**GROUP ASSIGNMENT: DUE APRIL 2016**

**QUESTIONS:**

**Based on other related sources and the two articles enclosed, in your own words (15-20 pages written work):**

**1) What are Ethics? Generally, why do people act unethically?**

**2) Justify why is there a special need for ethical conduct in professions including those in the accounting and auditing related field?**

**3) Discuss how the Barings collapse serves as an example of failed internal controls and governance within organization.**

**1st Article - Barings Collapse**

(Posted by RiskLearn on Sep 14, 2012 in Case Studies)

**Barings Collapse: The Backstory**

Nick Leeson was a poster child in many ways for the “Big Bang”, the deregulation of the banking sector in the city of London that brought so many opportunities to the gifted and talented. Leeson came from humble beginnings, the son of a plasterer from Watford. He left school with minimal qualifications and joined as a clerk with Coutts, the bank to the queen. From here he moved to Barings eventually via a few different banks. From the back office he managed to get to the trading floor. There were few indications that this man would be responsible for the Barings Collapse, one of the most famous financial disaster stories of our times.

He proved himself to be a star trader and eventually he was moved to Singapore to act as manager to the Barings operations on the SIMEX floor in Singapore. Again in this role he performed very well. In 1993 he singlehandedly contributed 10% of the bank’s profits, which was worth about 10 million sterling. This meant that he earned a £130,000 bonus on to top his base salary of £50,000. The strategy that was making them money at this time was what is known as a “switching” strategy. The play here was very simple – trading futures on the Nikkei 225 as the underlying. The Nikkei 225 was traded as a future on both the SIMEX and the Osaka markets. There were always known to be differences between the two markets which could be arbitraged. The idea was to exploit the differences between the 2 markets, and execute in the cheaper market on client orders. This would then allow Barings to net a profit as they execute in the cheaper market but quote the client the price in the more expensive market. The underlying idea was of course to always be long one and short the other.

**Barings Collapse: The Genesis**

His ability for generating profits essentially earned him the trust of the top brass back in London who thought what he was doing was pretty normal. Leeson went on to take control of the back office as well. Coming from a settlements background Leeson knew exactly how the back office worked. He used this to basically start hiding losses. This is where he created the infamous error 88888 account. An error account per se is quite normal, it is used by brokers to book small intraday errors which are then settled at the end of the day.

Leeson started to use this error account to engage in cross trading (the process of netting trades within the same counterparty). Trades would be booked as normal into regular accounts, however by the end of the day the trades would be crossed with the error account and essentially the risk transferred out. He also booked the trades with false prices so that profits would be shown on trading in the accounts that were being reported to management. Leeson made sure that error account 88888 was excluded from management reports. This meant that the management in London never saw the true picture of the size of positions that Leeson was taking. In fact they naively believed that their golden boy was making them huge profits, so they let the show go on.

**Barings Collapse: The Positions**

His position should of course have been to be long in one market, say the Osaka one and be short in the other, SIMEX. However Leeson was running an outright long position and was long in Osaka and on SIMEX. These trades were hidden in the error account along with his losses. As of the January of 1995 Leeson was running a long position of over 27,000 Nikkei futures contacts. Leeson was also selling straddles, that is he was short on puts and calls at the same strike and expiry. The amount of these positions that he was selling was considerable. He stood to make money from these trades as long as both the puts and the calls traded at around the same levels at expiry. The range of his straddles were from 18,500 to 20,000 on the Nikkei. Importantly none of these trades were reported to the management of the bank.

**Barings Collapse: Disaster Strikes**

This is when disaster struck, on the 17th of January 1995 a huge earthquake struck Kobe in Japan. The Nikkei plummeted putting Leeson’s positions under a lot of stress. The Nikkei plunged to 17950 by the end of that week and Leeson started recording big losses. Leeson’s solution was however to ask for extra funds from London to meet his margin calls and continue trading. His view was that the move down on the Nikkei was temporary and he could ride it out. In the weeks that followed he almost doubled his futures position to 55,000 contracts. However the Nikkei did not recover and the margin calls kept coming. Eventually Barings could not meet the margin call and ended up collapsing with losses of more than £800 million. By February 1995 Barings was bankrupt and Nick Leeson was on the run from Singapore. Eventually he was arrested in Frankfurt on the 3rd March 1995, the same day that Barings was sold to ING the Butch bank for the princely sum of £1. Leeson was convicted of fraudulent trading and went to prison for over six years for his role in the Barings collapse. Other executives at the bank resigned or were sacked as a result of the collapse.

