Barings Bank
An inquiry into the absence of integrated risk approach at Barings Bank prior to its collapse

Excerpts from the Bank of England report:
"REPORT OF THE BOARD OF BANKING SUPERVISION INQUIRY INTO THE CIRCUMSTANCES OF THE COLLAPSE OF BARINGS"
18 July 1995

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RETURN TO AN ORDER OF THE
HONOURABLE THE HOUSE OF COMMONS DATED
18 JULY 1995 FOR THE

REPORT OF THE
BOARD OF BANKING SUPERVISION
INQUIRY INTO THE CIRCUMSTANCES
OF THE COLLAPSE OF BARINGS

Ordered by The House of Commons to be printed 18 July 1995
Dear Sirs

We attach a copy of the Report of the Board into the collapse of Barings, with the intention that it is to be passed to the Chancellor of the Exchequer in accordance with our terms of reference.

Yours faithfully

E A J George
Chairman of the Board

Sir Alan Hardcastle
Convenor of the Independent Members
1. INTRODUCTION

The status of the inquiry

1.1 On Sunday 26 February 1995 joint administrators were appointed by the High Court in London to manage the affairs of Barings plc, the Barings Group parent company, and certain other companies within the Barings Group. This followed the discovery of massive losses incurred by Baring Futures (Singapore) Pte Limited (BFS), an indirect subsidiary of Barings plc, which had been trading in financial products on Singaporean and Japanese exchanges.

1.2 On 27 February 1995 the Chancellor of the Exchequer, the Rt Hon Kenneth Clarke QC MP, announced that we, the Board of Banking Supervision (BoBS) of the Bank of England (the Bank), should conduct an investigation into the events leading to the collapse of Barings plc. The formal terms of reference of the inquiry were later agreed to be: "To establish in detail the events that led to the collapse of Barings; to identify the lessons to be drawn, for institutions, for the Bank's own regulatory and supervisory arrangements, and for the UK system of regulation more generally; and to report to the Chancellor of the Exchequer".

1.3 BoBS consists of three ex-officio members, namely the Governor, Mr Eddie George, the Deputy Governor\(^1\) and the Executive Director of the Bank responsible for Regulation, Supervision and Surveillance (S&S), Mr Brian Quinn, and six independent members appointed jointly by the Chancellor of the Exchequer and the Governor of the Bank. The six independent members of BoBS are Mr Jon Fouls, Mr Peter Gerrard CBE, Sir Alan Hardcastle, Lord Swaythling, Mr Harry Taylor and Sir Dennis Weatherstone. The Banking Act 1987 (the Act) imposes a statutory duty on the independent members of BoBS to advise the ex-officio members on the exercise by the Bank of its supervisory functions under the Act and any other matters relating to, or arising out of, the exercise of such functions.

1.4 The report is divided into two parts. The first, Sections 1 to 13, sets out and analyses the events that led to the collapse of Barings. The second, Section 14, sets out the lessons that we believe may be drawn from this episode.

1.5 The report represents the product of an investigation conducted by BoBS with the assistance of a team led by Mr Ian Watt CBE\(^2\), Head of the Bank's Special Investigation Unit (SIU) and adviser to the Bank's Governors, assisted by: staff from SIU; Arthur Andersen, as accountants to the inquiry; Mr Nigel Davis QC and Norton Rose, as counsel and solicitors to the inquiry; and Mr Richard Evans of JP Morgan, as a derivatives and risk management adviser. Throughout the report references to 'the investigation team', 'the inquiry' or 'we' mean BoBS or members of the team assisting it. However, such conclusions on the facts as are expressed in the report are, of course, those of BoBS alone.

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1 Mr Rupert Pennant-Rea resigned as Deputy Governor on 22 March 1995. His place on BoBS was not filled during the remainder of the inquiry.

2 Mr Watt was also appointed by the Bank on 28 March 1995 to conduct an investigation under Section 41 of the Act and to report to the Bank on certain aspects of the nature, conduct and state of the business of Baring Brothers Ltd (formerly Baring Brothers & Co., Ltd.).
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1.6 The members of BoBS wish to commend the entire inquiry team led by Mr Watt for the expeditious and thorough way in which they conducted the investigation and for the assistance and advice they provided to us throughout the inquiry, which was of a very high professional standard.

1.7 Insofar as the report is concerned with the supervision of Barings by the Bank, the Securities and Futures Authority (SFA) and other regulators, it is based upon an investigation conducted on behalf of the independent members of BoBS only, and the conclusions expressed are those of the independent members alone.

Course of the investigation

1.8 Members of the investigation team have held meetings and discussions with directors and employees of Barings plc and its subsidiaries (the Barings Group) and representatives of regulators, supervisors and other parties in the UK, Singapore, Japan, Hong Kong, the United States and other jurisdictions. At the same time copies of certain documents were obtained from: the Barings Group in London, Singapore, Japan and Hong Kong; Coopers & Lybrand (C&L) in London; the Bank; the SFA; and other sources. This evidence has been analysed and interviews have been conducted in London and Tokyo with Barings Group directors and employees past and present, C&L London, and employees of the Bank and the SFA. Some of the interviewees have been interviewed on more than one occasion. When transcripts were taken of interviews, the interviewees were provided with transcripts of their interviews and invited to correct or make comments on the transcripts. We wish to acknowledge the assistance of those who were interviewed and whose names appear as Appendix I. Appendix II lists the names of other people referred to in the report.

1.9 The inquiry has been prevented from having the same degree of access in Singapore. Moreover, the inquiry has not been able to speak to Mr Nick Leeson, formerly General Manager and Head Trader, BFS, who is currently held in custody in Frankfurt, pending resolution of an application for his extradition to Singapore.

1.10 We have concentrated our investigation on the affairs of Baring Investment Bank (BIB), the organisation of which is described in Section 2, and on the individuals most directly concerned in the events that led to the collapse. We have not, as a consequence, addressed broader issues relating to the governance of Barings plc and the Board of that company, except insofar as individual directors were involved in the business of BIB.

1.11 We invited those persons who we considered might be affected by our preliminary proposed conclusions to make representations and observations on them prior to the finalisation of the report. Careful consideration has been given to the representations and comments made, whether orally or in writing, by those persons who responded to such invitations and changes have been made when points were accepted. It should be made clear, however, that many of the conclusions are not accepted by the persons to whom they relate. In arriving at our conclusions in relation to individuals and institutions we have been mindful that our understanding of the events described in the report was derived following the collapse of Barings. We consider that these conclusions reflect the information which was, or reasonably should have been, known at the relevant time.
1. Introduction

Format of the report

1.12 A short description of the Barings Group, the regulatory environment in which it operated, its auditors and management, the nature of BFS’s trading and the events immediately preceding the collapse is provided in this introductory section. We also describe the limitations on the access we have had to information relevant to the inquiry and the resulting implications. Appendix III provides a list of abbreviations used in the report and Appendix IV contains a glossary of some of the technical terms used. Appendices V and VI provide a description of the relevant instruments traded and the exchanges on which they are traded.

1.13 From the second half of 1992 until the collapse the Barings Group was engaged in a major restructuring, by which its banking and securities businesses were gradually being brought together under the umbrella of BIB. This represented a time of considerable change in the culture and organisation of those businesses and it is relevant to describe these changes in order to set into context the events concerning BFS during this same period. This description appears in Section 2.

1.14 Sections 3 and 4 cover the trading activity in BFS during the period July 1992 to 24 February 1995. This trading was executed on the Singapore International Monetary Exchange (SIMEX), the Osaka Securities Exchange (OSE), the Tokyo Stock Exchange (TSE) and the Tokyo International Financial Futures Exchange (TIFFE). Until the time of the collapse BIB’s London management believed the trading activity conducted within BFS to be very profitable and that it made a major contribution to the overall profits of the Barings Group. However, the true nature and profitability of the trading were concealed. The methods of concealment are described in Section 5. The actual trading carried out by BFS required substantial funding from Barings in London and Japan. The provision of this funding is described in Section 6. Section 7 describes the failings in BIB’s internal controls which were central to the failure to detect the unauthorised trading conducted by BFS. Our analysis of the actual trading activities carried on within BFS has revealed that during the financial years 1993 and 1994 there were significant unidentified and unreported losses in respect of BFS’s activities: the effects of adjusting the reported results of Barings plc to take account of the concealed losses are analysed in Section 8.

1.15 The internal audit of BFS in 1994 and the role of the external auditors are described in Sections 9 and 10 respectively. The reporting to supervisors and regulators by Barings, and the supervision and regulation of Barings, are covered in Sections 11 and 12 respectively. Section 13 contains our conclusions as to the factors leading to the collapse.

1.16 Finally, Section 14 sets out the lessons which we believe arise from the collapse of Barings for authorised institutions, the Bank and for the UK system of regulation generally.

1.17 In referring to individuals we have adopted the convention throughout this report of introducing them by their full name and title on their first mention and thereafter referring to them by surname only, unless the full name is required to avoid confusion. This convention is intended to simplify the report and no discourtesy to anyone is intended.
1. Introduction

Summary history, structure and principal activities of Barings

1.18 At the time of the collapse Baring Brothers & Co., Ltd (BB&Co) was the longest established merchant banking business in the City of London. Since the foundation of the business as a partnership in 1762 it had been privately controlled and had remained independent. BB&Co was founded in 1890 to carry on the business of the bank in succession to the original partnership. In November 1985 Barings plc acquired the share capital of BB&Co and became the parent company of the Barings Group. In 1991 the Barings Group acquired a 40% equity interest in Dillon, Read & Co Inc (Dillon Read), a US investment bank based in New York.

1.19 The voting share capital of Barings plc was held by its executive management and the non-voting share capital was held by the Baring Foundation, a UK registered charity.

1.20 In addition to BB&Co, the other two principal operating companies of Barings plc were Baring Asset Management Limited (BAM), which provided a wide range of fund and asset management services, and Baring Securities Limited (BSL), itself a subsidiary of BB&Co, which generally operated through subsidiaries as a broker dealer in the Asia Pacific region, Japan, Latin America, London and New York. Appendix VII includes charts setting out the corporate structure of the Barings Group as at 31 December 1994. BAM and the corporate finance activities of BB&Co are not referred to in any detail in the report as they are not considered relevant to the inquiry. Hereafter, when we refer to Barings we mean BIB and its component companies and operating units, principally BB&Co and BSL.

1.21 BB&Co was an authorised bank, based in London, with branches in Singapore and Hong Kong. BAM also owned two banks: Banque Baring Brothers (Suisse) S.A. and Baring Brothers (Guernsey) Limited.

1.22 The business of what became BSL was acquired from Henderson Crosthwaite by BB&Co in 1984. BSL was incorporated in the Cayman Islands, although its head office, management and accounting records were all based in London. BSL had a large number of overseas operating subsidiaries including two which are of particular relevance to this inquiry, namely BFS and Baring Securities (Japan) Limited (BSJ).

Regulatory environment

1.23 The Barings Group’s operations across the world were subject to the supervision of a variety of different supervisors. Of these, only supervision by certain UK, Singaporean and Japanese supervisors are relevant to the inquiry.

1.24 The Bank authorised BB&Co (which was therefore an authorised institution) under the Act to accept deposits. The Bank was therefore responsible for monitoring whether BB&Co continued to meet the criteria set by the Act for its continuing authorisation. The minimum criteria for authorisation are contained in Schedule 3 to the Act and the most relevant are summarised in Appendix XIV. The Bank was also responsible for the consolidated supervision of the Barings Group. This entailed the receipt and analysis of data on the consolidated (Group-wide) capital ratios and consolidated large exposures and the assessment of the risks to BB&Co emanating from the non-bank parts of Barings; it did not entail actual supervision of the non-bank parts of the Group. The limits on the Bank’s responsibilities in respect of its role as the
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consolidated supervisor of the Barings Group are described in more detail in Section 12.

1.25 The SFA, as a self-regulating organisation under the Financial Services Act 1986 (FSA), authorised BB&Co, BSL and Baring Securities (London) Limited (BSLL) (from its establishment in 1993) to carry out certain types of investment business in the UK. The SFA has a duty to regulate the investment businesses of its member firms conducted in the UK in order to afford an adequate level of protection for investors. Accordingly, the SFA regulates its members in relation to: their financial resources; the security of investors’ money and assets held by members; and the fair and proper conduct of investment business undertaken. The regulation of the financial resources of BB&Co was delegated by the SFA to the Bank under a Memorandum of Understanding (MoU) in April 1991, a copy of which is attached as Appendix VIII.

1.26 BFS was a corporate clearing member of SIMEX. SIMEX is a self regulatory organisation for the financial futures industry in Singapore. The approval for the establishment of SIMEX as a futures exchange was granted by the Monetary Authority of Singapore (MAS) under the Singapore Futures Trading Act. SIMEX is primarily concerned that its members are financially sound and are professional in their dealings with other members.

1.27 BSJ was licensed by the Japanese Ministry of Finance (MoF). It was also subject to the rules and regulations of the self-regulatory exchanges on which it traded.

The auditors

1.28 The Barings Group financial statements were the subject of an annual external audit pursuant to the Companies Act 1985. The purpose of the annual audit is to report to the shareholders on whether the financial statements give a true and fair view of the state of affairs and results of the group concerned and comply with applicable UK company legislation. The auditors of Barings plc, BB&Co and BSL at the relevant times were C&L London.

1.29 For the financial periods ended 30 September 1992 and 31 December 1993 the auditors of BFS were the Singapore firm of Deloitte & Touche (D&T), who were succeeded for the financial year ended 31 December 1994 by C&L Singapore. At the time of the collapse C&L Singapore had substantially completed its audit of BFS for internal group reporting purposes and had reported to the directors of Barings plc, but had not reported on BFS’s statutory financial statements.

1.30 For the financial periods ended 31 December 1992 and 31 December 1993 C&L London had audited and reported on the Barings Group financial statements. At the time of the collapse C&L London’s audit of the consolidated financial statements of Barings plc and the financial statements of BSL for the year ended 31 December 1994 was well advanced, but they had not yet issued their formal report on those financial statements.

Barings’ management

1.31 The management structure of Barings at the time of the collapse is described in Section 2. The Board of Directors of Barings plc (the Board), under the chairmanship
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of Mr Peter Baring, met six times in 1994. The Executive Committee of the Board (EXCO), also under the chairmanship of Peter Baring, met weekly to consider the key business issues and decisions affecting the Barings Group. The Management Committees of BIB (under the chairmanship of Mr Andrew Tuckey, Deputy Chairman of Barings plc and Chairman of BIB) and BAM were given a high degree of autonomy to make decisions relating to their business units. Mr Peter Norris was the Chief Executive Officer of BIB (CEO designate from December 1993, CEO from November 1994) and a Director of Barings plc (from December 1993), having previously been CEO of BSL.

1.32 In February 1994 the Board appointed an Audit Committee comprising three non-executive directors. Previously, the whole Board had had an annual meeting with C&L London. By the time of the collapse the Audit Committee had met only once, in June 1994, to receive a presentation on the management letter by C&L London in respect of the year ended 31 December 1993 and a report from BB&Co’s Internal Audit Department. No matters relating to BFS were discussed at that meeting.

Background to BFS’s trading activities

1.33 BFS, a Singaporean registered company, was an indirect subsidiary of BSL. BFS was originally formed to allow Barings to trade on SIMEX. At the time of the collapse BFS employed 23 staff. BSL’s other significant Singaporean subsidiary was Baring Securities (Singapore) Pte Limited (BSS) which employed some 115 staff. BSS’s principal activity was securities trading.

1.34 BB&Co and BSL issued a number of comfort letters to the MAS and to commercial banks which lent funds or securities to BFS. The purpose of the letters was to assure the recipients that Barings would financially support BFS. For example, in a minute of a BSL board meeting on 16 April 1991 it is recorded that the directors resolved to issue such a letter to the MAS. Included within the proposed wording was the statement: “[BSL] accepts full responsibility for the operations of [BFS] ... In addition to our legal responsibility deriving from our shareholding in [BFS] ... [BSL] will ensure that [BFS] maintains a sound liquidity and financial position at all times, and we will, on demand, provide adequate funds to make up for any liquidity shortfall in [BFS]”. The letter of comfort later issued to the MAS was the same as the proposed wording in all material respects.

1.35 From late 1992 to the time of the collapse BFS’s General Manager and Head Trader was Leeson. Prior to his move to Singapore in March 1992, Leeson worked for Barings in London in a back office capacity for almost three years. A more comprehensive description of his career and background is included in paragraphs 2.55 to 2.60.

1.36 Barings sought to control and manage its operations by means of a ‘matrix management’ system, a not unusual method of management control for financial businesses which have global operations. Managers who are based overseas often have local reporting lines (typically of an administrative nature) as well as reporting lines to a product manager (who may be based at the business’ head office or a regional office). Leeson reported to Barings’ management in Singapore for BFS’s office infrastructure, in particular to Mr James Bax, Regional Manager South Asia and Director of BFS, and to Mr Simon Jones, Regional Operations Manager South Asia, also Director of BFS and Chief Operating Officer of BSS. Jones and the heads of the support
functions in Singapore also had reporting lines to the Group-wide support functions in London. Whilst there was some debate about Leeson’s precise reporting lines (paragraph 2.27), from 1 January 1994, for product profitability, Leeson reported to Mr Ron Baker, Director of BB&Co and Head of the Financial Products Group (FPG) of BIB, via Ms Mary Walz, one of Ron Baker’s London based managers and also Director of BB&Co and Global Head of Equity Financial Products, BIB. Section 2 of the report sets out the conflicting views which existed as to Leeson’s precise reporting lines within Barings during his time in Singapore.

1.37 From mid-1992 BFS executed trades on SIMEX (in Singapore) and OSE, TSE and TIFFE (all in Japan). BFS primarily executed trades in three kinds of financial futures contracts (namely: the Nikkei 225 contract, the 10 year Japanese Government Bond (JGB) contract and the three month Euroyen contract), and some options on those same financial futures contracts. The market prices of these contracts were related to the price or value of the underlying Japanese securities. For example, the price of the Nikkei 225 contract was related to the value of the Nikkei 225 index of leading Japanese companies’ share prices. The products are described in Appendix V. Since SIMEX was created in 1984 it has developed parallel markets for these products in direct competition to the Japanese exchanges on which they are traded. Thus, the three products in which BFS primarily traded could be traded on one of the Japanese exchanges or on SIMEX or both, and the different characteristics and rules of the exchanges (described in Section 3 of the report) gave rise to advantages for certain customers to deal on one exchange in preference to the other.

1.38 BFS’ original function was to execute trades on behalf of Barings’ clients. Most of these clients were clients of either BSL or BSJ, and the trades were booked by BFS in the name of BSL or BSJ. This is commonly known as ‘agency’ business, and was managed by Mr Mike Killian, Head of Global Equity Futures and Options Sales, BIB, from Tokyo and latterly the United States. BFS would generate revenue from the commission it charged clients for this type of trading. Barings’ records show that in mid-1993 BFS began to generate profits from trading for Barings’ own account (‘house’ or ‘proprietary’ trading) by purporting to take advantage of price differences between SIMEX contracts and the equivalent contracts on the Japanese markets. This is commonly recognised as a form of arbitrage trading, and was called ‘switching’ business by Barings.

1.39 The reported profits from this trading were significant. We describe in Sections 4 and 5 how the reported profits from this activity from January 1993 to the collapse were in fact offset by much greater losses which were actually being incurred and which were concealed.

1.40 The trading conducted by BFS on these exchanges required very substantial funding in the form of margin payments to the exchanges to support the positions held by BFS. At the time of the collapse BFS’s unaudited balance sheet recorded that it had placed some £468 million with SIMEX as margin. Most of this funding was provided by BB&Co via BSL and BSLL or by BSJ. This funding is described in Section 6 of the report.

