Living in a fool's paradise: the collapse of Barings' Bank

Helga Drummond
Institute of Public Administration and Management, University of Liverpool, Liverpool, UK

On Thursday, 23 February 1995 the Directors of Barings' Bank hosted a lunch for City magnates. The conversation was animated, focusing upon Barings' new venture in Mexico.

The directors had good reason to be optimistic. For the last three years Barings had been enjoying a bubble of profit due mainly to the activities of Nick Leeson, their star trader in Singapore. "They had no idea", said a guest afterwards.

The Directors had no idea that Barings, one of the oldest and most respected banks in the City of London, was about to collapse. The alarm was raised in London later that afternoon, when Nick Leeson was reported missing.

In their gripping account of events Gapper and Denton reveal the horror, as Leeson's colleagues began to uncover the truth:

On Thursday, 23 February 1995 the Directors of Barings' Bank hosted a lunch for City magnates. The conversation was animated, focusing upon Barings' new venture in Mexico.

The directors had good reason to be optimistic. For the last three years Barings had been enjoying a bubble of profit due mainly to the activities of Nick Leeson, their star trader in Singapore. "They had no idea", said a guest afterwards.

The Directors had no idea that Barings, one of the oldest and most respected banks in the City of London, was about to collapse. The alarm was raised in London later that afternoon, when Nick Leeson was reported missing.

In their gripping account of events Gapper and Denton reveal the horror, as Leeson's colleagues began to uncover the truth:

The loss was escalating by the second. The futures in the five eight accounts were so volatile that each point the index changed made £100,000 difference to the amount that Barings owed... As the Nikkel fell again, the loss spiralled upwards at an almost dizzying speed. If these futures were not matched by others... they were all in terrible trouble (Gapper and Denton, 1996, p. 27).

By next morning it was clear that Barings was insolvent. What shocked Barings' management most, however, was not Leeson's behaviour but the gap between what they had understood and believed to be true and the reality:

The daily reports they had received from him had been a complete fiction... [Barings' managers] had met daily and had solemnly discussed the profits and supposedly any risks of Leeson's trading. But all this had been fantasy (Gapper and Denton, 1996, p. 29).

Malfeasance invariably generates evidence of its existence. In Barings' case signs emerged as early as 1992, that is, shortly after Leeson arrived in Singapore. Moreover, the danger signals grew more pronounced over the next three years, reaching a crescendo during the last eight weeks of the bank's existence. Barings saw the danger signs but failed to act upon them until it was too late to save the bank. How could it have happened?

The question is important, because the failure of Barings highlighted the possibility of systemic collapse with unthinkable consequences. Moreover, although it is seven years since Barings collapsed, there has been very little academic research into events. Gapper and Denton's account does an excellent job of telling the story. However, if we are to learn the lessons of the bank's collapse, analysis is required.

Risk-free profits

Leeson arrived in Singapore in July 1992. In early 1993, Barings' chairman Peter Baring told the Bank of England that the recovery in its faltering stockbrokerage division (known as securities) had been "amazing". The recovery was due mainly to Leeson's trading, which was to grow increasingly profitable over the next three years.

The first warning sign was that Leeson's trading was not only profitable, it also appealed to Barings, because it was apparently risk-free. In investment banking, higher profits invariably signal higher risk. Barings was risk-averse as a matter of policy-prefering to earn its profits by taking a commission on buying and selling financial contracts for customers, as distinct from the potentially more lucrative but also much riskier business of trading for itself.

Yet the notion of risk-free profits made sense to Barings, because they had seen it all before. Peter Baring said:

We had experienced, on a number of occasions, specific operations which were relatively low-risk and relatively high-profitability; the most pronounced example of this was the Japanese warrant trading
business... We had a number of businesses of that order of magnitude... (that) were low-risk and high-profitability.

What none of us believed was that this business would last. The basic instinct... that there is something about this business that defied gravity is something we shared; but it was in terms of its durability... In our experience, these businesses could last for a period but then they would go. That would happen to us again and again (Treasury Committee, 15 May 1996, p. 22).

