Regulatory responses and market discipline

Dr Alexander Ressos, TEP
Attorney-at-Law (Switzerland and Germany),
Solicitor (England & Wales and Hong Kong)
Of Counsel, KGP Legal LLC
alexander.ressos@kgplegal.com.sg
www.ressos.com.sg

Two inquiries and their findings

The collapse produced two official inquiries, one in each country. In London the Chancellor of the Exchequer announced an inquiry by the Board of Banking Supervision of the Bank of England, which published its report on 18 July 1995. The Board found a virtually total failure of risk management systems and controls, together with managerial confusion within the group. It identified the lack of segregation between front and back offices in Singapore and a matrix reporting structure in which nobody bore ultimate responsibility for Leeson. It also criticised the failure to act on an internal audit of August 1994 that had pointed to many of the weaknesses.[1]

The Board drew five lessons for management. Managers must understand the businesses they run. Responsibility for each activity must be clearly established. Segregation of duties is fundamental to any control system. Independent risk management must cover all activities, while top management and the audit committee must ensure that weaknesses identified by internal audit are resolved quickly. The Board also found that the Bank of England had made an error of

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judgement in 1993 by allowing Barings an informal concession on the large exposure limit. It saw no need, however, for a fundamental change to the framework of regulation. The British report was limited by the difficulty of obtaining information from Singapore. The Chancellor told Parliament that serious legal obstacles had prevented all the relevant documents from being provided to the Board, since the Singapore subsidiary was under judicial management.[2]

In Singapore the Minister for Finance appointed two inspectors from Price Waterhouse, Michael Lim and Nicky Tan, whose report was released in October 1995. They found that details of the margin calls on all of Barings' Singapore trades had been transmitted daily to Baring Securities in London.[3] The inspectors attributed the collapse to "institutional incompetence" and a lack of understanding of the futures business among the senior executives of Barings. They are also reported to have questioned whether SIMEX had been too liberal in raising Barings' position limits.[4] The two reports therefore agreed on the essential point. The failure lay in the management and controls of the bank, while the leverage of the instruments magnified the consequences.

The conduct of SIMEX

SIMEX's own conduct was examined with equal care. In early March 1995 the Singapore authorities stated that all margin calls on the Barings contracts had been met. The same press report noted that senior Barings executives had assured the exchange, about two weeks before the collapse, that the bank would cover the exposure of its subsidiary.[5] SIMEX had therefore put its question to the head office in London. The answer came from a management that did not itself know the truth about its Singapore subsidiary.

The outcome for the market was nevertheless clear. Two years later Lee Hsien Loong could tell the financial community that the collapse of the 233-year-old bank had inflicted no losses on SIMEX or on any other Singapore financial institution.[6] Margining and clearing had worked as designed. Every day the clearing house had collected cash from Barings to cover the movement in prices. When the bank failed, the exchange held collateral against the remaining positions, which could then be

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closed out or transferred. The episode thereby demonstrated a principle on which the safety of all modern derivatives markets rests: the central counterparty protects the market, while the protection of an individual firm depends on its own controls.

Parliament also acted. On 1 March 1995, within days of the collapse, the government introduced measures to tighten the supervision of futures trading. Amendments to the Futures Trading Act took effect in April 1995.[7]

International cooperation: Windsor and Boca Raton

Barings showed that national supervision could not cope with a firm whose positions spanned exchanges in Singapore and Osaka while its funding and management sat in London. In May 1995 the UK Securities and Investments Board and the US Commodity Futures Trading Commission convened a meeting of futures regulators from 16 jurisdictions in Windsor. On 17 May 1995 the participants adopted the Windsor Declaration. It set out common positions on cooperation between market authorities, the protection of customer positions and funds, default procedures and cooperation in emergencies. A follow-up report of September 1996 found that significant concrete steps had been taken, including information sharing on large exposures and procedures for market crises.[8]