1.41 Until the collapse, Barings’ management in London believed the trading conducted by BFS to be essentially risk free and very profitable. They believed that BFS entered into equal and opposite matched positions on a particular contract on SIMEX and one of
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the Japanese exchanges, and reasoned therefore that the net value of the two holdings would not be affected by price movements on the exchanges. However, as is set out in Sections 4 and 5, BFS did not in fact hold matched positions and the value of its positions was substantially affected by price movements on the exchanges.

Events leading up to the collapse

1.42 In March 1992 Leeson was transferred from London to Barings’ operations in Singapore. After passing local examinations, he himself began trading on the floor of SIMEX. At about the same time, or in early 1993, he was appointed General Manager of BFS.

1.43 In July 1992 account ‘88888’ was opened in BFS’s records as a ‘client’ account. As we describe in Sections 4 and 5, this account was used to conceal the unauthorised trading activities of BFS through 1993, 1994 and up to 23 February 1995.

1.44 In July and August 1994, a BSL internal audit team of three visited Singapore to perform a review of the operations of Barings’ offices in Singapore and other nearby countries. BFS’s operations were reviewed by one member of the team, Mr James Baker, an Internal Audit staff member, BSL. The report of the visit was finalised in October 1994. It identified, among other items, that there was a lack of segregation of duties between BFS’s front and back offices. The report, and the issues arising from it, are described in Section 9.

1.45 By January 1995 management of Barings in London became aware of market concerns and rumours regarding the scale of Barings’ trading activities on OSE (Section 7) and the possibility that Barings had a customer who could not meet a margin call. Barings received a telephone call on 27 January 1995 from the Bank for International Settlements (BIS) who had heard rumours to the effect that Barings had margin losses in the Nikkei contract and could not meet its margin calls. These market concerns and rumours do not appear to have caused management undue alarm because management thought that, unbeknown to the rumour mongers, Barings’ positions were matched with equal and opposite positions on SIMEX.

1.46 In January 1995 SIMEX noted from its financial surveillance programme that BFS appeared to be financing the positions of clients, in particular those in account ‘88888’. On 11 January 1995, SIMEX wrote to BFS, in Singapore, asking for an explanation for this.

1.47 From late January 1995 the size of the gross matched positions entered into by BFS on SIMEX and the Japanese exchanges increased, as reported to the Barings Asset and Liability Committee (ALCO) in London which discussed the associated funding issues and the market perception of Barings’ positions. On 26 January 1995 ALCO instructed that Leeson be ordered not to increase and, where possible, to reduce the size of the positions, but these instructions were not complied with in the period up to the collapse.

1.48 On 27 January 1995 C&L Singapore faxed a note to C&L London which identified that there was an amount of ¥7.778 billion (some £50 million) in BFS’s 31 December 1994 balance sheet apparently due from Spear, Leeds & Kellogg (SLK), a New York based specialist and securities trader. On or before 1 February 1995 C&L London informed
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Mr Geoffrey Broadhurst, Group Finance Director, BIB, of this supposed transaction. This supposed receivable was identified by us as one of the techniques used by Leeson to conceal the balance on account ‘88888’ which recorded the unauthorised trading activities. We describe it in more detail in Section 7, and deal with its use in concealment in Section 5, with its relevance to external audit in Section 10 and with its relevance to large exposure reporting to the Bank in Section 11.

1.49 On 31 January 1995 ALCO in London discussed a letter dated 27 January 1995 from SIMEX to BFS, a copy of which had been sent to London. The letter presented a summary of BFS’s positions at 30 December 1994, and reminded BFS of its responsibilities to ensure that it had sufficient funds to enable it to fulfill its financial obligations to SIMEX.

1.50 On 3 February 1995 Bax sent a memorandum to Norris, Broadhurst, Ron Baker, Mr Ian Hopkins (Director and Head of Group Treasury and Risk, BIB (from 23 August 1994) and Director of BB&Co) and Mr Tony Gamby (Settlements Director, BIB (from 1 January 1994), and Director of BB&Co) headed “SIMEX” and reading in part: “As you know recent incidents have highlighted the current operational weaknesses of our SIMEX business and an urgent need for a new approach ... The growing volumes traded on SIMEX have meant Leeson can no longer continue to run the trading and settlement roles effectively. In any case, it has long been acknowledged that there are control weaknesses in this arrangement”. The incidents referred to were not explained in the memorandum but clearly included a reference to SLK.

1.51 In the week beginning 6 February 1995 Mr Tony Hawes, Group Treasurer, BIB, visited Singapore with Mr Tony Railton, Futures and Options Settlements Senior Clerk, BIB, in an attempt to resolve a number of issues. Tony Hawes told us his agenda was to:

(a) understand the issue raised by Barings’ auditors, C&L, in relation to the large purported debtor of some ¥7.778 billion (£50 million), (referred to in paragraph 1.48), in BFS’s 31 December 1994 balance sheet;

(b) finalise a written response to the letter dated 27 January 1995 from SIMEX to BFS, in which SIMEX had sought reassurance from Barings as to its ability to fund large payments to SIMEX at short notice;

(c) brief his colleague, Railton, on: “improving the book-keeping and treasury in Singapore so that we would receive in London information that would allow us to identify what all the margin they were putting up there was for and to ensure that we were funding it correctly, we would know which clients we were lending money to and provide all the information which had been lacking up to that point”;

(d) arrange larger daylight overdraft facilities with local banks.

1.52 Railton told us that he felt that he was sent out in order to understand how the BFS Settlements Department worked and to provide cover for Ms Norhaslinda Hassan, the BFS Senior Settlements Clerk, who was on maternity leave.

1.53 Tony Hawes spent the week of 6 February 1995 in Singapore. He was unable to resolve the first of his issues, but did not believe the matter was urgent as he was told
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that the apparent debtor (SLK) had since repaid the funds to BFS. He knew that he was coming back to Singapore two weeks later and was prepared to resolve it then, leaving a list of questions for Leeson to answer in the meanwhile. He finalised the reply to SIMEX and met their representatives. He left Railton with some work to complete in Singapore and returned to London.

Railton was asked by Tony Hawes to complete a spreadsheet the purpose of which was to analyse the timing of the different types of margin which had to be paid to SIMEX by BFS.

Over the course of the week beginning 13 February 1995 Railton realised: “If you close out all the positions there is absolutely no way on God’s earth that you could actually return all the yen”. He described to us his increasing concern at what he seemed to be discovering. He told us that towards the end of the week he informed Mrs Brenda Granger (Manager of the Futures and Options Settlements Department in London, BIB), Gamby and Tony Hawes of this problem. He recalled informing Granger and Gamby of his estimated shortfall, ¥14 billion (some US$140 million). At this stage no misfeasance seems to have been suspected.

It was also during the week of 13 February 1995 that Railton discovered that the breakdown of the US Dollar margin funding requests which BFS had been submitting to London was meaningless. He had, in fact, had concerns about these requests since late 1994. Railton told us that BFS knew the total US Dollars that they wanted and that Ms Nisa Kader, BFS Settlements Clerk, Singapore: “was just changing the figures [in the breakdown analysis] to meet the total”. On 17 February 1995, following this discovery, Railton introduced a new form of margin request. Railton told us that around this time it became clear that: “half the stuff I had been advised on as to how it [the spreadsheet] worked did not work ... The project was becoming more and more complicated the further one went along. I advised Brenda [Granger] of this, and I said, ‘I really am stuck now because we are missing this 14 billion [Yen]’.”

According to Granger, Railton reported to her on 17 February 1995 that his reconciliation, of what he thought ought to be on deposit with BFS’s bank or as margin on SIMEX and what was actually there, did not reconcile, and that the funds at SIMEX and the bank were US$190 million less than the amount recorded in the BFS accounting records as owing to BSL, Banque Nationale de Paris (BNP) and BSJ. Railton recalls the figure as ¥14 billion, Granger ¥19 billion (US$190 million); we believe they are describing the same reconciliation problem and only differ in their precise recollection of the difference. Granger told us that Railton was now “really worried”. Railton still believed at this stage that the difference may have been due to his lack of understanding of the relatively complex BFS margining system, although by this time he believed that only Leeson could answer his questions.

By the third week the reconciliation problem remained unresolved. Railton told us that he was relieved that Leeson (whom he had not been able to see before to discuss the position in any detail) had eventually agreed to see him on the Monday morning. However, Leeson was reported to be ill on Monday and Tuesday (20 and 21 February 1995) and did not appear at the BFS office.

During the evening of Wednesday 22 February 1995 Railton met Leeson at BFS’s office and recalls telling him: “we were missing this amount of yen, and he said ‘Yes, I agree
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with you’, which took me back a bit”. Leeson then identified more detailed information that would need to be produced, although the matter remained unresolved.

The next morning, Thursday 23 February 1995, Railton went to SIMEX to see Leeson. Leeson gave him some explanations, but due to the noise of the exchange and because Leeson carried on trading, Railton did not feel that it was worth carrying on the discussion and returned to BFS’s office. That afternoon Leeson came back to the BFS office, sat down with Railton and Jones and started to discuss the situation. After 20 to 30 minutes Leeson left the office. Railton thinks this was at about 4pm to 4.30pm. Railton recalls continuing to discuss the matter with Jones and Miss Rachel Yong, Financial Controller, BSS. Railton recalls Jones saying: “I do not blame you for wanting to speak to Nick [Leeson]. This does not make any sense to me”. In the event Leeson did not return to the office.

On the evening of Thursday 23 February 1995 Leeson and his wife are believed to have travelled to Kuala Lumpur from where he faxed, on Friday 24 February 1995, a letter to Bax and Jones in which, according to Bax, he wrote that: “he was sorry, his health was deteriorating and therefore he wished to resign”. From there Leeson and his wife flew to Kota Kinabalu. On Wednesday 1 March 1995 they flew to Frankfurt, where Leeson was detained by the German authorities on Thursday 2 March 1995. Leeson has been charged with offences under the Criminal Procedure Code of Singapore and the Singaporean authorities are seeking his extradition from Germany.

In London, on Thursday 23 February 1995 Gamby, to whom Granger reported, was told by her that: “Nick [Leeson] was coming back to the office later on in the evening to ensure that the reconciliation was done”. Around midday (London time) on that day Gamby recalls hearing that Leeson could not be tracked down. Later that afternoon Gamby told Norris that they had: “a US$170 million reconciliation problem, but, more to the point, we could not find the trader”.

On Thursday 23 February 1995 Tony Hawes flew from Tokyo on his planned return visit to BFS, arriving in Singapore at 2am Friday (Thursday night in London). He told us that, on arrival at his hotel in Singapore: “The phone rang almost immediately. It was Peter Norris from London asking me ‘what on earth was happening in Singapore and where was Leeson?’”. Tony Hawes met Railton, who had also been called by Norris, and went to the offices of BFS. They started trying to reconcile the cash position, and Tony Hawes concluded that the apparent settlement of the SLK year end receivable (paragraph 1.48): “had been manufactured”. They were joined by Bax and Jones. Tony Hawes started looking at a computer printout and noticed an: “account called an error account with goodness knows how many transactions on it, all of them seemingly standing at enormous losses”. This was the account ‘88888’ which was used to conceal losses from Barings London. It is described in more detail in Sections 4 and 5.

Norris contacted Walz in an attempt to locate Leeson. Walz eventually spoke to Leeson’s mother-in-law who told her that Leeson and his wife had called a couple of hours earlier to say that they were going to Bangkok for the weekend. As Gamby said: “That was really when the alarm bells started flashing”. In London that Thursday evening a group including Broadhurst, Granger, Gamby, Mr George Maclean (Head of the Bank Group, BIB, and Director of BB&Co), Norris and Walz continued discussing
1. Introduction

the reconciliation. Mr David Hughes, Treasury Department Manager, BIB, who worked for Tony Hawes, told us that on the Thursday evening: "I got called into Peter Norris' office. News was then breaking that there was a significant problem ... As you can imagine, all kinds of speculation was occurring at that time". The team in London worked through the night: "looking at the positions". Early the next morning Norris instructed Gamby to travel to Singapore to verify the situation reported by Tony Hawes and, according to Gamby: "to see, hope against hope, if there was some client sitting behind the '88888' account that we were not aware of". Gamby travelled to Singapore with Granger and Mr Mike Finlay, who also worked in the Futures and Options Settlements Department in London. His team worked through Saturday night, and confirmed what Tony Hawes had uncovered, namely that BFS was apparently insolvent.

1.65 At some stage over that weekend the Barings team working in the office of BFS forced open a drawer in Leeson's desk. Railton told us: "There was a stack of paper. There were holes in some. You could see how he had produced [the] confirmation of the SLK deal, I believe, and also I think a bank statement as well". Granger told us she was there and: "He [Bax] opened the folder and there was this fraudulent document". Gamby also said that in Leeson's drawer: "We found some cut and paste material for the SLK transaction. There was this SLK letter with a scissor cut around the signature ... we also found a cut and paste of a Citibank statement". The significance of these documents is described in Section 5.

1.66 Meantime, on the morning of Friday 24 February 1995 certain Barings plc directors met in London and, having taken legal advice, decided that the Barings Group could continue to trade through that day. At noon on Friday Peter Baring met the Bank's then Deputy Governor and informed him that he considered that Barings had been the victim of massive fraud. The Governor returned immediately from holiday and vigorous attempts were made to save Barings over the weekend, but, owing in part to the uncertain cost of closing the open positions when the markets reopened on Monday morning and the related difficulty in establishing the facts about Barings' financial state, these efforts were unsuccessful. As a result, three partners of Ernst & Young (E&Y) were appointed as administrators of Barings plc and certain of its subsidiaries in the late evening of Sunday 26 February 1995. In Singapore, on Monday 27 February 1995, partners of Price Waterhouse were appointed by the Singapore High Court (the Court) as Judicial Managers of BFS, when BFS failed to pay a margin call.

1.67 Just over a week later the majority of the assets and liabilities of the Barings Group were purchased by Internationale Nederlanden Groep N.V. (ING), the large Dutch banking and insurance group, although BFS remains under the control of the Judicial Managers.

Indicators

1.68 This report identifies a number of warning signs which were available to Barings' management concerning the nature of the activities undertaken by BFS. The most significant indicators are set out in paragraph 1.70. The indicators vary in their weight and an individual item taken on its own may not have raised alarm. Taken together, however, we consider that they provided Barings in Singapore and London (some of them during 1993 and 1994, and all of them by January/February 1995) with significant warning signals of the danger to which it was exposed.
1. Introduction

Careful analysis of these indicators is important. There were substantial realised and unrealised losses resulting from BFS’s unauthorised activities in 1993 and 1994. The information provided to the inquiry indicates that, at 31 December 1994, the cumulative concealed losses were £208 million. The majority of the trading losses incurred by BFS’s activities occurred in 1995 (Section 4); the loss at 27 February 1995 being £827 million. If management had identified and realised the significance of the unauthorised activities in Singapore, depending on the date of discovery, Barings might have been saved from insolvency (although it would still have incurred a very substantial loss).

1.70 The indicators as identified by the inquiry are:

(a) The identification of the lack of segregation of duties in BFS between front and back offices, which was subsequently reflected in the internal audit report following the review of BFS’s operations which was conducted in July and August 1994;

(b) The high level of funding required to finance BFS’s trading activities;

(c) The unreconciled balance of funds (the ‘top up’ account) transferred from Barings in London to BFS for margins;

(d) The apparent high profitability of BFS’s trading activities relative to the low level of risk as perceived and authorised by Barings’ management in London;

(e) The discovery of the purported transaction relating to an apparent receivable of ¥7.778 billion (approximately £50 million) from one customer (SLK) of BFS as at 31 December 1994;

(f) The letter sent by SIMEX to BFS on 11 January 1995 (which was not communicated to London at that time), which included specific reference to account ‘88888’ and its large funding requirements; and the letter sent by SIMEX to BFS on 27 January 1995 (which was communicated to London) in which SIMEX sought assurance regarding BFS’s ability to fund its margin calls should there be adverse market movements;

(g) Issues and questions arising out of Barings’ reporting of large exposures and client money to supervisors and regulators;

(h) The high level of inter-exchange arbitrage (or ‘switching’) positions without any application of gross limits; and


Limitations on access to documents and individuals

1.71 The inquiry has not had unfettered access to all relevant directors and employees of the Barings Group and its records, or to third parties who hold, or may hold, relevant information. Indeed, we have not been able to perform some important investigation work. The position is summarised in the following paragraphs.
1. Introduction

In London, we have been able to interview all relevant directors and employees of the Barings Group. Although we have not had direct access to the offices of the Barings Group, we have been provided with copies of all the significant documents that we requested, with the exception of certain electronic mail messages which apparently have not been retained. We had requested access to Barings' electronic mail messages (either stored in hard copy or electronic form) sent and received by certain members of management and staff at Barings in London and BFS. We are informed that not all of these messages were routinely stored. In the case of messages sent from BSL's offices in America Square in November 1994 and January 1995, the computer tape archive is either missing or is corrupted. We have not had any access to electronic messages archived by BFS. Accordingly, we have not had full access to this source of information. During our investigation, we also requested access to telephone records and recordings for certain members of staff and management of the Barings' offices in London, Singapore and Tokyo. Barings' policy, generally, was to record the telephone lines of dealers, settlements staff and selected other personnel. In the course of our work we reviewed the telephone recordings available for Walz, Mr Fernando Gueler (Head Proprietary Equity Derivatives Trader, BSJ) and Mr Adrian Brindle (FPG Trader, Tokyo) for the period 23 January 1995 to 27 February 1995. Additionally we obtained transcripts of calls made by Ron Baker in New York during the period from 26 January 1995 to 27 January 1995. We were not, however, granted access to any telephone recordings made in Singapore which might have included lines for Leeson, Bax and Jones. Individuals who had taped lines may have chosen to take calls on or transfer calls to other extensions which were not taped.

In Tokyo, we have had free access to all the relevant documents, directors and employees of BSJ. BNP, whose Tokyo office was the only external client of BFS, has not permitted the inquiry access to its employees or documents.

In Singapore, we have been provided with copies of a limited number of documents by BFS and SIMEX. There remain a number of very significant categories of documents which we have not been permitted to examine, including BFS's bank statements. Similarly, while we have spoken to some BFS directors and employees on a brief and informal basis, we have not been permitted by the Judicial Managers (see below) to interview any of these important witnesses, while they remain in Singapore, nor to review any tape recordings of BFS telephone calls. Almost all the figures, analysis and conclusions in Sections 4 and 5 are derived from the inquiry's analysis of a photocopy of the '88888' account statement originally found by Tony Hawes. We were also given a copy of the same document by Jones. To verify this information we would need access to further SIMEX statements, BFS's records and selected BFS directors and employees. Since the collapse, a number of individuals and entities based in Singapore have had control of access to relevant documentation and individuals. The current situation in relation to each is as follows:
1. Introduction

(a) Judicial Managers - The Judicial Managers retain custody of the majority of BFS's records. They initially provided some documents, but thereafter did not permit the inquiry team access to any further documents requested, nor have they permitted interviews of BFS's employees without directions from the Court. An application for directions to be given access to information held by the Judicial Managers was therefore made on behalf of BoBS to the Court on 27 April 1995. The Court declined to give the directions requested principally because insufficient commercial benefit could be shown to accrue to BFS as a consequence of the proposed exchange of information between the inquiry and the Judicial Managers. The Judicial Managers did not support this application nor did they oppose it. However they did permit Bax and Jones to make representations to us in response to our notification of our provisional conclusions;

(b) Singapore Inspectors (the Inspectors) - The Inspectors, who are partners of Price Waterhouse, were appointed on 10 March 1995 by the Singapore Minister of Finance to investigate the collapse of Barings under their Companies Act. The Inspectors have not given the inquiry team access to the documents and information they control because they maintain that there is no 'gateway' for them to disclose information to any party other than their Minister of Finance. The Singapore Minister of Finance, in turn, has not permitted the inquiry access due, we understand, to legal constraints in Singapore. The joint administrators of Barings plc have given the Inspectors access to documents and members of staff in London. As a person appointed under Section 41 of the Act, Mr Watt has been able to obtain copies of transcripts of those interviews the Inspectors conducted in London. The investigation team has met the Inspectors and their representatives to discuss particular aspects of the investigation. While they did not provide the inquiry with any documents, apart from the transcripts, this has gone some way to assist the inquiry in overcoming the difficulties caused by the lack of access to documents and individuals in Singapore. However, there remain significant areas in which we lack information;

(c) Commercial Affairs Department (CAD) - CAD is responsible for conducting the criminal inquiry into BFS's and Leeson's activities in Singapore. They have a number of relevant documents under their control. CAD did not permit the inquiry access to these documents without approval from the Judicial Managers of BFS, which was not forthcoming;

(d) C&L Singapore - We have not been permitted access to C&L Singapore's workpapers relating to the 1994 audit of BFS or had the opportunity to interview their personnel. C&L Singapore has declined our request for access, stating that its obligations to respect its client's confidentiality prevent it assisting us;

(e) D&T - We have not been permitted access to the D&T workpapers relating to the 1992 and 1993 audits of BFS or had the opportunity to interview their personnel;
1. Introduction

(f) SIMEX and Citibank (Singapore) - We have approached both institutions in an attempt to verify the authenticity, accuracy and completeness of the transactions recorded in the '88888' account statement we have obtained. SIMEX would be able to provide an independent record of BFS's dealing, and Citibank copies of BFS's banking records. Initially SIMEX provided some statements of daily transactions by BFS, but, apart from that, both institutions informed us that the Judicial Managers, to whom obligations of confidentiality are owed, would not consent to the release of further information to the inquiry; and

(g) SIMEX - We have not been permitted to see the detailed supervisory working papers relating to SIMEX's supervision of BFS, nor to interview SIMEX's staff responsible for that supervision (paragraph 12.161).

