtually every study of derivatives markets over the past few years has emphasized the basic need for firms to separate risk management from trading functions.[39] Because I am speaking to a group of practicing lawyers and lawyers-to-be, let me add that if I were advising a client on the single most important step it should take in the aftermath of the Barings collapse, it would be for the client to reevaluate its internal controls to ensure that this basic principle is being followed. Moreover, if I were counseling an end-user of derivatives products, I would strongly advise against doing business with any financial intermediary that does not follow this simple rule.

IV. COULD IT HAPPEN HERE?

The question of what caused the Barings collapse is much easier to answer than the question of whether it could happen here. I wish I could say that all major U.S. banks and financial firms adhere to the highest standards of internal controls and risk management. I believe (and hope!) that they do, but obviously there are no guarantees. What the United States does have, however, is a sophisticated set of safeguards designed to give the CFTC and its self-regulatory organizations some advance warning when a firm's futures trading may be getting it into trouble. Had the Barings scenario started to play out in the U.S. marketplace, I believe these safeguards would have been triggered well before the situation reached the disastrous proportions it actually assumed overseas.

In a situation involving unusually large positions, such as those Barings accumulated, the CFTC's first line of defense would be its market surveillance system.[40] The CFTC and all U.S. futures exchanges maintain large trader reporting systems. If a trader's position exceeds a "reportable level," it must file certain information about itself with the CFTC.[41] The reporting thresholds for each contract are set fairly low in relation to volume and open interest in the contract.[42] For in-

39. *See, e.g.*, Commodity Futures Trading Commission, OTC Derivatives Markets and Their Regulation 134 (1993) (noting the need for such a separation); Global Derivatives Study Group, Group of Thirty, Derivatives: Practices and Principles 12-13, 15-16 (1993) (same); U.S. Gen. Accounting Office, Financial Derivatives: Actions Needed to Protect the Financial System 56 (1994) (same).

40. 2 Johnson & Hazen, *supra* note 2, § 3.118.

41. 17 C.F.R. § 18.04 (1995).

42. *See id.* § 15.03.

stance, the threshold for the U.S. futures contract on the Nikkei 225 Index is fifty contracts.[43]

When a trader's position becomes reportable, the trader must provide the CFTC with the name and phone number of the person who controls trading in the account and the identity of any other accounts controlled by that person.[44] Futures commission merchants, or FCMs, are also required to file daily reports about all accounts they carry which exceed reportable levels.[45] These can be cross-checked against the reports filed by the individual traders. Accounts under common ownership or control are aggregated for reporting purposes, meaning that a trader cannot avoid the CFTC's reporting requirements by controlling a number of small accounts below the reporting threshold.[46]

Large trader information is filed electronically.[47] Information reflecting positions of traders as of the market close on Monday is available on Tuesday morning to the CFTC surveillance economist responsible for monitoring a given contract. Large, unusual, or concentrated positions on one side of the market, or distortions between cash and futures positions, are carefully scrutinized. The CFTC surveillance staff briefs the Commission weekly on any unusual market conditions. There is no question in my mind that a Barings-type trading pattern developing in the U.S. marketplace would have quickly set off alarm bells, triggering a thorough follow-up by our surveillance staff and a prompt report to the Commission.

In addition to looking at unusual positions or market conditions, U.S. market surveillance systems also monitor for compliance with speculative position limits.[48] For example, the Chicago Mercantile Exchange's (the "CME") speculative limit for the Nikkei 225 is 5,000 contracts.[49] Any exemptions from the limits (for hedge positions, for instance) must be thoroughly documented.[50] Again, in the U.S. marketplace, the Barings positions undoubtedly would have triggered a review for exceeding speculative limits. Similarly, a review of the evidence submitted to obtain a hedge exemption would have occurred, including a review of any related cash market position. In this connection, the extensive information sharing arrangements among the CFTC, U.S. futures markets, and the CFTC's securities counterparts would enable the CFTC to verify independently whether a trader is holding positions in the securities markets that might offset large stock index futures positions.