On 15 March 1996 fourteen regulators, among them MAS, signed a Declaration on Cooperation and Supervision of International Futures Exchanges and Clearing Organizations. At the same time the exchanges and clearing houses signed a memorandum of understanding on the exchange of information about large exposures of their members, which SIMEX signed at Boca Raton in Florida. The industry association FIA records that 48 exchanges and clearing organisations signed the memorandum at that conference, while the CFTC release refers to 49.[9] The memorandum allowed SIMEX to learn for the first time whether a member that held large positions in Singapore held further positions elsewhere. Had it existed in 1994, the combined size of Leeson's positions in Singapore and Osaka would have been visible to both exchanges.

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From regulation to supervision

The longer-term response in Singapore was a change of regulatory philosophy. In his speech of November 1997, Lee Hsien Loong called for a shift of emphasis from regulation to supervision. Singapore should rely more on market discipline and full disclosure to protect investors, with a lighter regulatory touch and a focus on systemic risk.[10] The speech may appear paradoxical two years after a scandal that had been caused by the failure of controls. Its logic followed from the findings of both inquiries, however. No regulator could have substituted for the internal controls of Barings. Detailed rules that tried to do so would only have added cost for well-run firms.

What the regulator could do was to insist that firms maintain adequate controls, to verify that they did and to ensure that the market had enough information to impose its own discipline. That approach has guided MAS ever since. Chapter IV of this part shows how it informed the liberalisation after 1998 and the move to risk-based supervision. Part E describes how it shapes the supervision of wealth managers today. The guidelines that MAS issues on risk management, outsourcing and technology risk descend in spirit from the five lessons of the Board of Banking Supervision.

Market discipline in this sense has three elements. The first is the discipline of the clearing house, which forces every participant to pay for its losses daily and excludes those who cannot. The second is the discipline of counterparties and investors, who withdraw business from firms whose controls they distrust, provided that they receive enough information to judge. The third is the discipline of the criminal law, which the prosecution of Leeson demonstrated. Singapore's regulators have relied on all three, and they have reserved direct intervention for cases in which the stability of the system is at stake.

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Market discipline in practice: lessons for firms today

The Barings case remains the standard teaching example of operational risk. Its lessons apply directly to the firms that trade, manage or advise in Singapore today. A trading firm, a family office with a dealing desk or an external asset manager that executes for clients faces in smaller form the same risks that brought down Barings. The following checklist translates the findings of 1995 into questions for a modern firm.

- Separate the execution of trades from their confirmation, settlement and reconciliation, and ensure that no individual controls both.
- Assign to each trading activity a named manager who understands it and answers for it, with no ambiguity from matrix structures.
- Reconcile every error account, suspense account and omnibus account daily, and report balances independently of the trading desk.
- Question profits that exceed what the stated strategy can produce, since unexplained returns are as much a warning as unexplained losses.
- Limit and monitor intra-group funding of margin calls, and require independent verification before funds are released.
- Follow up the findings of internal audit with deadlines, and report open findings to the board or audit committee.
- Compare the firm's positions as reported internally with the positions reported by exchanges, clearing brokers and custodians.

Common misconception

Barings is often described as a failure of derivatives or of the Singapore exchange. The inquiries placed the responsibility on the bank. The British Board of Banking Supervision held that the failings could not be attributed to the complexity of the business and were primarily failures of individuals to do their jobs properly. SIMEX

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collected every margin call, while no Singapore institution suffered a loss. The instruments magnified the losses, whose cause lay in the absent controls of one bank.[11]