**Barings Collapse: The Lessons**

The Barings Collapse serves to illustrate some of the failings that led to the situation getting so out of control.

1. The first problem that we can note is that Leeson had control of the back office as well as the front office. This should never have been allowed. Clearly a man with experience of settlements system, as that’s where he started his career, he was able to manipulate things to suit his own ends. This should have raised alarm bells with management, but somehow he was able to get away with i without questions being asked. The proper separation of front and back office could have avoided the Barings Collapse.
2. Management did not investigate the unusual amount of P&L being generated – even in 1993 the signs were there when Leeson was generating a huge profit for what was essentially quite a safe business. Management were lacking in the knowledge of what Leeson was doing and were happy to turn a blind eyes as long as the money came in. In many ways management were also not particularly clued into the various strategies and products that contributed to the Barings collapse. It was still early days in derivatives trading and the bankers at the top were used to simpler and more traditional products.
3. Controls in place were inadequate – Accounts were not captured completely which allowed Leeson to mask the risk he was running. The internal audit should have picked this up and flagged it up as a problem / weakness, this again would have avoided the Barings collapse.

Even one of the links in the chain being more resilient would have meant that the chain would not have broken and the Barings collapse would have been averted. However there were failures at every level. While Nick Leeson was responsible for the fraud, there were other parties who completely failed in their duties and responsibilities. The challenge of course is to learn from the Barings Collapse and avoid the same mistakes in the future. However since the Barings Collapse, there have been many other cases of fraudulent trading causing huge losses. A recent example was that of Jerome Kerviel at the French bank Societe Generale. Like Leeson he was also from a back office background and so was apparently able to get around the systems easily. And even today, the trial starts for former UBS trader Kweku Adoboli. The details are still yet to emerge however he was allegedly able to make a series of unauthorised trades and run positions that the bank was unaware of, netting losses of over over a £1.4 billion.

So while fraud will always exist, the real challenge is to build a system that ensures that those with a mind to fraud cannot easily exploit the system and end up causing an event like the Barings collapse.

**2nd Article- Barings Collapse**

In February of 1995, one man single-handedly bankrupted the bank that financed the Napoleonic Wars, Louisiana Purchase and the Erie Canal. Founded in 1762, Barings Bank was Britain’s oldest merchant bank and Queen Elizabeth’s personal bank. Once a behemoth in the banking industry, Barings was brought to its knees by a rogue trader in a Singapore office. The trader, Nick Leeson, was employed by Barings to profit from low risk arbitrage opportunities between derivatives contracts on the Singapore Mercantile Exchange and Japan’s Osaka Exchange. A scandal ensued when Leeson left a $1.4 billion hole in Barings’ balance sheet due to his unauthorized derivatives speculation, causing the 233-year-old bank’s demise.

**How Nick Leeson Became Barings Bank’s Superstar**

Nick Leeson grew up in London’s Watford suburb and worked for Morgan Stanley after graduating from university. Shortly after, Leeson joined Barings and was transferred to Jakarta, Indonesia to sort through a back-office mess involving £100 million of share certificates. Nick Leeson enhanced his reputation within Barings when he successfully rectified the situation in 10 months (Risk Glossary).

In 1992, after his initial success, Nick Leeson was transferred to Barings Securities in Singapore and was promoted to general manager, with the authority to hire traders and back office staff. Leeson’s experience with trading was limited, but he took an exam that qualified him to trade on the Singapore Mercantile Exchange (SIMEX) alongside his traders. According to Risk Glossary:

“Leeson and his traders had authority to perform two types of trading:

1. Transacting futures and options orders for clients or for other firms within the Barings organization, and

2. Arbitraging price differences between Nikkei futures traded on the SIMEX and Japan’s Osaka exchange.

Arbitrage is an inherently low risk strategy and was intended for Leeson and his team to garner a series of small profits, rather than spectacular gains.”