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43. *Id.*
44. *Id.* § 18.04.
45. *Id.* § 17.00.
46. *Id.* § 18.01.
47. *See id.* § 17.02.
48. *See* 7 U.S.C. § 6a (1994); Johnson & Hazen, *supra* note 2, § 2.20.
49. Chicago Mercantile Exchange Rule 4402(D) (1994).
50. 17 C.F.R. § 19.00(b)(1) (1995).

In addition to conducting market surveillance, both the CFTC and the exchanges closely monitor for compliance with financial integrity rules. Exchange financial surveillance systems routinely produce "exception reports." These reports provide information about firms which are carrying positions that are large relative to the market, or that sustain a series of losses over time, or that have the potential to generate large losses relative to the amount of margin the firm has on deposit or the firm's capital. The exchanges also are required to do stress testing to monitor the vulnerability of their clearing members during times of market volatility.

Furthermore, U.S. futures exchanges maintain a joint information system that shares daily pay and collect information.[51] By sharing such information, they can obtain a better view of their clearing firms' activities across all futures and option markets.

Finally, U.S. exchanges have affirmative duties to supervise their markets as a matter of law, and they take those duties very seriously.[52] So does the CFTC. The agency conducts regular rule enforcement reviews of exchange self-regulatory programs and issues public "report cards" grading the exchanges' performance.[53]

I believe the system I have just described would make it very difficult, if not impossible, for the Barings crisis to have taken place in U.S. financial markets, particularly given the fact that Barings accumulated its ill-fated positions over nearly two months. As the firm's market position and its risk exposure built up, Barings undoubtedly would have drawn the attention of CFTC and exchange market surveillance experts. Moreover, Barings would have stumbled over any number of trip wires, in both CFTC and exchange systems, designed to protect the financial integrity of the U.S. marketplace.

V. The U.S. Response to the Barings Crisis

Let me turn now to the U.S. response to the Barings crisis. The CFTC first learned that Barings was on the verge of bankruptcy on Saturday, February twenty-fifth. Chairman Schapiro immediately assembled a "swat team" of senior staff members to determine the impact a Barings bankruptcy or default might have on U.S. firms and exchanges, as well as any potential systemic problems.[54]

Of preeminent concern was the danger of systemic risk resulting from Barings going into administration. All of Barings' accounts were

51. *See* Mary L. Schapiro, Remarks at the 20th Annual National Futures Industry Conference 6 (Mar. 16, 1995) (transcript on file with the *Fordham Law Review*).

52. Under CFTC regulations, every contract market is required to use "due diligence" to maintain a "continuing affirmative action program" to secure compliance with the Commodity Exchange Act, 7 U.S.C. §§ 1-25 (1994), the CFTC's regulations and the exchange's rules. 17 C.F.R. § 1.51 (1995).

53. *See* 7 U.S.C. § 12e (1994).

54. Schapiro, *supra* note 51, at 2.

frozen, including those representing approximately $350 million of U.S. firms' customer money.[55] In addition, SIMEX was dramatically increasing margin requirements, anticipating that there would be market volatility resulting from Barings liquidating its positions.[56] U.S. firms, however, were reluctant to post additional margin without some assurance from SIMEX that margin payments would not be used to make up for potential shortfalls in Barings' proprietary positions.[57] By 3:00 a.m. Singapore time on Tuesday, February twenty-eighth, Chairman Schapiro was able to obtain written assurance from the Monetary Authority of Singapore that customer funds would not be used to cover Barings' losses.[58] This assurance gave U.S. firms sufficient confidence to post additional margin, thus avoiding a potentially calamitous situation.