Notes

1. Reserve Bank of Australia, "Implications of the Barings Collapse for Bank Supervisors", *RBA Bulletin*, November 1995, pp. 1–3: the inquiry was announced by the Chancellor of the Exchequer on the day after the appointment of administrators; "The Board issued its Report on 18 July"; the Board's view was "virtual total failure of risk management systems and controls, and managerial confusion"; findings on the lack of separation between front and back offices, the matrix-based reporting system that made responsibility ambiguous, and the failure to act on an internal audit review of BFS in August 1994. ↩
2. Reserve Bank of Australia, *RBA Bulletin*, November 1995, p. 3: the five lessons for management, including that "clear segregation of duties is fundamental to any effective control system"; *Hansard*, House of Lords, 18 July 1995, "Barings": "an error of judgment was made in 1993" in giving Barings an informal concession on the 25 per cent exposure limit; the events "do not … point to the need for any fundamental change to the framework of regulation"; BFS was under judicial management and "There remained serious legal obstacles which prevented all the relevant documents being provided to the board." ↩
3. *Risk* (OR&C staff), "Baring Securities had full details of Leeson trades, says Singapore report", 6 November 1995: the Singapore government report released in October 1995, written by Michael Lim and Nicky Tan, found that "details of margin calls on all Baring's Singapore trades were transmitted daily to Baring Securities". ↩
4. Reuters report of 17 October 1995 (via reuters.screenocean.com) and *Risk*, "Barings Report Attacks 'Institutional Incompetence'" (1995): the Finance Ministry attributed the collapse to "institutional incompetence"; the report is

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said to have described SIMEX as possibly too liberal in raising Barings' position limits. ↩

5. *The Christian Science Monitor*, "Singapore Sent Warnings In Barings Bank Debacle", 8 March 1995: "Singapore monetary officials say all the margin demands involving the Barings contracts have been met"; senior Barings executives knew of the growing futures exposure and "had reassured regulators at the Singapore International Monetary Exchange" that the bank would cover it, about two weeks before the collapse. ↩
6. Lee Hsien Loong, "New Approach to Regulating and Developing Singapore's Financial Sector", 4 November 1997, mas.gov.sg: Barings was a 233-year-old merchant bank; its collapse did not inflict losses on SIMEX or other Singapore financial institutions. ↩
7. *The Business Times*, 2 March 1995, and NLB Infopedia, "Collapse of Barings" (Kong Yoke Mun): new measures to tighten supervision of futures trading announced on 1 March 1995; the Futures Trading (Amendment) Act 1995 in force on 1 April 1995. ↩
8. US Commodity Futures Trading Commission, "History of the CFTC: the 1990s", cftc.gov: on 17 May 1995 "Representatives of regulatory bodies from 16 countries" met in a meeting "hosted by the U.K. Securities Investment Board (SIB) and the CFTC"; CFTC release 3939-96, 16 September 1996: the Windsor Declaration, signed by futures regulators from 16 jurisdictions, responded to issues raised by the failure of Barings Plc; the final report of the Windsor co-chairs found "significant concrete steps" taken, including information sharing on large exposures, market crisis procedures, greater transparency of market protections and client asset protection. ↩
9. US Commodity Futures Trading Commission, release of 15 March 1996: fourteen founding signatories of the Declaration, including the Monetary Authority of Singapore; information sharing triggered when a member's positions or financial resources reach agreed thresholds; reference to 49 exchanges and clearing organisations signing the MOU; Emma Davey, "25 years ago, Barings offers a hard lesson in risk controls", FIA MarketVoice, 26

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February 2020: 48 exchanges and clearing organisations signed the MOU at the 1996 FIA Boca conference. ↩

10. Lee Hsien Loong, "New Approach to Regulating and Developing Singapore's Financial Sector", 4 November 1997, mas.gov.sg: "We need to shift emphasis from regulation to supervision"; "We should rely more on market discipline and full information disclosure to protect investors." ↩

11. Reserve Bank of Australia, "Implications of the Barings Collapse for Bank Supervisors", *RBA Bulletin*, November 1995, p. 3: the Board concluded that the failings "could not be attributed to the complexity of the business carried out within BFS, but were primarily a failure on the part of a number of individuals within the Barings Group to do their jobs properly". ↩

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