1.75 In Appendix IX we describe the steps we have taken in attempting to gain access to the information held in Singapore.

1.76 The inquiry has identified a number of third parties with whom BFS and Leeson in particular had a trading relationship. The investigation team has had limited discussions with some of these parties, but has not been able to examine their detailed trading records freely or conduct interviews with them.

1.77 Leeson has been invited to cooperate with the inquiry, but has declined to do so as long as he remains liable to be extradited to Singapore. There are no available means of compelling him to assist. Through his solicitors, he has been informed of the conclusions we have reached about his part in the collapse. His solicitors in a letter dated 22 June 1995 have replied to us: "We note the preliminary conclusions reached by your enquiry relating to Mr Leeson. These conclusions are inaccurate in various respects. Indeed, in relation to certain of the matters they betray a fundamental misunderstanding of the actual events. Unfortunately, given the uncertainty regarding Mr Leeson's position we are not able to provide you with a detailed response to your letter." Since receipt of this letter we understand that information has been provided by Leeson through his solicitors to the Serious Fraud Office (SFO) pursuant to undertakings of confidentiality which does not enable the SFO to pass this information to us. We have received no communication from Leeson since his solicitor's letter of 22 June 1995 that his unwillingness to respond to our requests for information or our invitations to comment upon our conclusions has altered.

Implications of limited access

1.78 The implications of not having had access to the information described above are as follows:

(a) we have not been able to verify with Leeson the strategy which lay behind the unauthorised trading conducted by BFS or to understand his motivation;

(b) we have not been able to verify the entries (and therefore the losses) on account '88888' against records held by SIMEX;

(c) we have not been able to exclude the possibility that anyone else at Barings (Singapore, London, Tokyo or elsewhere) was involved in this unauthorised trading;
1. Introduction

(d) we have not been able to exclude the possibility that third parties were involved in unlawful activities with any employees of Barings;

(e) we have not been able to exclude the possibility that any of the funds sent by BSL, BSLL and BSJ to BFS have been misappropriated;

(f) we have not been able thoroughly to investigate the management roles of Bax and Jones;

(g) we have not been able to review and conclude on the adequacy of the work performed by BFS’s auditors; and

(h) we have not been able to review and conclude on the adequacy of SIMEX’s supervision of BFS’s activities.

1.79 The contents of this report are based on information to which we have been able to obtain access, including that provided to us in interviews. In view of the limitations on access to information which we have described, it is possible that material new facts may subsequently come to light. Despite these limitations, we consider that we have been able to ascertain the causes of the collapse of Barings, and to identify some important lessons for the future.
6. FUNDING OF BARING FUTURES (SINGAPORE) PTE LIMITED

Introduction

6.1 Sections 3 and 4 of this report describe the nature of the trading conducted by BFS. One feature of this type of trading is the requirement for clearing members of a futures exchange to deposit funds with the exchange. This funding, known as ‘margin’, is both a form of collateral and a way of settling both realised and unrealised profit and loss on positions. It is required to be deposited by exchanges to ensure that clearing members have sufficient resources to support any open positions. The level of this funding may be substantial, particularly for loss making positions. BFS’s unaudited balance sheet at 24 February 1995 recorded that it had some £468 million of margin money with SIMEX. In London the funding was arranged by Group Treasury and remitted by Futures and Options Settlements. In Tokyo BSJ Futures and Options Settlements approved the funding which was then remitted to BFS by BSJ Cash Management (its own treasury).

6.2 This section of the report describes the requirements for margin funding on SIMEX, the sources of funds that supported BFS’s trading activities, and the nature of funding of BFS by BSJ, BSLL and BSL. The section then describes the build up of funds provided to BFS, and the degree of control over the total funding of BFS’s trading activities. We then describe the nature of the individual requests for funding from BFS to BSLL and BSL in London and BSJ in Tokyo and the way these payments were authorised and accounted for in Barings in London. The transfers created a balance known as the ‘top up’ account in an accounting report. We explain this and the lack of a key reconciliation procedure. We describe the credit implications of the funding of BFS and funding cost issues. Finally, we consider margin data, which was regularly sent to BSL from BFS and which contained information on account ‘88888’.

The requirement for margin funding on SIMEX

6.3 Members use their own funds to finance margin calls if the open positions are house positions, i.e. for their own account, or obtain funds from their clients on whose behalf the positions have been opened.

6.4 In common with other futures exchanges, SIMEX requires its members to deposit the following types of margin when opening a position and according to price movements in the market:

(a) Initial margin to cover all positions taken on the Exchange. SIMEX regulations stipulate that this should be paid one day (for US Dollars) and two days (for Yen) after the position is opened. The amount of margin is recalculated daily and is maintained until the position is closed. BFS usually paid this type of margin in US Dollars;

(b) Variation margin is paid to, or received from, SIMEX in respect of mark-to-market losses or profits respectively on existing open positions. This is due one day (for US Dollars) and two days (for Yen) after the relevant price movement. BFS usually paid or received this margin in Yen;
6. Funding of BFS

(c) Advance margin is occasionally called by SIMEX, and is payable for value the same day, for example when there are large price fluctuations on the Exchange during a trading day or when the Exchange is closed for holidays and general market volatility is perceived to be high. This type of margin represents an advance on variation or initial margin, and therefore reduces the amount of any margin paid subsequently. BFS settled advance margin calls in US Dollars. It should be noted that during the period 1 January 1995 to 24 February 1995, there was only one occasion when SIMEX requested substantial advance margin, this was immediately prior to the Chinese New Year holiday (31 January 1995 and 1 February 1995).

6.5 Most margins are paid in cash. However, SIMEX allows a proportion of the margin to be deposited in the form of letters of credit or government bonds.

The source of funding that supported BFS’s trading activities

6.6 All margins placed by BFS with SIMEX appear to have been sourced from either:

(a) third party clients of BSL, BSJ or BFS (which only had one client of its own, BNP in Tokyo); or

(b) Barings companies, who borrowed some of the funds from other banks or other Group companies.

6.7 The flow of funds to the exchanges is illustrated in the diagram in Figure 6.1.
6. Funding of BFS

Figure: 6.1

Simplified Barings cash flows in financing margin settlements

Source: Inquiry team based on discussions with Barings personnel

Note (1): Margin is covered both by cash and collateral in the form of JGBs or letters of credit

Note (2): In addition BSJ placed bonds with SIMEX, either directly or via BSL.

Note (3): The BSLL and BSL accounts shown above are based on book entries (accounting records), as explained in paragraphs 6.55 and 6.56.

Note (4): BSL and BSLL also remitted funds to BSJ (not shown in the diagram) in respect of client and proprietary business.

The nature of funding by BSJ, BSLL and BSL

6.8 The nature and source of funding for each of these companies is summarised as follows:

BSJ

6.9 From 30 January 1995 to 24 February 1995, BSJ had a reported equity balance of not less than ¥12.3 billion (£80 million) with BFS which by 24 February 1995 had risen to ¥45 billion (£300 million). Essentially this balance consisted of monies paid directly to BFS and BSJ’s realised and unrealised profits from its reported trading activities (paragraphs 3.26 to 3.40). These monies were ostensibly to fund the margin that BSJ’s positions on SIMEX required. Most of the BSJ positions related to the ‘switching’ book and were funded mainly by unsecured borrowings from Japanese banks. A very small proportion related to third party customers of BSJ.

6.10 A significant reported surplus arose in 1995 on the equity balance to the extent that there were realised profits (which had not been remitted to BSJ by BFS) and unrealised profits. This surplus was mainly due to the apparent profitability of BSJ’s short Nikkei
6. Funding of BFS

225 position and long JGB position in the ‘switching’ account on SIMEX. BSJ understood this surplus to exist on the basis of reported positions in account ‘92000’. As outlined in Section 5, these profits were falsified at the expense of account ‘88888’.

6.11 Although some of this surplus was returned to BSJ, on 24 February 1995 the unrepaid surplus had risen to approximately ¥20.4 billion (£133 million). We have been advised by Mr Satoshi Yamada, Futures and Options Settlements Manager, BSJ, and Sue, that significant excess margin was maintained with BFS to ensure that any intra-day calls from SIMEX could be met immediately. (BSJ advised us that it otherwise could take more than one day to transfer funds to BFS, which did not allow them to meet all margin calls for SIMEX on time.)

6.12 This situation was known within Barings in London but Barings’ overall position was not properly considered. A fax from Leeson and Jones to Hopkins and Tony Hawes (copied to Bax, Wali and Gamby) dated 27 January 1995 noted that: “recently Tokyo has kept excess balances with BFS”. David Hughes told us that in the week commencing 20 February 1995: “The treasurer in Tokyo had actually spoken with Tony Hawes about it [the excess funds left with BFS]. I think he was extremely upset at the fact that they had money that they were expecting to be repaid from Singapore that was not actually repaid to them. That was specifically mentioned to me by Tony Hawes”.

6.13 This situation resulted in significant excess funds being tied up in Singapore. On 17 February 1995 BSJ had a reported equity balance of ¥38 billion (£253 million) at BFS when the margin apparently required by SIMEX was ¥30 billion (£200 million). BSJ then requested the return of ¥5 billion (£33 million). This cash was not received until 22 February 1995, two days later than expected; the reason given for the delay was that there had been a bank holiday in New York. This did not cause undue alarm in BSJ, as similar problems had been experienced in the past. Between 17 February 1995 and 24 February 1995 the equity balance on BSJ’s positions increased from ¥38 billion (£253 million) to ¥45 billion (£300 million), which represented the total funding extended by BSJ to BFS.

6.14 The other side of the profitable legs of the ‘switching’ activities on SIMEX were loss making trades for BSJ on the Japanese futures exchanges. As Leeson built up ‘switching’ positions to facilitate the funding and concealment of his unauthorised trading activities, so the retention of BSJ’s positive variation margin on SIMEX (the excess balance referred to in paragraph 6.10) became ever more important for him, and the resulting corollary was that BSJ had to finance increasing negative variation margin on the Japanese exchanges.

6.15 BSJ funded the margins on SIMEX and the Japanese exchanges by borrowing funds and JGBs from Japanese banks. The chart in Figure 6.2 illustrates the build-up of funds from external banks and of JGBs over the period 1 December 1994 to 24 February 1995.
6. Funding of BFS

Figure: 6.2

The borrowings increased dramatically from 26 January 1995, principally due to the build-up of the Nikkei and JGB ‘switching’ positions and the unauthorised trading positions, as described in Section 4. The level of bank loans and JGB borrowings, however, fell towards the end of February 1995 due principally to the reduction in the margin requirements of the Japanese exchanges and reduced ‘switching’ positions.

BSLL

6.17 BSLL was the entity used by Barings in London for the booking of proprietary trading. Barings’ traders in Asia traded various strategies and products on SIMEX for the house (paragraph 3.18), which were funded by external borrowings and internal funds through BSGT.

BSL

6.18 All trades for third party clients of Barings in London were recorded in BSL’s accounting records. The margin funding requirements for these clients positions on SIMEX were initially funded by BSL, who would then reclaim these funds from its clients. As described below, BSL funded a great deal more than this.

The build-up of funds provided to BFS

6.19 The chart in Figure 6.3 illustrates the build-up of funding provided to BFS by BSL, BSLL and BSJ over the period 1 December 1994 to 24 February 1995.
6. Funding of BFS

Figure: 6.3

Source: Inquiry team based on analysis prepared by Barings

6.20 The cumulative funding of BFS at three different dates is reproduced in tabular form in Figure 6.4. The accounting treatment of the funding in London is considered in paragraphs 6.62 to 6.80.

Figure: 6.4

<table>
<thead>
<tr>
<th>Company</th>
<th>7 Jan 94 £ millions</th>
<th>31 Dec 94 £ millions</th>
<th>24 Feb 95 £ millions</th>
</tr>
</thead>
<tbody>
<tr>
<td>BSLL</td>
<td>7</td>
<td>13</td>
<td>105</td>
</tr>
<tr>
<td>BSL</td>
<td>33</td>
<td>142</td>
<td>337</td>
</tr>
<tr>
<td>BSJ</td>
<td>(1)</td>
<td>66</td>
<td>300</td>
</tr>
<tr>
<td>Total</td>
<td>39</td>
<td>221</td>
<td>742</td>
</tr>
</tbody>
</table>

Source: Inquiry team based on analysis prepared by Barings

6.21 The funding was high at 31 December 1994 and increased dramatically over the first two months of 1995, by some £521 million to £742 million. At 24 February 1995 this funding represented over twice the reported capital of the Barings Group.

Control over the total funding of BFS's trading activities

6.22 The responsibility for arranging the funding of BSLL and BSL and monitoring the Group position including BSJ was largely that of BIB Group Treasury. Tony Hawes
6. Funding of BFS

told us that one of his duties was to: “fund the businesses of IBG [now renamed BIB]”. He added that: “The largest cash demand by far came from the structured products part of the Financial Products Group”. Ron Baker managed FPG, which included the trading activities in BFS. Tony Hawes went on to say that: “There were three books within the Structured Products Group that were cash hungry: the volatility book, the index arbitrage book and the SIMEX switching activity”. (SPG is described in paragraph 2.46.)

6.23

We have been told that BIB attempted to control the overall level of funding for BFS’s trading. Broadhurst explained: “There was initially a funding limit for those businesses, the Ron Baker businesses, of US$400 million, however [the funding limit] with specific ALCO permission [was] up to US$600 million”.

6.24

Hopkins told us that the ‘switching’ activity: “was not structured against a pre-set [funding] limit but subject to daily review”. He went on to tell us that this review would have considered the ‘Daily Global Large Exposure Report’ (paragraph 11.42) which purported to show the house positions against such exchanges but not exposures relating to client positions.

6.25

Tony Hawes said that it was possible to set funding limits for each of the three books described above, but that: “It would seem more sensible to be aware of the overall [funding] constraint and let the Structured Products Group choose how ... to use the scarce resource between their three cash hungry businesses”. He added: “It was not necessarily a hard [funding] limit because there were ways of rebooking business ... to make better use of the funding available”.

6.26

We understand that the relationship between Tony Hawes, who arranged the funding, and Ron Baker and Walz, who were seeking the funding, was not good. Norris stated that: “That was a bad relationship ... [and] ... a very important [one]”.

6.27

Walz appears to have had a great deal of contact with Tony Hawes. She recalls that when trying to get funding: “The best way to sum it up is to say it was always a painful process”. She told us that she would like to have been able to say: “At the end of the day I have US$100 million of equity. Fund it. Bang. That is it”. She added: “It was not like that”. Tony Hawes recalls that: “They [Ron Baker and Walz] were quite demanding in what they expected from Treasury”. Ron Baker told us that he never needed to apply pressure to Tony Hawes to ensure funding was made available to meet margin calls as Walz dealt closely with Tony Hawes: “I never personally discussed it with Tony. Mary and Tony had a dialogue on Treasury requirements of the business. Mary was aggressive and definitely had an attitude about the way in which treasury was run”. Ron Baker also told us that he did not consider the funding of SPG’s activities was a problem. He told us: “I did not feel that throughout 1994 there was a problem with regard to the funding. The business was making good money on top of its funding costs”.

6.28

Through the latter part of 1994 and early 1995 the demands for funding increased. Tony Hawes told us that: “They [Ron Baker and Walz] did not really have to make a case. It was generally accepted that if possible we should put more funding in place. It was something that was accepted by the Asset and Liability Committee”.

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6.29 Norris told us that his concern in 1995 in relation to the size of the positions taken by BFS was not the total funding required, but the effect that a volatile market would have and the possibility of: “an intra-day margin call which our available funding in Singapore might not accommodate”.

6.30 Michael Baring said he was also concerned: “Whether we would make the variation margin on time ... We never specifically talked about the size of the position. People asked, and certainly I asked again in terms of was there a limit on gross contracts; was there a limit on cash? I was informed there was a limit on cash”.

6.31 Maclean, when discussing the growing need for margin funding in 1995, said: “At the time I was generally aware that it was increasing, yes. There was no particular problem about it, but, yes, it had been increasing”.

6.32 The minutes of the EXCO meeting on 1 February 1995 recorded that: “The volume of trading by the Structured Products Group on SIMEX and Osaka was exceptionally high last week and earned revenue of £10 million. We are allowing the positions to run off as our cash resources could have been insufficient to deal with immediate funding requirements”.

6.33 Ron Baker told us: “I am not walking away from the fact that I knew that there were margin calls and I knew that there were hundreds of millions of dollars involved in the margin calls that would be required in January and February [1995]. It was not something that I felt any responsibility for working out the details of”.

6.34 As we described in paragraph 1.51, one of the reasons for Tony Hawes’s visit to Singapore in February 1995 was to arrange higher intra-day overdraft limits to support BFS’s increasing requirements.

6.35 We do not consider that there was any effective limit placed on the funding of BFS’s ‘switching’ activities.

Specific daily requests for funding

BSJ

6.36 Statements were faxed by BFS to BSJ at the end of each day. These statements included details of the day’s trades, outstanding positions, realised and unrealised profits, BSJ’s equity balance with BFS and requests for additional margin in Yen. BFS statements received in Tokyo were compared by Futures and Options Settlements in BSJ to spreadsheets detailing SIMEX trading. These spreadsheets, prepared by BSJ trading assistants and which constituted BSJ’s records of SIMEX trades, were sourced directly from BFS in respect of BSJ’s ‘switching’ account. We understand that BSJ remitted funds to BFS on the basis of the daily statements although no independent recalculation of the margin requirements was made in BSJ, as BSJ did not have the SPAN margining program. Following approval by BSJ Futures and Options Settlements, the fund transfers were executed by the BSJ Cash Management department.
6. Funding of BFS

Barings in London

6.37 The requests for funding were received in London from BFS initially by fax and later by cc mail (a computerised electronic mail system linking Barings' offices around the world) before the start of business each morning. These were in respect of the close of business the previous day in Singapore. Two requests were usually received each day, one in respect of Yen funding and one in respect of US Dollar funding. We understand that these requests were sometimes superseded by later requests, either a further cc mail or a telephone conversation.