With that immediate problem resolved, the most difficult challenge the Commission encountered involved transferring U.S. firms' customer accounts out of Barings and into another clearing firm. Because these accounts had been frozen, these firms were trapped. They were vulnerable to adverse market moves, yet unable to trade out of their positions. In the words of Chairman Schapiro, "For five days, virtually eighteen hours a day, we talked, cajoled, and pressured foreign exchanges and regulators to transfer positions from various Barings accounts."[59]

The process was complicated significantly by the fact that, while the Japanese regulatory structure in general requires separate accounting for customer and proprietary positions,[60] it does not require the actual segregation of customer funds at the exchange.[61] In the United States, customer funds and positions must be clearly identified as belonging to customers and segregated from the funds and proprietary positions of the carrying FCM.[62] On the Japanese exchanges, however, margin funds posted by Barings on its own positions were commingled with customer margin.[63]

Ultimately, all customer funds were identified and transferred. Relying on extensive experience in transferring customer positions out of troubled firms in U.S. markets, the CFTC contributed significantly to resolving the problem. In effect, new systems were put together, *ad*

55. William Falloon, *Who's Missing From the Picture?*, Risk, Apr. 1995, at 20.

56. *Id.*

57. *Id.*; *see* Schapiro, *supra* note 51, at 3.

58. *See* Szala et al., *supra* note 30, at 68-69.

59. Schapiro, *supra* note 51, at 4.

60. CFTC, International Regulation of Derivative Markets, Products and Financial Intermediaries 530 (1995) (reporting that the Japanese Ministry of Finance requires financial intermediaries to keep records regarding customer funds).

61. *See* Szala et al., *supra* note 30, at 73.

62. *See* 7 U.S.C. § 6d(2) (1994).

63. *See* Szala et al., *supra* note 30, at 73.

hoc, to implement position transfers at exchanges that otherwise had no rules covering such a situation.[64]

VI. Applying the Lessons of the Barings Crisis

Fortunately, the global marketplace weathered the Barings storm. There were some bumps along the way, but exchange risk control and clearing mechanisms worked, as did the lines of communication that have grown among regulators and exchanges around the world. Nevertheless, every episode of extreme stress reveals weaknesses in the system and areas where improvements can be made. The Barings crisis is no exception.

The CFTC has adopted a twofold approach. First, in an independent initiative announced by Chairman Schapiro, the Commission plans to:

> (1) Conduct a thorough inquiry into the practical and legal obstacles that U.S. firms encountered in transferring positions and funds held through [Barings Securities];
>
> (2) Determine the extent to which existing CFTC and U.S. market operational, legal and regulatory systems sufficiently address such obstacles;
>
> (3) Assess what further measures can be undertaken to enhance the safety of customer funds; and
>
> (4) Work with SIMEX, the CME and other linked markets to assure that market linkages do not diminish existing market and financial protections.[65]

Second, in a joint initiative with the U.K. Securities and Investments Board, the Commission has organized a meeting, in May 1995 in London, among futures market regulators and exchange officials from twelve countries, representing the world's major financial markets.[66] Building upon existing international relationships, this group will develop an agenda of market and customer protection initiatives that will:

> [1] Enhance communication among international regulators and market authorities during [any future] financial crisis;
>
> [2] Identify [the] legal and practical impediments to containing the spillover effects of financial disruptions at specific firms or in specific markets;
>
> [3] Foster protection of customer funds wherever located . . .;
>
> [4] Promote national bankruptcy laws that [will] forestall liquidity crises by not freezing the margins and positions of solvent customers within insolvent firms; and

64. Schapiro, *supra* note 51, at 4-5.
65. *Id.* at 10.
66. *See id.*

> [5] Improve mechanisms for detecting and addressing concentrations of positions held in multiple markets that threaten the financial integrity of th[ose] markets.[67]

The Barings crisis was a painful episode for the world's financial markets. It provided exchanges, traders, and regulators alike with many anxious moments. If we take to heart, however, the lessons this episode can teach us, we can, I hope, create a marketplace and a regulatory system better prepared to withstand whatever unknown shocks the future may hold.

In that regard, let me add one final thought. Many of the post-Barings reforms currently being considered by the regulatory community may entail increased administrative burdens for firms and their customers, as well as potentially higher transactions costs. As a consequence, I doubt that many of these proposed reforms will be implemented unless the industry itself, both firms and end-users, weigh heavily into the debate. Foreign exchanges and their regulators need to hear whether vigorous market surveillance and protection of customer funds are important issues to those who use their markets—important enough that they might take their business elsewhere if such safeguards are not up to par.

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67. *Id.* at 11.