As human beings, we deal with complexity by simplifying. Simplification is a double-edged activity, however, because our perceptions are inevitably partial. Moreover, research by psychologists suggests that our perceptions may be systematically biased, causing us to see certain things, whilst unconsciously screening out other potentially important dimensions of our environment. Barings succumbed to what psychologists call the representativeness bias, whereby they saw the similarities between past and present but not the differences (e.g. Bazerman, 1998; Drummond, 2001).

More specifically, as Barings understood it, Leeson’s profits derived from arbitrage. For example, if apples cost 10p in London and 11p in Dublin, the arbitrageur buys a quantity of apples in London and immediately sells them on in Dublin. In theory, arbitrage is a low-risk activity, because it does not involve predicting market movements. The arbitrageur merely exploits price anomalies between markets. Provided that a contract to buy is matched with a contract to sell, the only risk is one of market movement in the time it takes for contracts to be executed. Barings’ senior management believed that Leeson’s positions were fully matched and so his trading was deemed to be risk-free.

In the mid-1980s Barings was virtually the only investment bank active in the Far East and therefore ideally placed to conduct arbitrage. When Leeson’s activities began to turn an unusually high profit, Barings assumed that their previous success in Japanese markets was being repeated in Singapore – a relatively new entrant to the financial markets, just as Japan had been in the mid-1980s.

Barings failed to see that the halcyon days of the mid-1980s had vanished. Competitors had awakened to the opportunities in emerging markets and exotic financial instruments. Moreover, competitors had abandoned arbitrage, because it was too risky. Price differentials between markets were wafer-thin and frequently changed before contracts could be executed, converting profit into loss. In addition, Leeson’s colleagues in Japan had the same experience – how Leeson could be making so much money out of arbitrage was a mystery.

In fact, Leeson was not conducting arbitrage but selling financial contracts known as options. An option gives another party the right, but not the obligation, to buy or sell a given quantity at some date in the future in return for payment of a premium. For example, to buy 1,000 apples at 10p each in nine months, time. Options are bought as a form of insurance against market movement, as they enable traders to “lock in” at a definite price. That is, if at the end of nine months the price of apples has fallen to 9p, the option expires worthless. However, if the price of apples has risen to 11p, the option is exercised. Options trading is extremely risky, because the party granting the option is obliged to supply the apples at the contracted price, regardless of how far the market may have moved in the meantime. If the price of apples rises say to 20p or more, the loss may far outstrip the premium received. Leeson was forbidden to expose Barings to such danger, though he was allowed to trade on behalf of Barings’ customers.

Options trading can be profitable but it requires a high level of mathematical sophistication to calculate the premium required to cover the risk. Lacking the requisite skills and experience and anxious to attract premiums, Leeson sold too cheaply: By borrowing blindly and in desperation Leeson was underpricing volatility. By January 1994 hedge funds and investment banks were trawling the world, seeking mispriced volatility... Leeson was way out of his depth... The options traders assumed that he was selling on behalf of a rather ill-informed or naïve customer and piled in to take advantage of whoever it was (Gupper and Denton, 1998, p. 241).

Whenever Leeson’s options lost money, he was forced to take bigger and bigger risks in order to generate new premiums to enable him to cover his tracks. Since Leeson booked the premiums received as pure profit, the more money he lost, the more lucrative his trading seemed.

**Missing money**

Shortly after Leeson arrived in Singapore, Barings’ financial controllers in London noticed a disparity in the Singapore accounts, whereby Barings appeared to have paid out £10 million more than it had collected from customers. An investigation was made but proved largely inconclusive, as the discrepancy was presumed to reflect...
currency fluctuations and trading across different time zones. Yet the unreconciled balance grew and by late 1994 had reached almost £100 million.

In December 1994 another danger sign emerged. The external auditors discovered that £50 million was missing from an account managed by Leeson. Leeson first suggested that it was a computer error. He subsequently claimed that it was uncollected debt from a firm of brokers known as Spear Leek Kellog (SLK) from an “over the counter” option that Leeson had sold. The incident caused consternation in London, because it meant that £50 million of Barings’ money had been unaccounted for over a period of two months. Besides, Leeson had no authority to conduct such a trade.