6.38 Railton told us he recalled telling David Hughes and Granger that Leeson: “asks us for a certain amount of money or estimates a certain amount of money and then we find that it is completely different at the end of the day ... We had no other source of information apart from Nick Leeson advising us how much it was”.

Yen requests

6.39 BSL clients' trades on SIMEX were effected by BFS. The details of these trades were passed onto the London Futures and Options Settlements Department (managed by Granger) by BFS. The details were then downloaded into the First Futures system in London. First Futures is a purchased software package designed to record and monitor futures and options transactions. The package is designed primarily to be used to record agency business but Barings also used the package to record their 'house' trading. The package records and monitors positions and margin balances and can be used to calculate amounts due from clients by way of margin on a daily basis. The package also automatically summarises positions by customer to provide relevant general ledger account balances.

6.40 At the end of each day, a report entitled the 'London Gross Report' was produced in Singapore by BFS and was sent to the Futures and Options Settlements Department in London. This report summarised the day's transactions and all movements on open positions held, both proprietary and client.

6.41 A Yen funding request was sent from BFS to the London Futures and Options Settlements Department, in accordance with the daily 'London Gross Report'.

6.42 The 'London Gross Report' and the associated funding request were reconciled by London settlements staff to the First Futures report produced in London, and the balance paid. The payment authorisation procedure is described in paragraphs 6.55 to 6.61.

6.43 The Yen margining requirements consisted of initial and variation margin calls as well as realised profits/losses. These could apparently be reconciled to individual client positions which were identified on the First Futures report produced in London. However, the First Futures report was sourced directly from information provided by BFS in Singapore. Consequently, although the margining requirements for all clients with account numbers accepted by the First Futures system were reconciled in London and funded accordingly, the omission of account '88888' was not identified by a reconciliation process that relied for all its key information on BFS.
6. Funding of BFS

US Dollar requests

6.44 The US Dollar requests sent by BFS to BSL were first used on 12 January 1994, although they were not sent regularly until 16 February 1994. We understand that the staff in London were not able to reconcile these requests to any trading records. Initially, the requests for US Dollar funding did not break down the amount between proprietary and client business. Granger described how they would: “just say 'Please pay - in this example - US$33 million to our customer account'”.

6.45 In late 1994 the format of these requests changed at the request of Tony Hawes and more detail was provided. David Hughes told us that the US Dollar requests were broken down following a visit he and Tony Hawes made to Singapore in October 1994. He said that: “Tony Hawes was not happy with the way the margin was being called and we needed this split between the house and the client and the breakdown of the actual monies being called and how it had been applied, what it was for”. Despite receiving the additional information contained in the breakdown of the funding requests neither Granger (in Futures and Options Settlements) nor Tony Hawes (in Treasury) made any attempt to use it; had they done so they would have discovered it was meaningless.

6.46 We described in paragraph 1.56 how Railton discovered in February 1995 that the breakdown of the total US Dollar request was meaningless, and that the BFS clerk knew the total funding requirement for that day and made up the individual figures in the breakdown to add up to the required total. Granger, who had been told of problems by Railton (see paragraph 6.51), had some doubts concerning the breakdown earlier on. On 24 January 1995 she sent a cc mail to David Hughes and Tony Hawes with regard to the payment of a US Dollar funding request. She wrote “Awaiting breakdown from my buddy Nick [Leeson] ... (once they creatively allocate the numbers)”. She told us that she had said this because: “Tony and I were trying to pin Nick [Leeson] down on how he actually calculated the numbers”. David Hughes told us that he took this message to mean that: “Obviously Brenda [Granger] was expressing her concern that the figures coming out of Singapore were not correct”.

6.47 Granger (who, according to Gamby, authorised most of these payments from BSL bank accounts - paragraph 6.58) recalled that she spoke to Leeson about these requests and said: “You are asking me for more money than I can collect in; so it is looking as if I have client debtors, which I do not. Nick [Leeson’s] basic explanation was, ‘Brenda, London is the cash cow. You are funding Singapore.’ He told me that BFS had no funding lines, so BFS would have to come to London for the funds”. Granger thought that these requests were to enable BFS to fund Barings’ house positions, including BSI. She told us: “It did not matter to me if Treasury was lending money to Singapore to fund Tokyo’s business. As a company I am sure that is allowable: it just bothered me the way that the money was flowing, that it should all come through the house”. Railton recalls being told by Granger that BSL was funding a Tokyo account.

6.48 Tony Hawes confirmed that Granger raised this concern on several occasions, that funds from client bank accounts should not be funding house positions.

6.49 From November 1994 the US Dollar funding requests usually split the amount being requested (itself usually a round sum amount) 50:50 between a request for client accounts and that for the house positions. Tony Hawes confirmed that when he
6. Funding of BFS

identified this feature of the requests: “That was one of the main reasons why during February [1995] I paid two visits to Singapore”. If the US Dollar funding requests had been in relation to genuine positions taken by clients and house, on any one day we consider it unlikely for the margin requests for these two sets of positions to be identical; as for having the requests split 50:50 most days, this in our view is beyond all possibility. Tony Hawes appears to agree with this view. He told us that: “It was just one of the factors that made me distrust this information ... It was too much of a coincidence. On a number of occasions, almost - but not quite - almost every day, there were equal amounts required from house account and customer account ... Throughout I put it down to poor book-keeping and sloppy treasury management in Baring Futures [BFS]”.

6.50 David Hughes also told us that the 50:50 split: “was a cause for concern ... we said, this cannot be right”. He explained that: “I did not think we could have house positions and client positions running totally in tandem”. Granger confirmed that she would have spoken to David Hughes about the split. She added: “We would joke about Singapore, 'Why don’t we send somebody's mother [anyone] out there to run the department since Nick [Leeson] is so busy now?'”.

6.51 Railton was questioning the funding requests in London from late 1994. In a cc mail message dated 28 December 1994 from Railton to Granger, Railton stated in connection with: “some thoughts in the way [BFS] is handling ... US [Dollars]” that there was a problem with the accuracy of the figures. He wrote: “I looked at the figures for the 22 Dec [1994] and 28 Dec [1994] and both the MOS [Mutual Offset] and BNP funding figures were the same, so I went back to the 15th, same again. My point is that I think this is inaccurate, I doubt very much if they were really the same for this period and it's the same for the FCT JGB funding figure”. He suggested that Futures and Options Settlements should tell Leeson that: “We want to keep a much tighter grip on the USD figures. We need to be able to justify why [BFS] wants a certain amount of USD on a particular day ... The best case scenario is that Nick [Leeson] is calling for the right USD but is changing the wrong figures on his breakdown spreadsheet, worst case is that its plain rubbish”. He also noted that BFS were: “not paying us the USD interest that they earn”.

6.52 On 3 January 1995 Railton sent a cc mail to Leeson asking: “how you come to the USD funding figure on a daily basis. A lot of the figures do not appear to move very often ... the ideal situation would be for us to reconcile the USD funding figures. I think this would be good generally for us and also for SFA requirements”. In the event these problems were only addressed when Railton visited Singapore. Gamby told us that he did not see the funding requests from BFS. In a letter to us Gamby stated that Granger had expressed concerns: “in relation to the flow of information that was coming out of [BFS]”. Gamby also stated that he: “ensured that these concerns were effectively addressed” and that this “culminated” in his “sending Tony Railton to Singapore for the purpose of looking at how [BFS] operated with a view to being able to liaise on a daily basis with Brenda Granger to ensure that steps were taken to impact the flow of information from BFS to London.”

6.53 In summary, BSL was unable to determine how much of the US Dollar funding requests was for margin on client positions, and how much was not. The majority of the funding sent in this way was used to fund the unauthorised trading concealed within account ‘88888’. Further, the funds were paid away without any independent
6. Funding of BFS

check on their validity and, as discussed later, with no attempt to reconcile the request to any known trading positions.

6.54 If the Futures and Options Settlements Department in London had used the SPAN margining program (paragraph 3.12) to recalculate the initial margin calls, they would have been able to identify that the amount of margin requested by BFS was significantly in excess of that called for under SIMEX's margining rules. We do not know why this was not done, although Railton told us that unsuccessful attempts were made in late 1994 to apply the system to the data provided by Singapore.

Payment authorisation

6.55 The flow of funds from Barings in London occurred in two stages, according to the bank transfers and book entries we have seen. First, funds were paid by BSGT, a branch of BB&Co, into the BSSL bank account and the client portion of the funding was transferred from the BSSL bank account to the BSL bank account. Secondly, funds were transferred from the BSSL and BSL bank accounts into the BFS Citibank accounts (and vice versa). The BSSL and BSL bank accounts were in the name of BSGT, although they only appeared in the accounting records of BSSL and BSL. Therefore for accounting purposes these accounts were considered to have belonged to BSSL and BSL respectively. For clarity, we refer to these accounts as the BSSL and BSL bank accounts.

6.56 On the basis of the description in paragraph 6.55, the diagram in Figure 6.5 below illustrates the internal flow of funds from one account to another in respect of US$ funding.

Figure: 6.5

(a) BSGT: Barclays a/c
BB&Co
(b) BSGT: Citibank a/c no.1
BSLL
(b) BSGT: Citibank a/c no.2
BSL
(b) BSGT: Citibank a/c no.3
BFS
(b) BSGT: Citibank a/c no.4
BFS

Key:
Bank account
Accounting records

Source: Inquiry team based on discussions with Barings' personnel
Note (1): a, b - see paragraphs 6.57 to 6.59
Note (2): Bank account numbers 1, 2, 3, 4 are notional numbers for four separate Citibank accounts.

6.57 The payments from BSGT to BSSL were made by the SWIFT (Society for Worldwide Interbank Financial Telecommunications) system (payment (a) in Figure 6.5). A
6. Funding of BFS

SWIFT payment advice was prepared by a BSGT clerk. Once prepared the clerk signed the advice and presented it to an ‘A’ signatory for further authorisation. The normal signatories for these payments were Mr Geoff Clark, BSGT, and David Hughes, both ‘A’ signatories in BSGT. These payments ensured that BSLL and BSL had sufficient funding to meet the necessary payments to BFS.

6.58 The payments made from BSLL and BSL to BFS were also made by SWIFT (payment (b) in Figure 6.5). A clerk prepared the payment advice, signed it as a ‘B’ signatory and presented it to an ‘A’ signatory for approval. We understand that Granger usually signed as the ‘A’ signatory.

6.59 We have reviewed a sample of ‘A’ and ‘B’ signatures on SWIFT request forms for the (b) transfers in Figure 6.5 for the period 1 December 1994 to 24 February 1995. In the case of ‘A’ signatories we have not always been able to match the signatures visually to the list of authorised signatories, although Granger told us she recognised them. We understand that Granger, Railton and Mr Trevor Wallace, Futures and Options Settlements Clerk, were removed from the list of authorised signatories following the move to 8 Bishopsgate from 1 America Square during December 1994. The names of Granger and Wallace were reinstated onto the list during February 1995, but Railton’s was not. All three of the above acted as ‘A’ signatories at various times throughout the period reviewed.

6.60 There was no specific requirement for higher authorisation by a more senior employee for high value transfers. Barings’ Futures and Options Settlements Department authorised the transfers of several hundred million pounds to BFS, which helped to fund BFS’s unauthorised trading activities.

6.61 Gamby told us that there was no requirement for a higher level of signatory based on amounts transferred. Barnett told us that he was: “not familiar with the funds’ movement authorisation procedure within the Group” and that he did not get involved with: “day to day operational issues”.

Accounting treatment and the ‘K2/P4’ balance

6.62 It is necessary to explain how these payments were accounted for in the records of BSL and BSLL.

BSLL

6.63 Where proprietary trading was undertaken, this was recorded in the books of BSJ or BSLL. In the case of BSLL, requests for margins were received and the monies were paid over to BFS and recorded in BSLL as a decrease in the bank balance with a corresponding increase in the balance on the intercompany account ‘Margin with Group Companies’, in this case BFS.

6.64 The ‘Margin with Group Companies’ balance at 31 December 1994 in respect of BSLL was £13 million, of which £3 million related to US Dollar funding requests. The ‘Margin with Group Companies’ balance at 24 February 1995 in respect of BSLL had increased to £105 million, the majority of which (£82 million) related to US Dollar funding requests. These amounts were recorded in a US Dollar house collateral account termed ‘BSSHSECOLLI’. It would have been difficult to associate this
6. Funding of BFS

US Dollar funding with unauthorised trading without recalculating the actual margin required using the SPAN margining program (paragraph 6.54).

BSL

6.65 In cases where BSL identified that it had paid monies in respect of client trading (as in the case of the Yen requests described above), it would call for the margin from its clients. The receipt of those monies would be recorded as an increase in the bank balance offsetting the payment to BFS and as an increase in the amounts received from the clients (recorded in an account called ‘Segregated Clients’).

6.66 In the records of BSL, the payment (b) in Figure 6.5 was recorded as a reduction in BSL’s bank balance and an increase in the balance on the intercompany account ‘Margins with Group Companies’, in this case BFS. Thus these payments increased the amount that was owed to BSL by BFS.

6.67 As set out in paragraph 6.44, the US Dollar funding requests were paid out to BFS. However, BSL was unable to allocate these requests to individual clients and only a small proportion was recovered from clients. The balance of £306 million, on 24 February 1995, was not allocated to individual clients. Within the accounting records of BSL this discrepancy would not have been apparent, as the payments out were merely added to the ‘Margins with Group Companies’ caption in the balance sheet and, in particular, within this caption, the US Dollar segregated cash collateral account termed ‘BSINGCOLL’ (paragraph 11.81).

6.68 Another accounting report, the solo balance sheet, showed as a separate item the difference between the funds transferred to BFS as margin and the monies collected from BSL’s clients. This difference, which appeared in the on-balance sheet account ‘P4’ (client loans) and in the off-balance sheet account ‘K2’ (loan contra), on the solo balance sheet, was derived from the difference between the general ledger accounts ‘Margins with Group Companies’ and ‘Segregated Client Bank Accounts’, and the account ‘Segregated Clients’. It was sometimes referred to as the ‘top up’ account by BSL employees and it is a term we use in this report in this context.

6.69 This difference had arisen during the period when the solo balance sheet was being designed at Barings. A minute of a ‘Solo Consolidation Working Meeting’ on 14 April 1993 recorded that: “The balancing of Fiduciary Funds in BU3 [Agency Derivatives] by the creation of a loan to represent the top up of segregated funds. In order to meet the deadline, in the short term this can be achieved by establishing the loan for the amount required to balance Fiduciary Funds. Longer term the reasons for the imbalance must be explained satisfactorily and corrected”. As we now know, this had not been achieved by the time of the collapse. The minute recorded that Broadhurst, Ms Deidre O’Donaghe (Head of BIB and BSL Credit Unit in London), Tony Hawes, Miss Lynn Henderson (Assistant Director in Financial Control), Mr Peter Hynd (Assistant Director, IT) and Mrs Valerie Thomas (Compliance Officer, BIB, and Assistant Director of BB&Co.) were present at the meeting. According to O’Donaghe, the imbalance at this time was between £8 million and £10 million, and was believed to represent timing differences on client business. The solo consolidation steering committee included, amongst others, for BSL: Norris, Broadhurst and Farley; and for BB&Co: Maclean, Hopkins, Tony Hawes, Barnett and Russell.
6. Funding of BFS

6.70 As part of the solo consolidation process (described in Sections 11 and 12) a solo balance sheet was produced, detailing individual entity balance sheets for BSL, BSGT and BSLL. This was produced in London on a daily basis by the Regulatory Reporting Department. This balance sheet had a limited circulation within Barings and was regarded as a Bank regulatory tool, although it provided funding information for the Treasury Department. Barnett told us that he had never seen this balance sheet, although he was involved in the solo consolidation working group.

6.71 Broadhurst (up to February 1994 when the ‘top up’ balance was £20 million) and Seal saw the solo balance sheet from time to time. The solo balance sheets for BSGT and BSL were consolidated together with BB&Co and Baring Brothers BV (a funding vehicle) on a weekly basis to form a solo consolidation balance sheet known internally as Schedule A. In both Schedule A and the monthly management accounts the ‘top up’ was not shown separately but was included within the caption ‘advances’.

6.72 The solo consolidation process combined the financial positions of BSL, BB&Co (including BSGT) and Baring Brothers BV. Prior to solo consolidation, balances between BB&Co and BSL, such as ‘top up’ funding, were shown explicitly. Maclean commented to us that: “Solo consolidation ... is one of the factors at the heart of this problem, this crisis”. This is considered further in paragraphs 11.21 to 11.29.

6.73 A key indicator of the problems experienced by Barings was the large amount of funding being provided to BFS, apparently in respect of advance margin on client business. In the daily solo balance sheet this account was visible, if a little confusing in presentation. The accounting treatment was both off balance sheet (loan contra or ‘K2’) and on balance sheet (client loans or ‘P4’).

6.74 The mismatch between margins placed with BFS and the identified client segregated funds relating to those margins can be calculated from the off balance sheet ‘Fiduciary Funds’ shown in the daily solo balance sheet, as illustrated in Figure 6.6. It is also shown in a bar chart in paragraph 11.88, Figure 11.5.
6. Funding of BFS

<table>
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<tr>
<th>Solo line reference</th>
<th>Description</th>
<th>31 Dec 1993 £'000</th>
<th>31 Mar 1994 £'000</th>
<th>30 Jun 1994 £'000</th>
<th>30 Sep 1994 £'000</th>
<th>30 Dec 1994 £'000</th>
<th>30 Jan 1995 £'000</th>
<th>24 Feb 1995 £'000</th>
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<tbody>
<tr>
<td>Z1</td>
<td>Client Bank Accounts</td>
<td>57,287</td>
<td>28,343</td>
<td>58,320</td>
<td>41,656</td>
<td>83,901</td>
<td>36,378</td>
<td>22,955</td>
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<tr>
<td>Z3</td>
<td>Margins with Group Companies</td>
<td>132,449</td>
<td>225,126</td>
<td>334,385</td>
<td>280,654</td>
<td>231,690</td>
<td>313,450</td>
<td>502,560</td>
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<tr>
<td>Z4</td>
<td>Margins with Brokers</td>
<td>16,393</td>
<td>26,962</td>
<td>12,026</td>
<td>7,939</td>
<td>8,751</td>
<td>7,116</td>
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<td>Total Fiduciary Funds (Off Balance sheet assets)</td>
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<td>280,431</td>
<td>404,731</td>
<td>330,249</td>
<td>324,342</td>
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<th>Solo line reference</th>
<th>Description</th>
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<th>31 Mar 1994 £'000</th>
<th>30 Jun 1994 £'000</th>
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<th>24 Feb 1995 £'000</th>
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<tr>
<td>K1</td>
<td>Segregated Clients</td>
<td>(162,074)</td>
<td>(194,414)</td>
<td>(280,429)</td>
<td>(184,502)</td>
<td>(198,980)</td>
<td>(204,445)</td>
<td>(219,331)</td>
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<td>K3</td>
<td>Pending Settlement</td>
<td>(22,337)</td>
<td>(11,252)</td>
<td>(4,008)</td>
<td>(2,154)</td>
<td>(5,322)</td>
<td>(2,144)</td>
<td>(2,266)</td>
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<tr>
<td>Total Fiduciary Funds (Off Balance sheet liabilities)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td></td>
<td></td>
<td>(184,411)</td>
<td>(205,666)</td>
<td>(284,437)</td>
<td>(186,656)</td>
<td>(204,302)</td>
<td>(206,589)</td>
<td>(221,597)</td>
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<tr>
<td>Mismatch (equal to the solo lines K2/P4)</td>
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<td>21,718</td>
<td>74,765</td>
<td>120,294</td>
<td>143,593</td>
<td>120,040</td>
<td>150,355</td>
<td>306,309</td>
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</table>

Source: Daily solo balance sheet
Note (1): line K2 is described as ‘loan contra’ (off balance sheet)
Note (2): line P4 is described as ‘client loans’ (on balance sheet)

6.75 As noted in paragraph 6.71, a weekly solo consolidated balance sheet was prepared ('Schedule A'). The solo line P4 was included in this balance sheet as part of the consolidated advances to clients (less than 7 days), figure, and was, in fact, a material component of the balance. For example, at 30 June 1994 and 30 December 1994, consolidated advances to clients (less than 7 days) were £232 million and £177 million respectively.