As a general manager, Nick Leeson oversaw both trading and back office functions, eliminating the necessary checks and balances usually found within trading organizations. In addition, Barings’ senior management came from a merchant banking background, causing them to underestimate the risks involved with trading, while not providing any individual who was directly responsible for Nick Leeson & the Collapse of Barings Bank Picture monitoring Leeson’s trading activities (e-Risk). Aided by his lack of supervision, the 28-year-old Nick Leeson promptly started unauthorized speculation in Nikkei 225 stock index futures and Japanese government bonds (Risk Glossary). These trades were outright trades or directional bets on the market. This highly leveraged strategy can provide fantastic gains or utterly devastating losses – a stark contrast to the relatively conservative arbitrage trading that Barings had intended for Leeson to pursue.

**How Nick Leeson Caused the Failure of Barings Bank**

Nick Leeson opened a secret trading account that was numbered “88888” to facilitate his surreptitious trading. Risk Glossary says of Leeson:

He lost money from the beginning. Increasing his bets only made him lose more money. By the end of 1992, the 88888 account was under water by about GBP 2MM. A year later, this had mushroomed to GBP 23MM. By the end of 1994, Leeson’s 88888 account had lost a total of GBP 208MM. Barings management remained blithely unaware.

As a trader, Leeson had extremely bad luck. By mid-February 1995, he had accumulated an enormous position—half the open interest in the Nikkei future and 85% of the open interest in the JGB [Japanese Government Bond] future. The market was aware of this and probably traded against him. Prior to 1995, however, he just made consistently bad bets. The fact that he was so unlucky shouldn’t be too much of a surprise. If he hadn’t been so misfortunate, we probably wouldn’t have ever heard of him.

Nick Leeson and the Failure of Barings Bank Image Betting on the recovery of the Japanese stock market, Nick Leeson suffered monumental losses as the market continued its descent. In January 1995, a powerful earthquake shook Japan, dropping the Nikkei 1000 points while pulling Barings even further into the red. As an inexperienced trader, Leeson frantically purchased even more Nikkei futures contracts in hopes of winning back the money that he had already lost. Most successful traders, however, are quick to admit their mistakes and cut their losing trades.

Surprisingly, Nick Leeson effectively managed to avert suspicion from senior management through his sly use of account number 88888 for hiding losses, while he posted profits in other trading accounts. In 1994, Leeson fabricated £28.55 million in false profits, securing his reputation as a star trader and gaining bonuses for Barings’ employees (Risk Glossary). Despite the staggering secret losses, Leeson lived the life of a high roller, complete with a $9,000 per month apartment and earning a bonus of £130,000 on his salary of £50,000, according to “How Leeson Broke the Bank.”

The horrific losses accrued by Nick Leeson were due to his financial gambling as he placed his trades based upon his emotions rather than through taking calculated risks. After the collapse of Barings, a worldwide outrage ensued, decrying the use of derivatives. The truth, however, is that derivatives are only as dangerous as the Nick Leeson and the Failure of Barings Bank Image - Time

After a series of lies, cover ups and falsified documents, Leeson and his wife fled from Singapore to Kuala Lumpur, Malaysia. By then, Barings' senior management had discovered Nick Leeson's elaborate scheme. The total damage suffered by Barings was £827 million, or $1.4 billion. In February 1995, England's oldest, most established bank was unable to meet SIMEX's margin call and was declared bankrupt. Leeson and his wife were arrested in Frankfurt, Germany on March 3rd, 1995. That same day, the Dutch bank, ING, purchased Barings for a mere £1 and assumed all of its liabilities (e-Risk).

Nick Leeson and the Barings Bank Crisis - Rogue Trader Nick Leeson was placed on trial in Singapore and was convicted of fraud. He was sentenced to six and a half years in a Singaporean prison, where he contracted cancer (Risk Glossary). He survived his cancer, and, while imprisoned, wrote an autobiography called “Rogue Trader,” detailing his role in the Barings scandal. “Rogue Trader” was eventually made into a movie of the same name. Nick Leeson was released from prison in July 1999 for good behavior.