Moreover, every afternoon Leeson was faxing requests for millions of pounds in collateral (known as margin) to support his trading. Yet Leeson was extremely reluctant to explain exactly how the money was being used. Such information as Leeson did supply was so brief and so vague that Barings’ financial controllers in London were left no wiser.

Another cue that should have alerted Barings to the possibility of malfeasance was that Leeson controlled both the front and the back office. The front office is where trades are conducted. The back office is where the paper work is settled. The two functions are normally kept separate as a basic precaution against fraud. Leeson was originally posted to Singapore to manage the back office and had since diversified into trading. The Singapore operation was so small, however, that Barings had been slow to appoint another back office manager to replace Leeson. Leeson, moreover, had made clear his willingness to undertake both functions.

**Rumour**

To be in profit Leeson’s options depended on the Nikkei index remaining virtually stable. On 17 January 1995, an earthquake struck Japan, prompting a wave of selling. The index fell sharply and continued falling. Leeson’s options lost millions of pounds, forcing him to double and redouble his bets in a desperate effort to force the index up. Since the premiums received also increased dramatically, Leeson’s apparent profits soared.

So did the unreconciled amounts, rising from £123 million to £388 million. Leeson’s margin calls also increased dramatically. In the last two months the total margin remitted increased from £221 million at the end of 1994, to £742 million by the time Barings collapsed.

By late January, London was straining to meet Leeson’s margin calls. Accordingly, Leeson was instructed not to increase and, if possible, to reduce the positions. Yet Leeson’s trading promptly doubled. Leeson’s “arbitrage” previously contributed 13 to almost 18 percent of Barings’ profits but, in January 1995, Leeson’s profits outstripped those of the entire organization possibly by as much as 133 percent. The daily income report for 24 January 1995, which was seen by Barings’ middle and senior managers, showed Singapore office profitability for the day as £3,387 million of which £3,265 million was attributable to Leeson’s switching. This was more than double any month’s reported profit from “arbitrage” during 1994.

In early February 1995, Barings’ managers in London learned that a rumour was circulating in the financial markets in the Far East that Leeson’s mystery customer “X”, for whom he was allegedly buying huge quantities of options, was none other than Barings themselves. Thereafter, the rumours suggesting massive exposure to risk grew louder and more specific. For instance, by 16 February reputable investment banks were warning customers to be careful about using Barings as a counter-party.

**Final days**

In February 1995 two of Barings’ financial controllers, Tony Hawes and Tony Railton travelled from London to investigate the SLK incident and the apparent reconciliation problem. After a few days Hawes returned to London to deal with other matters. Railton spent a fortnight struggling to make sense of Leeson’s accounts. Yet no matter how he computed the figures, the accounts showed an unreconciled balance of at least £90 million. Believing that he must have missed something, Railton reported his findings to London, who instructed him to persist with the task. Railton then spent another week wrestling with the figures. Leeson agreed to go over the accounts with him again, but proved extremely elusive. Finally, Simon Jones, the local manager in Singapore, insisted that Leeson attend a meeting with himself and Railton to explain the reconciliation problem. After a few minutes Leeson left the meeting on a pretext and did not return.

Leeson’s mysterious disappearance prompted alarm. A computer printout found on Leeson’s desk revealed that Barings was indeed in terrible trouble:
It made no sense... Every single contract they could identify was losing money... Using Barings' precious capital, Leeson had taken the largest losing bet in history. It [Barings] could have lost more than £200 million already, but the frightening thing was that Leeson had pulled it into a bottomless hole. The Nikkei was falling and Barings' bill was growing even bigger. It did not have much capital. The Barings Foundation's shares had a balance sheet value of £98 million and it had a further £101 million in loan capital. If Leeson's losses ate through this, Barings was finished (Gapper and Denton, 1986, p. 23).