6.76 The mismatch was believed by management to represent the margin paid to BFS for client business, but which had not been recovered from clients, although some staff were aware that client business represented a much smaller amount. Granger confirmed that she believed that some of this balance was funding 'house' trading by BSJ, and that it was in the wrong category on the solo consolidation balance sheet. This mismatch was not, however, reconciled to individual client balances and Broadhurst acknowledged to us: "I had no idea that they were not being reconciled". He later added that on a daily basis, Granger would have sent a list of known client debtors to BSL Credit and Group Treasury. It was assumed that this would then have been reconciled by one of Futures and Options Settlements, Finance, Credit or Treasury departments against the total client loans. We were told by representatives of each of these departments that this never happened.

6.77 Because of this mismatch a journal entry had to be processed to transfer the 'K2' balance into the solo balance sheet, where it was shown as client loans ('P4'). Without this entry the balance sheet would not have balanced. Hereafter, in this report we refer to the 'K2/P4' or 'top up' account.
6. Funding of BFS

6.78 Tony Hawes stated that: "In the course of the agency derivatives business we collected segregated funds from clients and we put margins with Group companies and other exchanges to collateralise the customers' securities [traded futures and options] transactions ... we very often had to put up margin with the Group companies or with exchanges in advance of receiving those funds from customers, or sometimes ... because margin was required today to be repaid tomorrow we did not collect the money from the customers at all ... This method of operating was ... not properly controlled".

6.79 The chart in Figure 6.7 below illustrates the growth of the 'top up' during the period 1 January 1995 to 24 February 1995.

Figure: 6.7

Source: Inquiry team based on analysis prepared by Barings.

6.80 As noted in paragraph 6.77 the 'top up' was shown separately as 'client loans' in the daily solo balance sheet. In the weekly Schedule A balance sheet it was included as part of advances to customers, less than 7 days. It was similarly disclosed in the monthly management accounts. In the annual consolidated statutory accounts 'top up' was not separately identified but was mostly reflected as margins placed with exchanges.

The absence of a key funding reconciliation

6.81 It is apparent that BSL and BB&Co staff did not reconcile to client records this 'top up' balance. Any reconciliation would have been impossible without knowledge of the transactions in account '88888'. Granger confirmed that she was not able to do it. She added: "I did not look at this as a reconciliation problem for myself. All the reconciliations that we do are done daily. I reconciled the total amount of cash I had on deposit there, and that reconciled to the amount of cash I had sent down there".
6. Funding of BFS

She added that the total amount of cash on deposit was reconciled to BFS broker statements.

6.82 We asked Railton if it was oversimplifying matters to say that if Singapore requested money it was paid. He told us: “On the dollars, if they requested the funds, then we paid them, yes”.

6.83 Gamby said that he was aware that the Financial Control Department performed a reconciliation of the intercompany balances in the books between BFS and BSL. This only ensured that both sets of books reflected the monies going from London to Singapore. They were not reconciled to the underlying transactions. Gamby told us that in January 1995 Granger told him about ‘top up’ as: “something that was like an intra-day margin call from the Exchange”. Gamby told us he received assurances at the time that Granger was in regular contact with Tony Hawes regarding the funding “that was going down there”. He accepted however that it is now clear that: “we were not in a position in London to actually check the validity of the sums in total being requested, because we had missing bits of information and [were] incapable of undertaking the actual SPAN margining routines in any case in London”. Gamby said he had no direct conversation with Tony Hawes regarding it.

6.84 Tony Hawes claims to have known that this reconciliation was not being done from some time in 1993 and for the whole of 1994. He claims to have talked to Bowser (who at the time of the collapse was Risk Manager in Hong Kong, but who was then in the Futures and Options Settlements Department in London) in the second half of 1993 and in 1994. Tony Hawes told us that in his opinion the responsibility: “ought to have been [with] Futures and Options Settlements. I think it very likely that no specific arrangements were made for anybody to reconcile it”.

6.85 Tony Hawes told us that: “We were also financing the advance margin calls and things like the [Eurodollar contract] MOS [mutual offset business] which we did not see in London. We just accepted his [Leeson’s] word that the figures required ran into millions. Yes, we just about accepted what he said”. Tony Hawes also noted: “The weakness was that the money ostensibly sent down for the client was not being tied down to a particular client. That was a fundamental weakness”.

6.86 Hopkins told us that responsibility for the reconciliation was: “very unclear. You could say that it was a finance function responsibility; you could say that it was a Futures and Options Settlements responsibility; you could say it was a Treasury responsibility. I think it was probably the responsibility of all three, but this is certainly something that we wanted to resolve”.

6.87 Barnett told us that in his opinion the: “responsibility for reconciliation lay ... I would have expected it to have been in Singapore rather than in London. As between the treasury desk and the settlements desk in London, I do not have a view as to ... It is clear that one of them should have been doing it and the other clearly need not have done it”. As we now know, it was not done. Tuckey also told us that he would have expected the reconciliation to be performed.

6.88 Tony Hawes briefed James Baker in a meeting prior to James Baker’s July/August 1994 internal audit visit to BFS. The note produced by James Baker, the accuracy of which was confirmed to us by Tony Hawes, recording the meeting includes the following
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comment: “One specific concern in the futures area is the level of margin calls paid by BSL London without knowing precisely on whose behalf the cash is being paid ... Tony [Hawes] simply receives a request for US$ to make up the shortfall and has to satisfy the demand at very short notice, sometimes even during SIMEX trading hours. The request is in a lump sum form and the payment is debited to a ‘Loans to Customers’ account. Tony [Hawes] would at least like to know how much of the payment is for house positions and how much for customers”. James Baker told us that: “[Tony Hawes] had really just explained to me a little tip of the iceberg and given me the day-to-day shortages that occur ... I was as surprised to learn as anyone else about accumulated balances that had lasted for weeks, months, a year, without being addressed”.

6.89 Gamby told us that the reconciliation was not done because: “There is information on here [the cc mail funding request from Singapore] that London would not be able to verify ... Anything that relates to advance margin; anything that relates to BNP [Japan] being the local client; anything that relates to FCT funding, which was the Tokyo client”. He admitted that: “Nothing happened to the difference, basically [between the amount he knew was for London customers and the total amount paid over]”.

6.90 In a letter to us Hopkins stated that: “[I] was extremely concerned to learn, upon taking up [my] post in September 1994, of the unreconciled balances. [I] was not prepared to permit the unreconciled balances to remain unresolved, as had apparently been the case for some very considerable time before [my] appointment”.

6.91 Hopkins told us that he recalls Tony Hawes telling him that: “Despite a number of attempts we were not able to reconcile the amount of funding we were putting up”. Hopkins agreed that BSL funded calls coming from Singapore for margin advances without anyone in London knowing precisely what they were in respect of.

6.92 Figure 6.7 shows that at 24 February 1995 of the total funding to BFS of some £337 million only £31 million had been recovered from individual BSL clients (represented by the difference between total margin and ‘top up’). The balance or ‘top up’ of some £306 million, was perceived by some in BSL to be ‘owed by clients’. Review of the chart indicates that from 1 January 1995 to 24 February 1995 the proportion of genuine client monies which were transferred to BFS fell as a proportion of the total funding. There is no clear explanation as to why Barings’ management did not question why BSL should be apparently lending over £300 million to its clients to trade on SIMEX, when it had only collected some £31 million from clients for those trades.

6.93 The principal reason for the excessive funding was the need to finance the equity balance and initial margin requirement relating to account ‘88888’. Up to January 1995 the margin calls on account ‘88888’ were met with funds provided by BSL (the ‘top up’), funds provided by BSLL, and with BSJ’s apparent excess margin at SIMEX. Later, when the SIMEX margin calls on account ‘88888’ increased substantially and it was difficult to finance by this method alone, BFS created artificial end of day transactions to net down the balance between account ‘88888’ and the SIMEX ‘switching’ account ‘92000’ (Section 5), thereby reducing the margin calls from SIMEX.

6.94 It was not until Railton went to Singapore in February 1995 that a proper investigation into the funding of margins was conducted leading, as we describe in paragraphs 1.51
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to 1.60, to the discovery of the unauthorised funding, some eight months after Tony Hawes expressed his concerns to James Baker.

6.95 The failure to reconcile the 'top up' account allowed BFS to continue requesting, and receiving, US Dollar funding from without serious challenge. In our view, a methodical and determined attempt to perform this task in 1994 would most likely have revealed the meaningless breakdown of the US Dollar requests and caused management to question the whole rationale for the requests. This failure highlights what Tony Hawes has previously referred to as a ‘fundamental weakness’ in Barings’ credit control procedures. These are described in paragraphs 6.96 to 6.112.

Credit risk on client margins

6.96 Barings was exposed to the risk of financial loss through the failure of its counterparties or customers to meet their obligations. BB&Co’s exposures were monitored by the Credit Committee, assisted by BB&Co’s Credit Unit. In early 1994 BSL’s exposures were monitored by BSL’s Risk Committee and when that committee ceased to exist in mid-1994, Russell told us that: “The primary focus for counter-party credit and issue of risk was that committee [the Credit Committee]”.

6.97 The credit aspects of the ‘top up’ balance were never formally reviewed or ever considered by the Credit Committee. If the Credit Committee had considered the implications of the ‘top up’ account during 1994, and had asked to review the creditworthiness of the constituent parts of that balance, the impossibility of the task might have initiated more rigorous attempts to reconcile or even understand the balance. In any event the ‘top up’ problem would have been brought to the attention of more senior management in Barings, including Maclean.

6.98 There is general agreement that it was the responsibility of BSL’s Credit Unit to bring the credit implications of the ‘top up’ to the Credit Committee although the Credit Committee did not use the information available to it in the weekly and monthly balance sheets to identify significant items for review.

6.99 In December 1993 O’Donaghue was appointed head of BSL’s Credit Unit and initially she reported to Tony Hawes. She told us that she: “was very much involved in setting up or re-establishing the London credit”. She also told us that she had no previous credit experience nor had any detailed job specification or written terms of reference. In July 1994 Blyth joined IBG to: “head up the part [of IBG] looking at counterparty risk across the whole of the Investment Bank’s sphere of activities”, from when O’Donaghue reported to Blyth. He told us that the: “mandate which was given to me was to try and bring the best of banking, tight credit controls, into Barings Securities’ activities”.

6.100 Blyth had two reporting lines. The first was initially to Tony Hawes and then from August 1994 to Hopkins, the newly appointed head of GTR. The second was to Russell, who on 23 August 1994 was announced, in an internal memorandum from Norris, as becoming head of BIB credit, taking up the position (at the latest) on 1 January 1995. Blyth admitted that this structure was not perfect, but thought that the matter was going to be clarified on BIB’s proposed move to a single building, which had not occurred by the time of the collapse. Blyth told us that he reported to Tony Hawes: “on a day-to-day basis, but my main line of reporting on credit matters was to
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Johnnie Russell and on to the Credit Committee”. On Hopkins’ appointment in August 1994, Blyth told us that he discussed with Hopkins: “the structure of the team, any individual credit problem that had arisen ... I do not remember a substantial amount of discussions with him”.

Hopkins recalled that: “Iain’s [Blyth] direct reporting relationship [from September 1994] was to Tony Hawes, who reported to me. He, as I say, also had the relationship with Johnnie Russell, becoming rapidly established through that time ... I suppose the best way to describe it was that it was unclear where the primary relationship, reporting line, actually went”. He added: “Johnnie [Russell] became very much the controller of Iain Blyth in terms of what he was doing ... through November, December [1994] and January [1995]”. Russell confirmed that he became gradually more involved in BSL’s credit issues from 1992. When Russell was asked the date from which credit was managed centrally and he became the Head of Credit he said: “I do not think I would agree with that in the sense that the management of credit in Barings Securities was from a date, but I cannot remember when exactly”. Subsequently he wrote to us and stated: “At no stage did Credit operations [Blyth] report to me”.

There was general agreement that BSL credit procedures were weaker than those of BB&Co. In a memorandum to Norris dated 4 November 1994 Hopkins referred to the poor quality of the credit function and wrote: “Our efforts on credit are more form than substance. Deidre [O’Donaghe] and her group, although very energetic and well-intentioned, struggle due to inexperience. Iain Blyth has yet to establish his credentials”. We asked Blyth whether he was being provided with the information that would enable him to fulfil the job for which he was appointed. His response was: “No. I think there were shortcomings in the systems generally ... There was a need for better quality management information in my view”.

Maclean, who was chairman of the Credit Committee, wrote to us and stated: “I had discussed with Mr Russell (head of credit in Baring Brothers) the need to put [Baring Securities’] credit policies on to a basis consistent with those of [Baring Brothers] but it was clear to us both that this would only be possible over a considerable period of time. We were well short of that at the time of the collapse”. Russell told us that: “We were looking to bring the credit standards of that organisation [Baring Securities] up to those of the bank”. He added that: “It was not until ALCO came into being, which was in the latter part of last year [1994], when the Credit Committee began to focus much more on the credit issues which arose in Baring Securities. They were not really very satisfactory discussions because, as I say, the credit culture in that organisation was very different from [BB&Co]”.

Credit risk on trading is the exposure which results from a counterparty failing to settle a trade as agreed. Although the Credit Units did not differentiate between the risk on agency and proprietary business, credit risk on agency trading can be mitigated if client funds are used throughout the process although it would arise if margin is paid to an exchange before it is received from a customer. The Credit Units’ responsibility was to monitor all counterparties and customers to ensure credit risks were controlled and to inspect all counterparties for evidence of money laundering.

Granger told us that Futures and Options Settlements would verify that they had sufficient client margin on deposit on a daily basis. The ‘Margin Excess Limits’ report listed only those customers whose overdue margins exceeded their limits at the end of
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the previous day, but did not include the total of all margin advances. The Credit Unit
reviewed this throughout the period in question but saw only those balances where
limits had been exceeded. No problem with the BFS agency business was identified by
the review.

6.106 However, this review did not address the apparent advance margins paid by BSL to
BFS which management believed to have been made on behalf of clients. These
amounts were included in ‘advances’ in the weekly solo consolidation balance sheets.

6.107 The BSL Credit Unit did not routinely receive a copy of the solo consolidation balance
sheet and Blyth and O'Donaghue told us they were unaware of the growth of the

6.108 We asked Granger whether anyone from Credit in London ever asked her about the
‘K2’ account. Granger noted that: “Credit had asked me this before as well as the
accounting people. I explained this. They would look at our debtors report and it
would very clearly not equal up to the amount that we had down there. I would
explain, ‘well we have given a loan down to Baring Futures (Singapore)’”. Granger
told us she spoke to O'Donaghue on this matter and “very seldomly” to Blyth.

6.109 O'Donaghue told us that she thought that the: “classification of ‘client loans’ was
always incorrect because, again, it was the timing, so it was not a loan in the short
term. Timing was the understanding that we had at the time [1993]”. She went on to
say: “Baring Securities is not in the business of funding any clients other than one
client, which was FCT, so there would be no reason to have ‘client loans’ in the balance
sheet”.

6.110 The usual credit control procedures were designed only to monitor individual
counterparty limits, not the overall advance margin position. We have not been
provided with any explanation as to the lack of credit approval for the advance
margins sent from BSL to BFS.

6.111 We asked Russell about the credit approval process for those advances. He stated: “To
my certain knowledge, those advances escaped the credit process altogether. They
were not identified ... as loans to clients”. As a result, he explained that they were not
picked up as credit exposures. We asked who should have been responsible for
identifying that and he replied: “I think it should be the Accounts Department. As we
now know, it represents unreconciled balances in respect of money remitted to
Singapore, so clearly the Treasury must have known what was going on there ... I
think the fault probably lies in the way in which the solo system was configured, in the
sense of there not being any system to capture the individual loans within that account
and include them in our exception reporting”.

6.112 We consider the purported receivable from SLK at 31 December 1994 in Section 7. No
assessment was made of the credit implications resulting from the SLK year end
receivable once management believed that payment had been received. Russell told us
he was not aware of the SLK receivable and that it “probably should have been”
brought to the attention of the Credit Committee.
6. Funding of BFS

Conflicting management policy in respect of financing client margin

6.113 We asked Maclean about the monies advanced to BFS and whether he would have expected to have seen credit approval for the clients if the assumption was that the funding to BFS was made for clients.

6.114 Maclean said: “Baring Securities had a general approval to finance client margin until it could be collected as quickly as possible from the client. In other words, they could not leave it outstanding for as long as the trade was outstanding, but because SIMEX makes its claim intra-day or pronto - makes it either at the end of the day or before it could conceivably be collected from the client - then they were allowed to put it up. Baring Securities’ financing mechanism was allowed to put the money up and collect from the client immediately. That was understood. That was a general understanding, that they could finance that”.

6.115 We asked: “So they had a free rein on that one without any limit per se?”

6.116 Maclean replied: “As long as they could collect overnight, yes. As long as they could collect as quickly as possible. I would have to say that once the two businesses had been fully merged and brought together, and the credit process had been fully merged, we would not be happy with that. No, we would not have allowed that in the bank [BB&Co], but this is how it had worked for years and we were told to keep the business going. You had to allow them to do that. We certainly would not do that in the bank [BB&Co]”.

6.117 He went on to explain that: “Our assumption was that they were very, very small amounts and very widespread amongst some good clients of long standing of Baring Securities. It was not something that we thought about. It did not seem to me to be a major issue”.

6.118 We asked Norris whether: “short term - or long term even - funding of client margin positions was not something that went through the Credit Committee”. When we mentioned Maclean’s comments in paragraph 6.114, Norris replied: “That is simply not true. The whole rationale for the solo consolidation exercise was to bring all of these financial exposures and the prudential management to the balance sheet into one place”.

6.119 He went on to say that: “There was no remit within the Barings world for the agency equity broking side to advance the bank’s [BB&Co] funds to customers”.

6.120 We asked Russell whether there was any general permission or credit approval for Baring Securities to advance money to customers in respect of margins. He stated: “No. There was no consent for them to do that”. He explained that there was a specific case, FCT, where facilities were put in place but: “To my memory, that was the only occasion on which that happened”.

6.121 Walz told us: “I had a view about the level of intensity of operational credit at Baring Securities, which was that it was pretty average and they were struggling”.

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6. Funding of BFS

6.122 Allocation of funding cost

Allocation of the costs of funding appears to have been the subject of some attention in Barings but did not result in management identifying the house positions in account ‘88888’.

6.123 Tony Hawes told us: “I think the chronological order [in respect of allocating funding costs] ... was the run-up to the bonus calculations. The Structured Products Group were questioning the amount of funding they were being charged. It was really something between them and Financial Control but I got involved, I would perhaps describe it, as a referee ... I passed most of the comments that I got from the Structured Products Group through to David Crookston, Financial Controller, but I did talk to Geoff Broadhurst about the way the funding was calculated and said could it be due to this unexplained top up balance and the cost of funding that”.

6.124 He told us that he briefed Jeremy Stunt (Barings Financial Control) about a two phase project to: “solve the immediate problem of coming up with a funding calculation that everybody would buy into, but, secondly, to investigate exactly what this excess funding was ... The agency derivatives team, who at this stage were separate from the Financial Products Group, were also unhappy with the amount of funding credit they received for the funds that their clients deposit with Baring Securities as margin”.

6.125 Broadhurst recalled that in September 1993 during the annual bonus calculations Tony Hawes raised the fact that the internal funding of £3 million charged by Barings London to the exchange traded futures and options client activities might be overstated. Stunt reported back to Broadhurst within a few weeks that it had been explained by Leeson (apparently to Stunt’s satisfaction) that the £3 million internal funding charged by London was offset by £3 million credited to the exchange traded futures and options client activity by Singapore and that no misallocation existed. Accordingly, Broadhurst considered that this issue was “resolved”.

6.126 In a letter to us, Broadhurst stated: “I was also aware that Ms Walz had asked Mr David Crookston to check that the internal funding charged in the management accounts to Equity Financial Products was correctly stated. Mr Crookston delegated much of the detailed work on this to Mr Stunt. The main emphasis of this investigation revolved around the Japanese cash futures arbitrage and Hong Kong derivatives businesses and not Mr Leeson’s inter-exchange arbitrage (‘switching’) business. Mr Crookston was managing the project and regularly gave me an overview of progress. He communicated to me on completion of the exercise that the numbers included in the management accounts did not require material adjustment. In addition Ms Walz expressed satisfaction to me as to the way in which the investigation had been carried out in such a way that my understanding was that it had been concluded to everyone’s satisfaction”.

6.127 Tony Hawes did not share Broadhurst’s view that the funding cost issue had been resolved. He told us that early in 1995 the project had stalled after the first stage and that it was: “something I would have to do myself within Treasury”. He considered that for most of 1994 Treasury: “did not have the resources to undertake such a project” . He added: “By the start of 1995 I felt we did have the resources to look fully at what was going on with margin generally, and specifically with margin in Singapore, and it was a project I started”.

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6.128 The specification of what he termed the 'Singapore Project', described later in paragraph 7.32, was outlined by Tony Hawes in a note to Hopkins dated 11 January 1995 as follows: "The project is to investigate the way in which margin is provided to, and used by [BFS]. Both Agency and House margin should be addressed". The project included the identification of the causes of the very large and consistent requirement for funding from London under the heading "Loans to Futures and Options Customers".

6.129 Tony Hawes sent the project specification to Bax for him to consider with the intention that it would be discussed jointly with the nominated project manager who decided to leave Barings before it started.

6.130 Tony Hawes told us: "James Bax gave this project to Nick Leeson and Simon Jones to have a look at, and promised us a response by the end of the month [January 1995] which did arrive but I thought it was a pretty worthless document ... I think you have to put it against the background that I expected this project to be addressed in the form of a three or four week project by somebody independent, dedicated to it. The fact that it was answered in a three and-a-half page memo by the two people I really wanted the enquiry to be independent of made it fairly worthless, as far as I was concerned".

Data sent to London

6.131 We described in paragraph 5.3 how Leeson arranged for details of account '88888' to be suppressed from all reports, except for the margin files that were sent to London. We found that information on account '88888' was, in fact, received in London as part of the daily transfer of those files via cc mail from BFS but that this information did not alert Barings to the unauthorised trading.

6.132 Prior to accepting data on a particular account, the First Futures system in BSL determined whether it recognised the account number by reference to a master file which contained a list of known account numbers. It appears that if the account number was not on the master file, the data were not entered into the First Futures ledger. If the account was recognised, the information was downloaded, and was used, for example, to call for margin from a BSL customer. Account '88888' was not on the master file. Therefore, information sent to BSL in relation to account '88888' was not downloaded into the First Futures system.

6.133 The information relating to accounts which were not loaded into the First Futures system was left in a suspense file, and no effective investigation of such items appears to have been carried out. Although reports were produced to indicate whether margin data had been downloaded to First Futures successfully, these did not detail all accounts skipped during the download because the account number was invalid. Farley explained this to us in a letter: "There are two 'margin processing' screens available to users of the First Futures system. The first screen listed all the margin balances loaded from the CONTAC system in Singapore. The second screen listed the accounts recognised by First Futures as being valid London accounts, for which the margin balances were loaded into the First Futures database. A comparison of the two screens would indicate those accounts rejected by First Futures as being not relevant". In addition, we noted there were no system based reconciliations or control totals to ensure that all data records received in London were processed (or deleted/posted to a suspense code).
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6.134 Gamby told us: "If it could not actually find a relevant client in the First Futures system, then in effect it would be held in suspense waiting allocation ... That [the responsibility for clearing out the suspense] would have been the responsibility of the settlements area in London, i.e. Brenda Granger's area".

6.135 Granger told us that she "never saw" account '88888'. We asked her whether it had come across on one of the downloads of the file. She said: "It did. I found that out in retrospect, that it was in the margin file ... I do not know how long it has been there ... There is a bunch of other accounts in there that do not belong to Barings (London)". She told us there was never any effort to print off all of the accounts from BFS and reconcile the total amounts. She stated it was not the responsibility of her department to review the accounts which were not loaded into the First Futures system. She added: "In hindsight if we had looked at this, we probably could have questioned something". It appears that the margin file was used by Futures and Options Settlements, for example when reviewing FCT's balance, but that account '88888' was not investigated.

6.136 The margin file could be viewed on a computer screen showing account numbers and balances in Yen. Review by us of the items held in suspense in London revealed that at 1 February 1995 account '88888' was recorded as having a balance of ¥48.2 billion (£320 million). This is a material amount, as would be expected given the balance (or loss) on BFS's account '88888', as may be seen in Figure 4.2.

6.137 On 21 February 1995 Hassan sent to Futures and Options Settlements in London by cc mail a list of account numbers, including account '88888', with amounts in Yen, presumed to be margins. It is not clear what was done with this information, although it was only received in the week leading up to the collapse.

6.138 The absence of any systematic analysis of items in suspense or the lack of effective exception reporting helped ensure that account '88888' was not identified and investigated by Barings' London staff.

Funding to BFS

6.139 In Section 4 the unauthorised trading activity is described based on an analysis of account '88888' and available SIMEX statements. We have not had access to BFS accounting records and we are therefore unable to reconcile the cash sent to BFS against the margins placed at SIMEX by BFS.

6.140 The funding from BSL was thought by management to represent advances to clients although, in fact, it was for unauthorised house positions at SIMEX. Almost all of the funding described as advances to clients in BSL was used to fund the unauthorised trading in BFS. The majority of funding from BSSL was considered to be in respect of reported proprietary positions although only a proportion may have been required to support reported positions. It appears that funds remitted by BSJ to BFS were in respect of reported positions. However, due to the apparent profitability of the reported positions, BSJ understood that excess margins returned by SIMEX to BFS were not similarly returned to BSJ. There was no apparent attempt by Barings in London or Tokyo to consider the Group's overall funding of BFS in respect of known positions on SIMEX. Finally, in Section 5 we have described how non-market
transactions were booked to account '88888' and account '92000' which enabled the funding requirement to be reduced.

6.141 The funding provided to BFS by BSL, BSLL and BSJ was extremely high. The funds were transferred, at least in part, on the basis of unsupported requests from BFS for which there was no reconciliation to underlying records. The failure to investigate thoroughly these transfers of funds played a major part in the collapse of Barings.
13. CONCLUSIONS

OUTLINE

13.1 We think it appropriate to emphasise here the caveats which we set out in the introductory section to this report. In particular, we have had very limited access to documents of BFS or SIMEX in Singapore and we have not been able to conduct formal interviews with the senior management, or more junior staff, of BFS in Singapore. Nor have we been able to see the work papers of, or interview, BFS's auditors. Further, Leeson, the General Manager and Head Trader of BFS - who, from any viewpoint, is a central figure in the events leading to the collapse of Barings - has not provided any information to this inquiry or given his own explanation of events. His response has been confined to the letter from his solicitors noted in paragraph 1.77.

13.2 Nevertheless, on the basis of the information provided to us we consider that a number of conclusions can be drawn.

13.3 The key questions are:

(a) how were the massive losses incurred?

(b) why was the true position not noticed earlier?

13.4 Our conclusions, in summary, are:

(a) the losses were incurred by reason of unauthorised and concealed trading activities within BFS;

(b) the true position was not noticed earlier by reason of a serious failure of controls and managerial confusion within Barings;

(c) the true position had not been detected prior to the collapse by the external auditors, supervisors or regulators of Barings.

HOW WERE THE MASSIVE LOSSES INCURRED?

The unauthorised and concealed trading

13.5 Leeson had no authority to maintain open positions overnight. He was given certain specific limits on intra-day trading. He had no authority to trade in options (save as execution broker on behalf of clients). In all these respects Leeson persistently acted beyond his authority.

13.6 Account '88888' was opened in July 1992, shortly after Leeson was posted to Singapore. Thereafter Leeson engaged, latterly on a rapidly increasing scale, in unauthorised trading in futures and options through this account. By 31 December 1994 he had accumulated losses on this account of some £208 million. Throughout he represented that he was in fact making profits. Indeed, he was perceived within Barings to be a 'star performer'. Barings understood that the profits from the trading activities within BFS were principally made from inter-exchange arbitrage activities involving 'switching' between SIMEX and Japanese exchanges, with (as they believed)
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fully matched trades at no real risk to Barings. In the event, by 27 February 1995 the accumulated losses on account '88888' amounted to some £830 million.

13.7 This unauthorised trading was funded:

(a) by the use of money advanced to BFS by BSJ and BSLL for what BSJ and BSLL understood to be their own account trading through BFS;

(b) by the use of money advanced by BSL to BFS on BFS's requests for the payment of margin to the exchanges; requests which were met without any effective query and without any adequate steps being taken by Barings in London to verify them or to reconcile the advances to the trading records of clients;

(c) in January and February 1995 - when the funding problems of BFS were becoming acute - by the use of artificial trades created with a view to reducing the level of margin calls from SIMEX.

13.8 The unauthorised trading was concealed by a number of devices. These included the suppression of account '88888' from Barings in London (which account was mentioned only in the margin files and did not attract the attention of Barings in London); the submission of falsified reports to London; the misrepresentation of the profitability of BFS's trading; and a number of false trading transactions and accounting entries.

13.9 The unauthorised trading activities within BFS, which intensified in January and February 1995, built up such massive losses that (when discovered on the 23 February 1995) they led to the failure of Barings.

WHY WAS THE TRUE POSITION NOT NOTICED EARLIER?

Controls

13.10 In 1992 Norris, as Chief Operating Officer of BSL, started to introduce additional controls into the relatively uncontrolled environment then prevailing at BSL. This process continued under his direction when BSL and BB&Co were combined to form IBG (subsequently BIB), of which he was designated Chief Executive Officer. Even so, as late as 1995, it appears that the objective of imposing a satisfactory level of controls had not been achieved within BIB. The Chairman of Barings plc, Peter Baring, described the failure of controls with regard to BFS as "absolute". We agree. It was this lack of effective controls which provided the opportunity for Leeson to undertake his unauthorised trading activities and reduced the likelihood of their detection.

13.11 We consider that those with direct executive responsibility for establishing effective controls must bear much of the blame. We identify below the ways in which, we have concluded, they failed to discharge this responsibility; and how others at lower levels of management were also at fault for failing to act effectively in relation to their own responsibilities.

13.12 As set out in paragraph 1.70, a number of warning signs were present which, had they been properly addressed, should have caused Barings to detect the unauthorised activities of Leeson and the losses that they were generating. This did not happen, mainly because individuals in a number of different departments failed to face up to,
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or follow up on, identified problems; and because there was inadequate communication between departments and between individuals.

Lack of segregation of Leeson’s duties

13.13 The fact that Leeson was permitted throughout to remain in charge of both front office and back office at BFS was a most serious failing. Witnesses whom we have interviewed on this point agreed that the need for a separation of responsibilities was fundamental. Tony Hawes, the Group Treasurer, had relatively early on (in February 1994) identified this as unsatisfactory. He subsequently made his views known to James Baker, prior to James Baker’s internal audit of BFS undertaken in July/August 1994. Although the internal audit did not unearth the existence of the unauthorised activities, the internal audit report did make specific recommendations as to the separation of roles. These recommendations were never implemented.

13.14 At the local operational level Jones (who had responsibility for Barings’ operations in Singapore and was a Director of BFS) seems to have taken no significant steps to give effect to the recommended segregation of duties; even though in his management response to the report he had stated that with immediate effect Leeson would cease to perform certain functions and that he (Jones) would ensure the adequate supervision of all settlement and recording processes. We consider that this failure to put into effect his management response to these recommendations in the internal audit report was reprehensible. Further, Bax (Director of BFS and Regional Manager of South Asian Region) failed to concern himself with, or check as to, the implementation of the internal audit report.

13.15 The internal audit report was circulated widely among management in London and was generally acknowledged as important. Copies were seen by (among others) Norris, Chief Executive Officer of BIB; Broadhurst, Group Finance Director of BIB, who had personally taken an active role in the drafting of the report; Hopkins, Director of Group Treasury and Risk of BIB; Barnett, Chief Operating Officer of BIB; and Ron Baker, Head of FFG. Yet by February 1995 nothing had been done to implement the recommendations of the report as to the segregation of duties. Most of those who received the report said that they considered that it was the responsibility of others (and particularly Singapore management) to implement. We consider, however, that management in London was not justified in simply assuming that these recommendations would be acted upon. The points raised by the report on segregation of duties were of such importance that we consider that it was necessary for checks to have been made to ensure that they had been implemented. But there was no internal communication in this respect, and the necessary steps to give prompt effect to the recommendations were not taken. It is significant that when Railton, Futures and Options Settlements Senior Clerk of BIB, was eventually sent out to Singapore in February 1995, the discrepancies caused by Leeson’s unauthorised trading were uncovered within a relatively short space of time.

Supervision of BFS

13.16 Leeson was not properly supervised.

13.17 Leeson’s back office functions were never effectively monitored; and to the extent that there were other staff in the back office in Singapore they were relatively junior and, it
13. Conclusions

would seem, simply obeyed Leeson’s instructions. The matter was compounded by
the fact that Jones concerned himself primarily with the affairs of BSS and devoted
little attention to BFS. Bax took no steps to ensure that the appropriate degree of
supervision and internal control was in place. Thus BFS was operated almost entirely
by Leeson alone.

This lack of supervision was reflected in the failure on the part of Jones to deal
satisfactorily with the letters of SIMEX to BFS of 11 January 1995 (marked for Jones’
attention) and 27 January 1995. These letters were important. The letter of 11 January
1995, which referred to account ‘88888’, queried the accuracy of information provided
by BFS relating to certain margin requirements, complained of the lack of information
and explanations in the absence of Leeson and referred to a possible violation of
SIMEX rules by BFS’s financing the trading margins of clients; yet Jones did not send a
copy of this letter to Barings in London at the time and essentially left it to Leeson to
draft the response. The letter of 27 January 1995 sought an assurance of BFS’s ability to
fund its margin calls; and, although a copy of this was sent (by Bax) to Barings in
London, it should have caused Jones to investigate why such a letter had been sent
and to check that adequate answers to it were given; especially in the light of the letter
of 11 January 1995 received some two weeks earlier.

The lack of supervision of BFS extended elsewhere. The Head of FPG in BSJ, Gueler,
who was based in Tokyo and was experienced in the operation of Japanese markets,
accepted that he had responsibility for analysing the risks on Leeson’s intra-day
trading activities from 1992 until the last quarter of 1994 (thereafter Walz had principal
responsibility). He did not have a clear understanding of the extent of the supervision
which he was to have over BFS’s trading activities, and has disputed that he was
responsible for supervising Leeson’s switching activities. Whatever the precise
position was as to his responsibilities in this regard, knowing as he did that BFS’s
trading activities were not properly supervised, he should not have allowed this lack
of proper supervision to continue. We also consider that he should have questioned
with management the high reported profitability of the switching activities before he
actually did so in October 1994. Further, although they had responsibility for the
financial products traded on a proprietary basis within BFS, neither Ron Baker nor
Walz checked properly on BFS’s trading activities. This unsatisfactory position was
made worse by the fact that reporting lines with regard to Leeson were not clearly
understood; there were no clearly laid down reporting lines for Leeson, through the
management chain, to Ron Baker; and there was also uncertainty as to whether Ron
Baker reported to Maclean or Norris.

Nor did senior management in London address the position adequately. Norris had
identified Jones as being extremely difficult to manage within the matrix structure of
organisation which had been introduced by 1993. Indeed, Norris had formed the view
in 1993 that Jones should be replaced; although, in the event, he decided not to do so,
mainly because he did not want to cause any upset for Bax. It was also the case that
Broadhurst and Jones were barely on speaking terms. We express no criticism in
principle of a matrix structure; but such a structure can only work effectively,
especially in a global operation, with tight controls, with a clear understanding of
individual responsibilities and with managers at the ‘hubs’ communicating effectively.
This did not happen in the case of BFS and, given the perception which senior
management of BIB had of Jones (which was that he was a poor communicator and
that he undertook little involvement in the affairs of BFS, as opposed to BSS) the risk of
13. Conclusions

a failure of operational controls relating to BFS should have been recognised and acted upon at an early stage.

13.21 A further significant failing was that Barings did not control the high level of BFS’s ‘switching’ positions by the use of gross limits or otherwise (and notwithstanding the fact that James Baker had made a recommendation that this be considered in the internal audit report). This was imprudent. The responsibility for this lay with Ron Baker (as Head of FPG), Walz (as Head of Equity Financial Products), Hopkins (as Director of Group Treasury and Risk) and Norris (as Chief Executive Officer). In addition, Ron Baker and Walz should have taken more vigorous steps than they did to require Leeson not to increase, and where possible to reduce, his positions in accordance with the decision of ALCO on 26 January 1995. In fact, Leeson’s positions increased after that date.

Funding of BFS

13.22 The manner in which Barings in London funded the trading of BFS was wholly unsatisfactory. Evidence given to the inquiry indicated that Leeson regarded Barings in London as the ‘cash cow’. Significant US Dollar amounts were regularly remitted through BSL’s client account by way of ‘top up’ to BFS without any clear understanding on the part of Barings’ management on whose behalf those monies were to be applied, and without any real demur. This level of funding became ever higher, both in absolute terms and in terms relative to the authorised ‘switching’ activities. At the time of the collapse the balance of the ‘top up’ payments exceeded £300 million.

(1) Settlements and Treasury

13.23 There was no clear understanding as to whether or to what extent the sums requested by BFS were for client trading or for house trading. In consequence the true position was not reflected in the accounts. The Settlements Department was simply not able to reconcile the ‘top up’ payments as loans to clients; and yet that is how the payments seem to have been considered (to the extent that the matter was thought about at all) by most of senior management. The requests by BFS to Barings in London were, for the most part, acted on without question. Granger, Manager of Futures and Options Settlements, BIB, was concerned that she could not reconcile the payments as loans to clients; and was concerned that BSL’s client account might be funding house trading. However, she failed to raise her concerns with Gamby, Director of Settlements, or to ensure that those problems which she had identified were appraised by him. Granger further appreciated that inadequate information for the funding requests was being provided by BFS which could not be verified. She should have had a proper understanding of what these large advances actually represented and for what purpose they were being paid before they were authorised (mainly by her) to be paid. Gamby knew that Granger was authorising payments by SWIFT to BFS, only part of which were recoverable from London clients. He was also aware that Granger had expressed concerns about the flow of information coming from BFS. We consider that Gamby, as Director of Settlements, should himself have taken steps to understand what these payments to BFS actually represented and for what purpose they were being paid. Yet neither Gamby nor Granger took sufficient steps to address the position.
13. Conclusions

13.24 Granger mentioned her concerns about the lack of reconciliation and about the inadequacy of information provided by BFS to Tony Hawes, Group Treasurer. Tony Hawes had by the end of 1993 himself realised that there was a lack of reconciliation. This issue was eventually (by the autumn of 1994) raised by Tony Hawes with Hopkins. Hopkins told us that he was extremely concerned about it. Furthermore, James Baker (who had himself previously had the point mentioned to him by Tony Hawes) in his internal audit report had recommended a review by Group Treasury of BFS’s funding requirements. Yet no effective attempt was made, whether by Hopkins or Tony Hawes or anyone else, to follow up these concerns and recommendations and no prompt and detailed investigation was undertaken into the precise basis for the funding of BFS. Nor was there any significant attempt to consider the Group position taking into account the funding of BFS by Barings both in London and in Japan.