Relatedly, although Barings knew about the rumors, they assumed that, since the Osaka exchange published details of trades and Singapore did not, the market was selling only one part of the equation. Specifically, Barings assumed that Leeson's contracts in Osaka were matched by an equal and opposite contract in Singapore of which the market was unaware—hence the concern. Interestingly, it was not the missing money or the market rumour or the escalating margin calls that finally alerted Barings to danger, but Leeson's disappearance. Here was something that could not be rationalized to fit expectations.

The role of expectations

The eminent organization theorist Weick (1995) suggests that expectations play a crucial role in sense-making. That is, once decision makers form a view of a situation they tend to rationalize new information in order to fit their preconceived views.

This is precisely what happened to Barings. The Bank of England's investigation into the collapse acknowledged that, whilst the various danger signs might not have meant much in isolation, taken together they should have alerted Barings to danger (Board of Banking Supervision, 1986). In fact, the opposite happened, because once the notion of risk-free profits was accepted, Barings rationalised emerging danger signs to fit the expectation of a trader doing his utmost to exploit a unique bubble of profit at the expense of administrative efficiency. Although Barings' financial controllers in London were virtually certain that Leeson was making the numbers up, they assumed that he was doing it in order to conceal chaos in the back office. The reconciliation problem and SLK incident all pointed to the same conclusion, namely that Leeson was over-burdened. The fact that Leeson controlled both front and back offices lent credence to this explanation, as mistakes and other shortcomings were only to be expected from someone trying to do two jobs. The joke in London was that anyone could send their mother out to Singapore and get a better idea of what Leeson's funding requests meant, "since Nick is so busy now". Indeed, the SLK incident prompted Barings to appoint a back office manager. The bank collapsed before an appointment was effected.

Frequently it is not the problem itself that prevents us from achieving a solution but the assumptions we make about the nature of the problem (e.g. Watzlawick et al., 1974). Railton wasted three weeks, because he assumed matched positions, when Leeson's positions were completely open. Consequently, no matter how many times Railton computed the figures, they made no sense.

Ego defensiveness

Expectations were by no means the only factor in Barings' collapse. Research by psychologists suggests that decision makers will go to considerable lengths in order to protect themselves from ego damage (for recent reviews, see Drummond (1996) and Staw (1996)). Ego defensiveness probably contributed to Barings' collapse in that, when decision makers' information made "no sense", they hesitated to probe for fear of appearing foolish.

Moreover, Leeson was an expert in blinding people with science. Whenever he was asked to explain his activities, he would talk mysteriously about "intra-day variation", his position on the customer information curve and crossing a "tick" here and a "lag" there. Although he was courteous in dealing with enquiries, he obliquely signalled that it was tiresome to have to keep repeating details for the benefit of uninformed colleagues. More specifically, Leeson's product manager Ron Baker was subsequently criticised by a High Court judge for failing to probe Leeson adequately about his trading. The judge concluded that Baker was restrained for fear of revealing his ignorance (The Secretary of State's Case against Mr Baker, in the High Court, 1996). Barings' senior management were also criticised by the same judge for accepting a note from middle management explaining Leeson's trading methods, that was "gobbledygook", without questioning it. When challenged in court, Barings' deputy chairman Andrew Tuckey could not explain what the note meant (The Secretary of State's Case against Mr Tuckey, in the High Court, 1996).

Look hard and look twice

Once a myth gains credence, it is like throwing a blanket over an accident victim who has been pronounced dead. No one is
likely to lift the blanket again. In Barings’ case everyone knew that Leeson’s positions were matched, because everyone else said so. Yet no one ever checked – why?

Ego defensiveness can be ruled out, because, unlike trading strategies, the issues were not complex. Barings’ senior management only had to ask “How do you know?”, when told by middle management that Leeson’s positions were matched. Senior management should have ordered a rigorous check and ensured that their instructions were properly carried out. It is a matter of record that no such enquiries were initiated.

The behaviour of senior management is consistent with a phenomenon known as “groupthink” (Janis, 1972). Group think results in diminished intellectual rigour, as members refrain from analysis and conflict in order to preserve the cohesive atmosphere within the group. Consequently, there is no reality testing.