13.25 The upshot was that nothing was done (by the Settlements Department or Treasury Department) properly to respond to the problems identified, in spite of the increasing level of funding and the inadequate details provided by BFS in its requests for payments.

(2) Credit

13.26 There was no system in place to ensure that the credit aspects of this funding were reviewed. Although there were clear credit implications if the sums were indeed considered to be advances on behalf of clients, the Credit Committee did not pay attention to the growth in the advances as recorded on the balance sheets. Tony Hawes was, from late 1993 to August 1994, responsible for BSL’s credit unit: knowing that the ‘top up’ payments were not reconciled to client records, while believing that they represented loans to clients, he should have assessed the credit implications. Hopkins, as Director of Group Treasury and Risk from 23 August 1994 with responsibility for credit matters relating to BSL until the end of 1994, recognised that there were weaknesses in the credit department. By the autumn of 1994 he was also aware (having been told by Tony Hawes, as noted above) that there was a lack of reconciliation to client records of the advances to BFS. We consider that Hopkins and Tony Hawes both have responsibility for the credit failings in this respect. Maclean, as Chairman of the Credit Committee, believed that BSL gave credit to clients in a way which the credit department of BB&Co would not have accepted: we consider that, as Chairman of the Committee, it was his responsibility to ensure that proper details about what he understood to be advances to clients were put before the Committee for their consideration. Russell only became Head of Credit of BIB on 1 January 1995, but his appointment had previously been announced in August 1994; and he had had increasing involvement with BSL’s credit department during 1994 and had formed the view that there were shortcomings in it. It was unfortunate that he did not promptly address these shortcomings within BSL from 1 January 1995.

(3) Financial Controls

13.27 There was a failure of financial controls with regard to the ‘top up’ payments. There should have been a proper understanding of what the large advances as shown on the weekly balance sheets (of which the advances to BFS were, in fact, a major component) actually represented and for what purpose they were being paid. Maclean, as Head of Banking; Barnett, as Chief Operating Officer; Broadhurst, as Group Finance Director (and who had, moreover, agreed with an initial recommendation in an earlier draft of
13. Conclusions

the internal audit report that margin call reconciliation procedures for BFS should be introduced; and Tony Hawes, as Group Treasurer share responsibility in this regard. In addition, Broadhurst and Tony Hawes should have checked that adequate verification of the requests from BFS was being undertaken. Indeed, if it was considered that these advances were advances to clients, there should have been a detailed assessment of the question of charging clients for the costs of the advances, or at the very least, of the cost to Barings of making such advances.

13.28 Norris was aware of a continuing debate about the level of funding of BFS and of the ‘switching’ activities as a whole. We consider that he must, as Chief Executive Officer, take some responsibility for failing to acquaint himself with the position and to make enquiries as to the precise basis of funding being provided to BFS or as to the reconciliation to underlying records of the sums advanced.

Level of reported profitability of BFS

13.29 There was no sufficiently informed assessment as to how BFS could generate such large (reported) profits from activities perceived to be essentially risk free (being matched ‘switching’ activities). Given the very high level of reported profitability, this was a serious failure. This issue of the profitability of the ‘switching’ activities was of such significance that it ought to have been given much more detailed and critical assessment than it received. Yet there was no informed analysis or appraisal of the issue; indeed, to the extent that queries were from time to time raised about it they seem to have been answered without any thorough investigation. We consider that the responsibility for this rests with the highest level of management within BIB, including Tuckey, Norris, Maclean, Barnett, Hopkins, Ron Baker and Broadhurst; and ultimately must be shared by Peter Baring, as Chairman of Barings plc.

13.30 Neither Ron Baker (with responsibility, as Head of FPG, for Leeson’s proprietary trading from the end of 1993), nor Walz (as Head of Equity Financial Products and having responsibility for risk for Equity Financial Products) had, in our view, any real understanding of the nature or true profit potential of BFS’s apparent trading activities; and even while they expected Treasury to fund BFS’s ever increasing requirements, they failed to familiarise themselves with what Leeson was doing or to exercise a sufficient degree of supervision over BFS’s trading activities. Moreover, neither Norris, as Chief Executive Officer, nor Maclean, as Head of Banking (of which Division FPG became part), took sufficient steps to satisfy themselves that Ron Baker had proper management control over BFS’s trading activities.

Implications of the SLK receivable

13.31 We consider that the incident communicated by C&L Singapore to London by the beginning of February 1995 of the alleged receivable from SLK in the sterling equivalent of around £50 million - which the information now available indicates to be a spurious transaction - required much more prompt and firm action by senior management in London and Singapore than it received.

13.32 There was no clear understanding in London of what had actually happened, but we were told that the matter was regarded at the time as very unusual. On one version of events (known at least to Broadhurst by the beginning of February 1995) Leeson appeared to have involved BFS, in some way, in trading or broking an OTC option
transaction - which would have been an unauthorised activity for BFS. On another version of events, known to Norris, Maclean, Barnett and Ron Baker, among others, there had been an 'operational error' (as it was called) within BFS, whereby a payment had in December 1994 wrongly been made to a third party. It is the case that the money was reported as having been repaid on 2 February 1995. But the potential implications were that BFS either had engaged in an unauthorised activity (in the form of OTC option broking or trading) or, at all events, had somehow been involved in the erroneous payment of a very large sum. In operational terms the matter was, on any basis, very serious; and there were obvious risk and large exposure reporting implications. When Hopkins was told of the matter on 6 February 1995 he expressed serious concerns; and circulated a note on 10 February 1995 for MANCO, including (among others) Norris, Barnett and Maclean, which referred to the error as being an incorrect payment relating to an OTC option brokered by BFS. But that note by Hopkins was not given the attention which it deserved. It is the case that Tony Hawes went to Singapore on 6 February 1995 to look into this matter, among other things: but this was only part of the purpose for his visit and neither he nor anybody else was requested to establish as a matter of urgency exactly what had occurred. In consequence, Tony Hawes had not concluded his report on that point prior to the collapse.

13.33 Because of the obvious seriousness of the matter, the confused and unsatisfactory information available to management in London at the time required an urgent and detailed investigation. Broadhurst and Norris in particular, and also Ron Baker, Maclean and Barnett, should have ensured that the necessary urgent steps were taken to ascertain precisely what had happened.

13.34 As to management in Singapore, Jones and Bax should have taken more effective steps than they did to ascertain the precise circumstances of what they understood, by the beginning of February 1995, to have been an unauthorised payment by BFS relating to an OTC option trade.

13.35 The appreciation by certain members of management that there were very unsatisfactory features relating to this transaction is, we consider, illustrated by the fact that Broadhurst (at the request of Norris, who had himself been so requested by Bax) asked C&L London that no reference to this transaction be made in the auditors' management letter for BFS. We consider that it was inappropriate for Broadhurst, Norris and Bax to have caused such a request to be made, which was done with a view to attempting to avoid potential problems with the regulators of BFS in Singapore.

Market concerns in 1995

13.36 There were, therefore, by the beginning of February 1995, features which should have alerted management to the existence of potential problems within BFS. It was also the case that there were rumours in the market concerning Barings' very large position on OSE, and possible client problems, which were known to management in London in January 1995. Indeed, queries were raised at a high level from reputable sources, and even included a query on 27 January 1995 from the Bank for International Settlements in Basle. These rumours persisted in February 1995.

13.37 While management of BIB may initially have been justified in taking no steps with regard to these market concerns, given their perception that the positions in respect of the 'switching' activities were fully matched, nevertheless we consider that at the
13. Conclusions

beginning of February 1995 it would have been appropriate for steps to have been taken to investigate the foundation for them.

13.38 By the beginning of February 1995 the incident of the SLK receivable had been communicated to London - which at the least suggested that there had been a serious operational error within BFS and which remained unexplained. It was also the case that by 31 January 1995 the letter from SIMEX dated 27 January 1995 had been sent to London; that indicated that SIMEX was seeking an assurance of BFS's ability to fund margin calls at short notice if market conditions should become adverse. Moreover, the fax of 3 February 1995 from Bax drew attention to the fact that Leeson was, in fact, still in charge of both trading and settlement operations of BFS. As Tony Hawes and Railton had gone out to Singapore and were there by 6 February 1995, there was every opportunity to require them to check whether there was any foundation for these market concerns and whether (by reference to BFS's own records) the positions on OSE were indeed fully matched.

13.39 Given all this, we consider that the basis for the rumours should have been more vigorously investigated at the time; and Norris, as Chief Executive Officer, and Ron Baker and Walz as being in charge of Leeson's proprietary trading, should have taken steps to verify that the positions were indeed fully matched.

Reporting to regulators

13.40 In consequence, to a considerable extent, of the lack of understanding of BFS's trading activities, the lack of reconciliation to client records of the funding provided by Barings in London to BFS and the lack of verification of the (false) information provided by BFS, there were deficiencies and inaccuracies in large exposure reporting to the Bank. The 'top up' payments to BFS were not included in the large exposure reports to the Bank. Concurrently, these 'top up' payments were not included in the SARS returns submitted to the SFA (until the return for January 1995, delivered just before the collapse).

13.41 It appears that the question of whether the 'top up' account should be reflected in the large exposure reporting to the Bank was not internally discussed within Barings nor was its very existence drawn to the attention of senior management. It is surprising that it was not raised as an issue for discussion. For if the money was considered to be paid as margin for (unidentified) clients, then it should have raised questions as to whether there were large exposures to particular clients; whereas if the money was considered to be paid in respect of house positions, then it should have raised questions as to the large exposure position to BFS at the solo consolidated level and to SIMEX at the consolidated level. Equally, there is no clear explanation of why the 'top up' account (as substantially reflected in the account maintained by Barings from February 1994 designated BSINGCOLL account) should not, until 31 January 1995, have been reflected in the SARS returns to the SFA, if it was indeed considered that these payments reflected advances for client margin.

13.42 There was, overall, an inconsistency in Barings' approach to these 'top up' payments for regulatory reporting purposes. They were not included in the large exposure reports to the Bank because, apparently, they were considered to represent advances to a large number of clients; but, at the same time, they were not included in the SARS
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returns to the SFA as advances to clients and, on the contrary, were reflected in the balance sheets submitted to the SFA as amounts due from affiliated companies.

13.43 Barnett and Maclean were the members of senior management principally involved in discussions with the Bank on the large exposure reports. They must share responsibility with regard to the inaccuracies in them, even though they did not know of them. Seal, who, as Financial Controller of BIB from September 1994, signed the reports, and before that, as Financial Controller of BB&Co from November 1993, had responsibility for the BB&Co solo consolidated large exposure reports, failed sufficiently to analyse the information provided to her by BSL for this purpose and failed sufficiently to consider whether the 'top up' payments (of which she knew by the end of 1994) should be included. In addition Broadhurst (to whom Seal reported), although he informed us that he did not see the large exposure reports, should have apprised himself, as the Group Finance Director of BIB, as to the reliability of the systems and sources generating the information needed for such reports. He was also responsible for the accuracy of the returns to the SFA, which he did see. Tony Hawes, given the concerns which he had about the payments to BFS (which had implications for risk and large exposure reporting) failed sufficiently to apprise senior management of his concerns for the purposes of reporting to the Bank and to the SFA. Norris, as Chief Executive Officer, must bear ultimate responsibility for the accuracy of the reports to the Bank and, as Chief Executive Officer and nominated Senior Executive Officer under the SFA’s rules, for the accuracy of the returns to the SFA.

EXTERNAL AUDITORS

13.44 For the 15 month period ended 31 December 1993, there were realised and unrealised losses from the trading activities of BFS for that period which we assess to have been in the region of a sterling equivalent of about £19 million. The reported profits of BFS, however, were of a sterling equivalent of about £9 million. These profits, as reported, then flowed through to the group profits of Barings. We have not been permitted access to the working papers of the then auditors of BFS, D&T Singapore, and we have not been able to interview any of the relevant personnel engaged in the audit for that period or the preceding year. We do not, therefore, know what records, explanations and details were provided to them by BFS. In the event, it is now apparent from the reality of Leeson’s trading activities that the profits from the activities of BFS must have been materially misstated.

13.45 C&L Singapore undertook the audit of BFS for the year ended 31 December 1994. Its audit of BFS had substantially been completed by the time of the collapse. On 3 February 1995 C&L Singapore provided to C&L London (who were, and had for some years been, the auditors of Barings plc and others of its subsidiaries) an Audit Report to the Directors of Barings plc, with consolidation schedules for BFS for the year ended 31 December 1994, which, without qualification, C&L Singapore stated were presented fairly for the purposes of the audit of the consolidated financial statements of Barings plc. A first stage of the subsequent events review for BFS was signed by C&L Singapore on 23 February 1995, which gave confirmation to C&L London that no events had occurred subsequent to the year end which would affect C&L London’s signing of the Group accounts, subject to the finalisation of the bonus provision.
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13.46 It is not established if C&L Singapore were ever provided with a copy of the internal audit report of James Baker. An Audit Strategy Memorandum prepared by C&L Singapore in November 1994 stated that no major issues were raised by the internal auditors from London during their visit in August 1994. In the absence of detailed comments from C&L Singapore we cannot properly assess the basis for that statement.

13.47 C&L Singapore performed an assessment of BFS’s control environment as part of their audit planning, which was completed in November 1994. This concluded that the control environment within BFS was satisfactory. C&L Singapore resolved, as recorded in the Audit Strategy Memorandum, that given the high volume of trades and adequate internal controls a controls-based audit would be done; but that balance sheet trade items would be validated by confirmations, as there were only four clients. Since we have not been permitted access to the work papers of C&L Singapore, for the reasons given in paragraph 1.74, and have not been able to interview any of their personnel engaged in the audit, we do not know the basis on which their conclusion as to internal controls was reached. This conclusion was, on the face of it, not readily compatible with the fact that there was a lack of segregation between front and back office: and this was so whether or not C&L Singapore had seen the internal audit report, or knew that its principal recommendations had not been implemented.

13.48 At the time of the collapse of Barings the audit for the year ended 31 December 1994 of Barings plc and BSL by C&L London was well advanced. However, there was a number of important audit matters which had not by then been completed by C&L London which included: agreement of subsidiaries’ financial statements and the signature of a working copy of the Group financial statements (scheduled for 10 March 1995); the subsequent events review in London; and the auditors’ management letter.

13.49 C&L London adopted an audit approach to BSL which was based on the examination and testing of the internal controls in operation. This work included an assessment of the controls in relation to payments of margin. C&L London assessed the control environment to be good. Where such an approach is adopted, adequate testing of the effectiveness of controls which are in place should be performed. As we have concluded, Barings’ controls with regard to the payments of margin from BSL and BSL to BFS were deficient in that BSL could not verify the information provided, and was confused as to whether the payments were for client trading or house trading; did not reconcile the payments to underlying client records; and did not assess the credit implication of such payments.

13.50 We do not consider that C&L London performed sufficient tests to satisfy themselves that the controls over payments of margin and the associated accounting balances were operating effectively. In their testing, in December 1994, of the controls of the Futures and Options Settlements Department, managed by Granger, they undertook insufficient compliance testing and relied inappropriately on their perception of Granger’s experience. Such testing as took place involved observing her department’s handling of funding requests during an interim audit visit, with no analysis and without proper scoping of the sample being tested; in consequence, there was no effective test of funding requests from, or margin payments to, BFS.

13.51 We accept that C&L London might have queried the very high level of funding of BFS by BSL which occurred in January and February 1995 during the course of its subsequent events review (which it had not concluded by 23 February 1995).
13. Conclusions

Nevertheless, we consider that, had C&L London carried out more thorough tests on the effectiveness of the controls in place with regard to payments for margin at the time of their controls testing, it is likely that the inadequate support for the funding requests from BFS would have been revealed at that stage, and the amounts paid which could not be reconciled to individual client balances identified.

13.52 As noted above, we have not been permitted access to the working papers of C&L Singapore and have not been able to interview any of their personnel engaged in the audit. We are thus unable to express any conclusion as to the sufficiency of the steps taken by C&L Singapore with regard to the matter of the SLK receivable - it was, in fact, C&L Singapore who first queried the entry relating to the SLK receivable - or with regard to the confirmations purportedly emanating from Ron Baker in London and from SLK, or the purported summary of transactions through BFS's Citibank account. Nor do we know what explanations were given to C&L Singapore by the management of BFS.

13.53 C&L London were aware of the matter of the SLK receivable and were aware that varying explanations for it had been given. They took the report of C&L Singapore of 3 February 1995 and explanations of management to be confirmation that the outstanding audit issue, so far as it affected the audit of financial statements, relating to the receivable had been resolved. They did not themselves at that stage inquire further with a view to resolving the conflicting explanations of which they were aware.

13.54 The conflict between the explanations which had been given about the transaction (most notably as to whether or not BSL had been a counterparty) was not resolved by the comments of Broadhurst at the meeting with C&L London on 9 February 1995. Although C&L London were told by C&L Singapore on 2 February 1995 that the sum involved had been paid, even so the whole transaction, on whatever version of events was put forward, was unusual. It involved a very large sum, and raised a serious question as to the validity of the controls, by reference to which the audit had, to a considerable extent, been conducted. Moreover, Broadhurst had, as noted above, requested C&L London that reference to the SLK receivable be excluded from the management letter relating to BFS. C&L London rightly left that to the decision of C&L Singapore; but it was an unusual request in itself and one which should have indicated to C&L London that management believed that there were very unsatisfactory aspects involved in the issue of the SLK receivable.

13.55 Accordingly, we consider that the matter required further investigation by C&L London before the conclusion of the audit process. However, by 23 February 1995 C&L London had not completed their audit. As noted above, the signing of a working copy of the financial statements was planned for 10 March 1995; and the group subsequent events review in London and the management letter had not been finalised. We consider that C&L London were entitled, having had discussions with management in the early part of February 1995, to proceed at that stage on the footing that the money had been paid, as reported to them by C&L Singapore on 2 February 1995. While we think that C&L in London would have been fully justified in insisting on more detailed explanations at that stage, we conclude that it would be a judgement of hindsight to say that they positively should have done so then: and they were entitled to leave the matter for a later stage of the audit process.
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THE BANK OF ENGLAND

Supervision by the Bank

13.56 As noted in Section 1 of this report, the conclusions expressed here are those of the independent members of the Board. The ex-officio members have not participated in this part of the report.

13.57 The Bank was at all relevant times the consolidated supervisor of the Barings Group and lead regulator of BB&Co. The supervision was primarily carried out by its Supervision and Surveillance Division (S&S). The only relevant supervision for the purposes of this report was that of S&S. From April 1991 the senior manager in that division with responsibility for UK merchant banks (including Barings) was Thompson. Until March 1993 he reported to the Head of Banking Supervision, Barnes; from that date he reported to the Head of Major UK Banks Supervision Division, Sergeant, who in turn reported to the Deputy Director in charge of S&S, Foot (from September 1993). Thompson had a number of different individual analysts assisting him over a period of time in supervising Barings.

13.58 The Bank was told of the intention of Barings' management to apply BB&Co's standards of control to BSL. The Bank regarded the controls in Barings as informal but effective. It had confidence in Barings' senior management, many of whom were longstanding Barings' employees. Accordingly, it placed greater reliance on statements made to it by management than it would have done had this degree of confidence not existed. With regard to Barings' overseas subsidiaries the Bank undertook no reviews. In that respect, it placed reliance on what it was told by Barings and its auditors and reporting accountants (C&L); on the existence of a 'connected lending' limit on BB&Co's (or the solo consolidated group's) exposure to the overseas securities subsidiaries of 25% of unconsolidated (or solo consolidated) capital base; and (in accordance with recognised supervisory practice) on the supervision performed by the relevant overseas regulators.