Detachment from reality can lead to an illusion of control that makes decision makers feel invulnerable. Feelings of invulnerability heighten risk-taking propensity (Griffiths, 1990). Risk taking means more than staking desperate gambles. The biggest danger is complacency, because it leads to decision makers taking risks without realising it (Drummond, 2001).

Barings’ senior management were content to accept an assurance from middle management that Leeson’s positions were matched without considering the possibility that this information might be wrong.

The dangers are heightened where decision makers have experienced repeated success. This is because repeated success makes us feel that we cannot fail. Moreover, repeated success need not be sensational an organization that functions day-in-day; out is an example of repeated success – it may have a good safety record but this is not the same as saying that its working practices are safe (Drummond, 2001). Although Barings’ senior managers were respected, not least by the Bank of England, it was largely for their work as merchant bankers. Barings’ control of its securities division was weak and a culture of risk awareness and risk management was conspicuously absent. Consequently, at the organizational, group and individual level, Barings was less sensitive to danger than it might otherwise have been.

Another factor contributing to “groupthink” was the senior management culture of non-interference in one another’s operations. The minutes of Barings’ senior management team show that one member pointed out that the level of Leeson’s profits had to imply risk. He did not press the point, however. Likewise, no one in the management team commented upon the so-called SLK incident. The report was merely noted in passing.

“Groupthink” is ultimately ego-defensive in that the absence of conflict enables members to conclude that their judgement must be correct (Janis, 1972). It was more than that, however. All meaning, all understanding come from looking backwards (Weick, 1979; Drummond, 2001). Yet what we see when we look backwards may be highly subjective, because we tend to reconstruct the past in a manner that enables us to make sense of the present. Although the businesses to which Peter Baring refers were profitable, they eventually lost money. They cannot have been risk-free, therefore. Moreover, in mid-1994 Barings imposed certain limits upon Leeson’s trading, which was itself a tacit acknowledgement of risk. Rationalising Leeson’s profits in this way served two purposes. First it vindicated Barings’ strategy of achieving early entry into new markets. In other words, Leeson’s apparent success told Barings’ senior managers that they had been right all along. Second, it suggested that Barings could extend its success by replicating Leeson’s strategy in emerging markets; hence the animated allusions to Mexico. Vividness is a cognitive heuristic that causes decision makers to see opportunity rather than danger. Indeed, if an image is sufficiently compelling, it may cause decision makers to disregard factual information altogether (Schwenk, 1986).

Leeson’s profits told Barings’ senior management not only that a miniscule player could outwit the giant investment houses, but also that Barings was returning to its swashbuckling days as a merchant adventurer, when merchant bankers decided the fate of nations (e.g. Kynaston, 1994). In late 1993 Peter Baring told an audience in Mexico, “It is difficult not to be impressed that, with sailing-ships and quill-pens, our predecessors nearly 170 years ago were doing international business similar in form to what we do to day,” (Gapper and Denton, 1996, p. 171). Such myopic vision resulted in illusion shading into delusion. Illusion means seeing things as better than they are, whereas delusion means seeing things that are not there at all (Taylor, 1980).

The media attributed Barings’ collapse to greed and incompetence. Indeed, although the scale of Leeson’s profits strongly suggested that he was breaking the rules, the contribution those profits made to the bonus pool was hardly an incentive to probe. The danger with this conclusion, however, is that
it implies that Barings’ case was unique. Research by psychologists suggests that as human beings we tend to over-estimate our abilities (e.g. Taylor, 1980). For example, gamblers behave as if they can control chance, shaking hard for a high number on the dice and softly if they need a low number (e.g. Langer, 1975). Our inflated belief in our ability to control events and consequent risk-taking propensity are heightened when the game involves a mixture of skill and luck. (Fruit-machines incorporate so-called “nudge” and “hold” buttons, to encourage gambling by creating an illusion of control (Drummond, 2001)). Moreover, whilst we generally attribute failure to bad luck, we are happy to assume that success reflects our own skill and hard work (Taylor, 1980). This means that as human beings we are already half way towards replicating Barings’ mistakes.