13.59 While the Bank's supervision was primarily focused on BB&Co, as the authorised institution, the Bank's supervisory responsibilities extended, and were understood by the Bank to extend, to the activities of other parts of the Group insofar as such activities were capable of affecting the financial soundness and reputation of BB&Co.

13.60 In the event, Barings in London received false information from its subsidiary, BFS, and Barings in London itself failed to distinguish adequately between its house and client trading. In consequence, it was not aware that it was not complying with the connected lending limit and not providing the Bank with accurate information. It is true that the Bank knew that the Far Eastern operations of Barings were reporting very significant profits; it knew that there were issues relating to large exposures and that large and increasing funding was required for these operations; and it would have appreciated that there could be reputational risks to BB&Co arising from any significant default in these operations. However, we consider that the Bank reasonably placed reliance on local regulators of the overseas operations; and it was also entitled to place reliance on the explanations given by management as to the profitability of these operations and on the other information provided by Barings to the Bank.
13. Conclusions

13.61 Had the Bank had a greater understanding of Barings’ Far Eastern operations and a
greater awareness of the degree of control of these operations as exercised by Barings
in London it would have been better placed to supervise the consolidated group.
There does not appear to have been any guideline or system in place within the Bank
for determining whether the situation with regard to a member of a banking group for
which the Bank was responsible for consolidated supervision was material such that it
could affect the well-being of the bank. Although consolidated supervision requires
an evaluation of risks presented to a bank by the activities of other members of the
same group that evaluation is left to the unaided discretion of individual managers.
We consider that there should be guidelines to assist this process. From this a wider
lesson can be identified and it is one which we address in Section 14 of this report.

Large exposures

13.62 One key aspect of the Bank’s supervision for the purposes of monitoring credit risk
was the large exposures rules which it imposed, or which were imposed by the Act, on
banks. These included a requirement that (to the extent that the Bank had a discretion
to allow exposures to exceed 25% of capital base) BB&Co should first notify the Bank
of any proposed exposures that would exceed 25% of its or its Group’s capital base;
and from 1 January 1994 a requirement (under the EU Large Exposure Directive) that,
subject to certain specific exceptions and transitional arrangements, consolidated large
exposures should not exceed 25% of consolidated capital base.

13.63 In 1993 Thompson permitted Barings, by what he described as an ‘informal
concession’, to exceed the 25% limit with regard to the Group’s exposure to OSE. This
concession, not surprisingly, was taken by Barings also to apply to its exposure to
SIMEX. Further, Barings apparently took the concession to release it from the
obligation to pre-notify those exposures. The concession was granted without any
apparent reference to more senior management at the Bank, which was a breach of the
relevant internal Bank guideline. Moreover, no limit was at any time imposed on the
concession. In consequence, Barings in London was prepared to allow exposures to
the exchanges often to exceed 25% and latterly (by February 1995) to reach 73% on OSE
and 40% on SIMEX. We consider that this informal concession, permitting Barings to
exceed the 25% limit and without imposing any limit on the concession, was an error
of judgement. Although we do not suggest that the Bank could, on the information
then known to it, have appreciated that this concession involved any material risk to
Barings, the unfortunate consequence of this concession, which continued over a
lengthy period, was to facilitate the increasing transactions being undertaken by BFS.

13.64 The informal concession was granted pending a review within the Bank as to whether
Barings could be exempted from the 25% limit in respect of its exposures to overseas
exchanges. Barings referred this matter to the Bank in January 1993. It was recognised
that it involved a policy issue but nothing was done by the Bank to progress it until
May 1994. Even the coming into effect of the EU Large Exposure Directive on 1
January 1994 did not cause the Bank to consider whether it should continue the
concession, which had been granted pending resolution of the issues regarding the
correct treatment of the exchange exposures. Barings prompted the Bank, by their
letter of 29 April 1994, for a response. While the Bank’s S&I Policy Group was then
consulted, it was only asked the narrow question whether exposures could be reported
net of segregated clients’ funds. The point was then discussed by Thompson at a
meeting with senior management of Barings on 18 May 1994. The result of this
13. Conclusions

meeting was that the Bank, through Thompson, indicated that it would write to
Barings setting out its understanding of the position. Again, nothing was done until
eventually (in January 1995) the question as to whether there could be an exemption
from the 25% limit in respect of exposures to exchanges was raised with the Bank’s
S&S Policy Group, who confirmed that no such exemption was possible. This view
was then passed on to Barings by Thompson by letter dated 1 February 1995.

13.65 We have considered whether, but for this delay, the unauthorised trading activities
within BFS might have been curtailed or uncovered earlier. If the Group’s exposure to
OSE had been kept within the 25% limit throughout the period from 1 January 1994
(the date on which the EU Large Exposure Directive took effect), the authorised
‘switching’ activity between OSE and SIMEX would have had to be reduced in the
absence of third party guarantees of the exchange exposures. The maintenance of
smaller positions, however, would not necessarily have caused a curtailment in
Leeson’s unauthorised activities until around the end of January 1995. Until that time
the concealment of the unauthorised activities booked in account ‘88888’ was
unrelated to the authorised ‘switching’ business; and therefore, because all trades in
account ‘88888’ were through SIMEX, they would not have been affected by any
reduction of exposure to OSE. However, from the end of January 1995 the funding
ostensibly obtained for authorised ‘switching’ activity was used in part to finance the
unauthorised activities. From that time, therefore, had the 25% limit been strictly
enforced and complied with and in the absence of third party guarantees of the
exchange exposures, Leeson would have had either to curtail significantly the
positions on account ‘88888’; or to call for significantly increased funding from London
by way of ‘top up’; or to seek some other unauthorised means of funding the positions.
If the second course had been adopted it might have caused senior management at
Barings to investigate the positions and thereby uncover account ‘88888’.

13.66 We are therefore unable to determine whether or not the delay on the part of the Bank
in imposing the 25% limit with regard to Barings’ exposure to OSE was a contributory
factor in Barings’ collapse. Nevertheless, we consider that the delay was unacceptable;
the Bank was not entitled to assume that the delay would be inconsequential.

Solo consolidation

13.67 A lack of rigour was also displayed by the Bank in the context of the solo consolidation
of BSL with BB&Co towards which Barings had been moving from 1992. This was a
very significant step - since it would result in BSL (a substantial securities operation)
being included in the unconsolidated returns submitted by BB&Co to the Bank and in
BSL being, in effect, treated as one with BB&Co for capital adequacy and large
exposures purposes. It was also novel, being the first solo consolidation of such a kind
which the Bank had experienced. Yet the Bank failed properly to address all the issues
regarding the solo consolidation of BSL with BB&Co or to finalise conclusions on
points which had been raised.

13.68 Sergeant, in handwritten notes to Thompson dated 20 October 1993, made a number of
relevant comments as to whether solo consolidation was appropriate. There is no
record of all the issues raised by her being properly answered. By the letter from
Thompson to Barings of 4 November 1993 a number of proposals were put forward,
with the Bank indicating that it was prepared to treat BSL as solo consolidated with
BB&Co on a provisional basis, pending further review by the Bank. But there was no
13. Conclusions

follow up to this letter; nor (although the letter indicated that the Bank was giving consideration to whether solo consolidation was appropriate) does there appear to have been any further review (save with regard to capital adequacy measurements) undertaken by the Bank. Given the novelty of solo consolidating a substantial securities company with a bank, and the questions already raised, we believe that the matter should not have been left on this provisional basis with no further consideration of all the outstanding issues being undertaken after 1993. Indeed, the whole issue of the solo consolidation of BSL with BB&Co was of sufficient importance to warrant its being referred up to the highest level within the Bank. We would have expected that the matter, because of its novelty and importance, would then have been referred to BoBS itself.

13.69 In consequence of the informality with which solo consolidation was permitted, important points - including the need to give a direction under Section 38(3) of the Act - were not addressed. As a result the criminal sanctions potentially available under Section 38 in respect of failures to make reports of large exposures as required by that section were not extended to cover transactions of BSL; although we accept that BB&Co would probably have established that no offence had been committed because it did not know the facts requiring it to make the reports.

13.70 We consider that the Bank did not fully assess the impact of BSL being solo consolidated with BB&Co. A consequence of solo consolidation was that no limit was imposed on the amount that could be advanced by BB&Co to BSL; as a result, owing to the inadequate controls within BB the remittance of large advances from BB&Co via BSL to BFS, ostensibly to finance client trading but in fact (as it has transpired) substantially to finance the concealed trading, was in practice facilitated. We accept that it could not have been appreciated by the Bank at the time that such trading on the part of BFS would be so facilitated, and we also accept that solo consolidation was not of itself the cause of the collapse. Nevertheless we consider that, because of its importance, the Bank should not have permitted solo consolidation of BSL with BB&Co to continue on a provisional basis for so long without a proper analysis of the issues that arose.

THE SECURITIES AND FUTURES AUTHORITY (SFA)

13.71 As noted in Section 1 of this report, the conclusions here expressed are those of the independent members of the Board. The ex-officio members have not participated in the formulation of the conclusions set out in this part of the report because of the potential overlap between the responsibilities of the SFA and the Bank.

13.72 The SFA was at all relevant times the regulator of BSL and BSLL. The regulation was primarily carried out by its Surveillance Division.

13.73 The review of financial returns submitted to the SFA and the annual review of the systems and methods used to prepare and complete the returns were the SFA’s principal methods of supervising BSL and BSLL’s financial resources and checking that customer assets were properly safeguarded. In addition, the external auditors, C&L, reported to the SFA annually.

13.74 The information provided by BSL to the SFA on the Segregated Account Reporting Statements (SARS) did not until a late stage include the advance margins placed with
13. Conclusions

exchanges ostensibly on behalf of clients because the BSINGCOLL account (which reflects the advance margins funded by BSL) did not feature in those returns. In 1994, margin excesses of up to £35 million had been shown by BSL in its returns; but they were not so great or unusual that they should have attracted the attention of the SFA, whose principal interest in the SARS was to check that it did not show a deficit. The BSINGCOLL account was (for the first time) included in the SARS for the period up to 31 January 1995, delivered to the SFA on 22 February 1995. It showed a margin excess of nearly £160 million, apparently indicating that BSL had advanced on behalf of clients substantial amounts in excess of those actually required for their margins. The revelation of so large a figure could have caused the SFA to investigate further, but by then it was too late.

13.75 The SFA did not regard itself as required to consider the activities or financial position of the subsidiaries of BSL and considered that its responsibilities with regard to subsidiaries were limited to the express notification requirements relating to subsidiaries set out in its rules. However, we consider that the SFA’s responsibility for monitoring a member firm’s obligation to maintain adequate financial resources to meet its investment business commitments and to withstand the risks to which its business is subject requires it to have regard to the activities and financial soundness of a member firm’s subsidiaries insofar as they are capable of materially affecting the financial integrity of the member firm.

13.76 A consequence of the SFA’s perception of what it was required to do was that the individuals concerned on behalf of the SFA with the regulation of BSL did not give consideration to the question of whether or to what extent BSL’s exposure to its subsidiary BFS might adversely affect BSL’s financial integrity. We consider that a wider lesson should be drawn from this, to which we refer in Section 14.

13.77 The SFA knew, or should have known, from the ample information in the public domain that the Far Eastern operations were very significant to BSL. However, BSL did not provide the SFA with accurate financial returns; and BSL at no time informed the SFA of any exposure that it had to BFS or BSJ or of the level and nature of BSL’s funding of BFS’s trading activities. The financial returns submitted by BSL to the SFA did show substantial balances receivable by BSL from its affiliates in aggregate; for example £178 million at 31 December 1993 and £254 million at 31 December 1994, having risen to over £500 million in May 1994. We consider that the SFA’s regulation of BSL should have had regard to any material exposure of BSL to its affiliates; but on the information contained in the returns submitted by BSL to the SFA, and given the SFA’s perception of those balances (which was that they represented transactions undertaken through affiliates on behalf of clients) we consider that it would not be right to criticise the SFA for failing to raise queries as to those balances on receipt and appraisal of the returns.

OVERSEAS REGULATORS

13.78 We have not been able to make detailed enquiries as to the overseas regulation of Barings, and have not had sufficient information to enable us to express any conclusions on that aspect.
13. Conclusions

GENERAL

13.79 We should record that, since that we have not had access to evidence from a number of sources including Leeson himself, we are unable to determine what the motives were for Leeson's activities. Leeson was awarded very sizeable bonuses for what were thought at the time to be his consistently profitable activities; such bonus for 1994 being proposed as £450,000 (compared to £130,000 for 1993). Whether the prospect of an increased bonus was, in whole or in part, the motivation to Leeson for his unauthorised trading which resulted in such massive positions being taken cannot at present be determined. We also cannot determine, in the absence of full access to documentation in Singapore, whether or not there was a misappropriation of any of the funds advanced to BFS. Moreover, we cannot rule out the possibility that Leeson may have been acting in concert with one or more persons.

13.80 We have set out in the previous sections of this report the matters which we have, on the information available to us, identified as the events leading to the collapse of Barings. This collapse was brought about by the unauthorised trading activities within BFS - one overseas subsidiary within a large group but whose activities accumulated losses of around £830 million and caused the ultimate parent company, Barings plc, to be placed in administration. Most of the assets and liabilities of the Barings Group were subsequently purchased by ING and the interests of depositors and creditors were thereby protected. But others, including the shareholders and loan note holders of Barings plc, the providers of capital, have suffered serious loss. The collapse of Barings is an illustration of how a viable and prosperous group can, in circumstances where controls are ineffective, be brought down by unauthorised activities within one of its subsidiary operations.

13.81 We have concluded that the system of checks and balances necessary for the proper management and control of a financial institution failed in the case of Barings with regard to BFS in a most serious way, at a number of levels and in more than one location. That lessons can be learned from the collapse is clear to us; and it is to these lessons that we turn in the following section of this report.
<table>
<thead>
<tr>
<th>CONTRACT</th>
<th>NIKKEI 225 STOCK AVERAGE FUTURE OSE</th>
<th>NIKKEI 225 STOCK AVERAGE FUTURE SIMEX</th>
<th>OPTION ON NIKKEI 225 STOCK AVERAGE FUTURE SIMEX</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trading Unit (%)</td>
<td>1,000 times Nikkei 225 price</td>
<td>500 times Nikkei 225 Stock Average Futures price</td>
<td>1 SIMEX Nikkei 225 Futures contract</td>
</tr>
<tr>
<td>Minimum Price Movement</td>
<td>10 index points</td>
<td>5 index points</td>
<td>5 index points</td>
</tr>
<tr>
<td>Tick Size &amp; Value</td>
<td>¥10,000</td>
<td>¥2,500</td>
<td>¥2,500</td>
</tr>
<tr>
<td>Contract Months</td>
<td>Mar, Jun, Sep, Dec cycle (5 contract months listed at all times)</td>
<td>Mar, Jun, Sep, Dec</td>
<td>Three serial months &amp; Mar, Jun, Sep &amp; Dec contracts listed on a five quarterly-month cycle</td>
</tr>
<tr>
<td>Last Trading Day</td>
<td>One business day before the second Friday of the contract month</td>
<td>One business day before the second Friday of the contract month</td>
<td>One business day before the second Friday of the contract month</td>
</tr>
<tr>
<td>Initial Margin Requirements</td>
<td>For Members, initial margin is 10% of the transaction value. For Clients, initial margin is 15% of the transaction value (of which at least one fifth must be cash). When the initial margin has been eroded by more than 3% the Member will call the Client for additional margin.</td>
<td>¥906,250 per contract on a stand-alone basis. However, SIMEX uses a SPAN system (almost identical to the Chicago Mercantile Exchange’s SPAN system), which calculates margin calls on a daily basis based on the aggregate position (gross for initial margins &amp; net for variation margins) and current market volatilities.</td>
<td>The buyer of the option pays the full premium in cash immediately. The seller of the option posts margin of roughly the size of the premium received, if this were the seller’s only position. However, a short options position as part of a portfolio would be subject to the SPAN margining system.</td>
</tr>
<tr>
<td>CONTRACT</td>
<td>3 MONTH EUROYEN FUTURE (SIMEX)</td>
<td>3 MONTH EUROYEN FUTURE (TIFFE)</td>
<td>10 YEAR JAPANESE GOVERNMENT BOND (JGB) FUTURE SIMEX</td>
</tr>
<tr>
<td>---------------------------------------------------------------------</td>
<td>---------------------------------</td>
<td>---------------------------------</td>
<td>-----------------------------------------------------</td>
</tr>
<tr>
<td><strong>Trading Unit (¥)</strong></td>
<td>¥100 million</td>
<td>¥100 million</td>
<td>Standardised 6% 10-yr JGB with a face value of ¥50 million</td>
</tr>
<tr>
<td><strong>Minimum Price Movement</strong></td>
<td>0.01</td>
<td>0.01</td>
<td>1/100 point</td>
</tr>
<tr>
<td><strong>Tick Size &amp; Value</strong></td>
<td>¥2,500</td>
<td>¥2,500</td>
<td>¥5,000</td>
</tr>
<tr>
<td><strong>Contract Months</strong></td>
<td>Mar, Jun, Sep &amp; Dec (contracts listed on a three year cycle)</td>
<td>Mar, Jun, Sep &amp; Dec (contracts listed on a two year cycle)</td>
<td>Mar, Jun, Sep &amp; Dec cycle (5 contract months at all times)</td>
</tr>
<tr>
<td><strong>Last Trading Day</strong></td>
<td>Second business day immediately preceding the third Wednesday of the contract month</td>
<td>Second business day immediately preceding the third Wednesday of the contract month</td>
<td>First business day immediately preceding the TSE JGB Futures’ last trading day</td>
</tr>
<tr>
<td><strong>Initial Margin Requirements</strong></td>
<td>¥54,000 per contract on a stand-alone basis (subject to overall SPAN margining system)</td>
<td>¥80,000 per contract for clients &amp; ¥50,000 per contract for members</td>
<td>¥877,500 per contract on a stand-alone basis (subject to overall SPAN margining system)</td>
</tr>
</tbody>
</table>
### APPENDIX XIII  OPEN INTEREST AS REPORTED ON THE OSAKA SECURITIES EXCHANGE

Open Interest Report for March 1995 Nikkei 225 Contract

<table>
<thead>
<tr>
<th>Date</th>
<th>BSJ Net long position (no. of contracts)</th>
<th>Total number of open contracts</th>
<th>BSJ's percentage of open contracts</th>
</tr>
</thead>
<tbody>
<tr>
<td>30 December 1994</td>
<td>5,400</td>
<td>104,712</td>
<td>5.16%</td>
</tr>
<tr>
<td>6 January 1995</td>
<td>4,939</td>
<td>106,073</td>
<td>4.66%</td>
</tr>
<tr>
<td>13 January 1995</td>
<td>3,024</td>
<td>111,353</td>
<td>2.72%</td>
</tr>
<tr>
<td>20 January 1995</td>
<td>7,135</td>
<td>117,889</td>
<td>6.05%</td>
</tr>
<tr>
<td>27 January 1995</td>
<td>16,852</td>
<td>128,048</td>
<td>13.16%</td>
</tr>
<tr>
<td>3 February 1995</td>
<td>14,399</td>
<td>123,975</td>
<td>11.61%</td>
</tr>
<tr>
<td>10 February 1995</td>
<td>14,975</td>
<td>125,220</td>
<td>11.96%</td>
</tr>
<tr>
<td>17 February 1995</td>
<td>20,076</td>
<td>128,749</td>
<td>15.59%</td>
</tr>
<tr>
<td>24 February 1995</td>
<td>15,928</td>
<td>119,850</td>
<td>13.29%</td>
</tr>
</tbody>
</table>

Source: OSE data that is made publicly available every Tuesday for close of business the previous Friday.

For every week reported in January and February 1995, BSJ had the largest outstanding position of any of the members of the OSE.