The question is, how can we avoid them? In Barings’ case senior management bear ultimate responsibility, because they define the organizational culture and realities within which expectations are formed. It may seem trite to point out that senior managers require fluency in all aspects of the business. Yet Barings’ senior managers were primarily merchant bankers with relatively limited knowledge of exotic financial contracts. Knowledge is power. Another reason why Barings’ senior managers failed to ask the questions was that they did not know what questions to ask.

It was more than that, however. Barings’ senior management team meetings were distinguished by polished courtesy. Conflict was regarded as unhelpful and even unseemly. Whilst conflict can be destabilizing, it can also be productive. This is because, although conflict is usually perceived as an obstacle, it is also a transaction (Brown, 1977). Conflict is conducive to sense-making, because it is the means whereby alternative perspectives and understandings are brought to bear upon a problem and received ideas challenged (Drummond, 2001). Instead, Barings’ culture protected Leeson, because it prevented senior management from asking hard questions of one another.

Yet there was no need even for conflict. Barings might have been saved, if someone at senior level had simply stepped forward and said, “I don’t understand this.”

Few people enjoy appearing foolish. Yet in drama and literature the fool is often more penetrating than establishment counsellors, because the fool asks the seemingly obvious questions, that is, those that frequently turn out to be the most difficult to answer.

Another technique of reality testing is to take an analytical approach to information, distinguishing between that which is known, that which is unclear, and that which is mere assumption (see Neustadt and May, 1986). If Barings had used this approach, they might have realised that the notion of matched positions was only an assumption.

I say “might”, because in organizations assumptions have a habit of hardening into fact – hence our faith in unsinkable ships, in wars ending by Christmas, in the absolute safety of pension funds and in clearing banks that are too big to fail. The ultimate lesson of Barings is that it is the “knowns” that are the most dangerous (Drummond, 2001). Any decision involving uncertainty implies risk. Yet it may not be our doubts that prove to be our undoing but that of which we are most sure.

**Summary of indicators for research and practice**

For research:
1. All organizations are detached from reality to some extent. The question about which we need to know more is what sustains a myth, as the gap between myth and reality widens.
2. Barings’ managers met and received reports daily about Leeson’s trading. Did the frequency of meetings contribute to an illusion of control and, if so, how?
3. Success can be dangerous, because we see it as confirming our competence. How incredible must success become before we start to question it?

For management:
1. Managers must thoroughly understand the business they are in. Are there dangers in “fast track” careers?
2. Conflict can be unpleasant but it helps to maintain a sense of reality. Managers should try to stimulate it rather than repress it.
3. Assumptions have a habit of shading into “knowns”. Develop the habit of reality testing.
4. Most importantly, we should always remember that pride comes before a fall.

**A note on method**

This account of events is mainly compiled from the two official inquiries into Barings’ collapse (Board of Banking Supervision, 1985; Ministry for Finance, Singapore, 1996). In addition, the researcher consulted reports of the Treasury Committee’s inquiries and
transcripts of evidence pertaining to proceedings against Barings’ former directors in the High Court. It is a case where the facts are not in dispute. Unless otherwise stated, the events related in this article are based upon the Board of Banking Supervision’s report.

Several books have been written about the bank’s collapse. The most authoritative and best written is Gapper and Denton’s (1996), which is based upon transcripts of telephone conversations between Barings’ managers and documentation, including minutes of meetings. Unlike official inquiries, it tells the story in chronological sequence. Short extracts have been quoted to try and convey a flavour of the atmosphere in Barings, as the truth about Leeson’s activities emerged.

References

Janis, I.L. (1972), Victims of Groupthink, Houghton-Mifflin, Boston, MA.
(The) Secretary of State’s Case against Mr Baker, in the High Court (1998).
(The) Secretary of State’s Case against Mr Tuckey, in the High Court (1998).
Treasury Committee (1996), Barings’ Bank and International Regulation, Minutes of Evidence, 15 May.
Weick, K.E. (1979), The Social Psychology of Organizing, Addison-Wesley, Reading, MA.