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Barings Bank

What Happened?

Nick Lesson, chief trader at Barings Bank in Singapore, accumulated losses of $1.3 billion between 1992 and 1995 engaging in unauthorized derivatives trades.

He gave the impression that he was involved in inter exchange arbitrage, “switching” between the Simex and Nikkei indexes using fully matched trades with no risk to Barings.

In fact, he was making unhedged bets and hiding his mounting losses in error account 88888.

When the dust settled, the 233-year-old Barings bank was sold to ING for £1.

Barings Bank

Why did it happen?

Lessen was thought of as a “star” trader and was viewed as infallible to the executives at Barings because of the huge profits the bank was making from his trades.

The Bank allowed Lessen to be in charge of both the front office and back office of the trading desk.

The Bank did not question how such huge returns were being made on essentially risk less trades.

The Bank did not use gross limits or otherwise for switching positions.

Barings Bank

When his trades started to lose money, Lesson concealed this from the Bank by falsifying settlement reports and taking even larger position to try and recoup his losses.

The key trigger event was the Kobe earthquake of 1995 that caused the Nikkei index to drop 7% in one week. Lesson had bet that the index would not drop below 19,000.

Over the next three months, he bought 20,000 futures contracts at $180,000 each in a futile attempt to move the market.

Lack of effective controls and supervision by Bank executives.

Lack of follow-up to identified problems.

Barings Bank

Inadequate communication between departments.

Barings head office in London could not distinguish whether the funds requested by Lesson to cover his losses were for house or client trading.

Internal audit recommendations of looking into the Singapore operations funding requirements were not implemented.

External auditors were incompetent.

A receivable in the amount of £50 million to SLK finally brought the episode to management's attention.

Barings Bank

What Type of Risk Failure?

Operational risk failure.

Had Lesson bought long straddles, he would have partially hedged his losses.

Daiwa Bank

What Happened?

Toshihide Iguchi, Head bond trader of Daiwa Bank's operations in New York, amassed losses in the amount of $1.1 billion dollars between 1984-1995.

He hid his losses from the Bank and U.S. regulators by forging over 30,000 trading slips and other documents.

Unlike Barings, Daiwa did not go bankrupt as it had $200 billion in assets and $8 billion in reserves.

Daiwa Bank

As a result of the scandal, Daiwa withdrew from most of its overseas banking operations and focused on its core regional business in Osaka, Japan.

Daiwa paid $340 million in fines to U.S. regulators. Some of its Board members and executives were fined $775 million by an Osaka court as restitution to shareholders for the debacle.

Daiwa Bank

Why did it happen?

Iguchi had front and back-office control of the bond-trading desk.

Iguchi made an initial trading loss of a few hundred thousand dollars. He made unauthorized sales of securities to cover his losses while he tried to recover his losses. This set an avalanche effect into motion as his losses continued to spiral.

Internal audit was weak at Daiwa Bank.

Bank management in New York collaborated with Iguchi to conceal the losses from U.S. regulators when they became aware of the situation.

Daiwa Bank

An attempt was made to transfer losses to Japan to avoid action by the Americans as this had been done for other traders who had suffered losses.

External audit and regulators were lax.

Iguchi eventually confessed after becoming fatigued from perpetuating the cover-up.

Daiwa Bank

What Type of Risk Failure?

Operational risk failure.

National Bank of Australia

What Happened?

In January 2004 National Bank of Australia announced losses of A$340 million due to the fraudulent currency option trading activities of four of its traders since 2001.

National Bank of Australia

Why did it happen?

These four traders concealed their losses to meet profit targets so that they could realize large bonuses.

They used "smoothing" to hide losses, shifting profits and losses from one day to another by using incorrect dealing rates for genuine transactions.

They processed false spot exchange rates and false currency option transactions.

They took advantage of a one-hour window on the Horizon reporting system for options trades, to amend transactions from the day before to avoid detection by the system.

National Bank of Australia

They took advantage of the fact that the back-office stopped checking internal option transactions.

VaR and vega limits were regularly breached with authorization from the joint Head of Global Foreign Exchange, Gary Dillion.

Multiple limit breaches and other warning signs from the market indicated by internal audit were not acted upon.

National Bank of Australia

Risk management did not report irregularities to the CEO or the Board.

The key trigger event was the devaluation of the U.S. dollar against the Australian dollar.

The fraud unraveled when a currency option desk employee raised concerns about significant losses.

National Bank of Australia

What Type of Risk Failure?

Operational risk.

Market risk.

Long Term Capital Management (LTCM)

What Happened?

In 1994 John Meriwether started the hedge fund LTCM with $1.3 billion dollars of initial equity capitalization.

Among those he enlisted to run the fund were Robert Merton and Myron Scholes - two Nobel laureates.

Using relative value convergence trading arbitrage, LTCM had 40% and 41% returns in its first two years and had amassed $7 billion dollars in investment capital.

This method requires betting on small price differentials between similar instruments that will converge as the market identifies the arbitrage.

Long Term Capital Management (LTCM)

Thus to generate large returns an excessive amount of leverage was utilized to create huge LTCM positions.

In 1997 LTCM returned $2.5 billion of investors' funds and in the process further increased its leverage position.

In July 1998 Salomon Smith Barney liquidated its sizable dollar interest arbitrage positions. This caused losses to some of LTCM's positions as Salomon was selling things LTCM owned.

In August 1998 the Russian ruble crisis caused spreads on high quality G 10 instruments to widen. This hurt LTCM as they had massive bets on the convergence of spreads.

Long Term Capital Management (LTCM)

LTCM's equity dropped $2.5 billion to $2.3 billion and the fund had positions totaling a staggering $125 billion.

In September 1998 LTCM's equity fell to $600 million with no sizeable reduction in its portfolio. It was faced with the prospect of defaulting on its obligations due to a liquidity crisis from the large margin calls it was getting.

The U.S. federal reserve, fearing a global systemic financial meltdown, organized a bailout package for LTCM under which a syndicate of banks and major creditors infused $3.5 billion into the fund in exchange for a 90% equity stake and management control.

Long Term Capital Management (LTCM)

By June 1998 the fund was up 14.1% net of fees from the time of the bailout. Nevertheless, some of the original investors had substantial losses, the biggest loser being UBS, with $690 million.

Long Term Capital Management (LTCM)

Why did it happen?

LTCM was allowed to leverage to infinity due to the celebrity status of its founders. At one point its swap positions were valued at $1.25 trillion notional - 5% of the entire global market.

Wall street allowed LTCM the privilege to write swaps and pledge collateral with no initial margin. LTCM was not a bank or AAA-rated financial institution.

Too much of a cozy relationship with LTCM and other banks.

Executives at other banks had personal investments in LTCM.

Long Term Capital Management (LTCM)

Crony capitalism.

LTCM was forced to liquidate to meet margin calls exacerbating the problem.

Not enough stress testing was done.

Stress test assumed high correlations between short and long positions. In liquidity crisis the correlations were smaller.

There was concern over disciples that had similar convergence strategies to LTCM that could contribute to a systemic meltdown.

Long Term Capital Management (LTCM)

Liquidity bets should not be highly leveraged.

LTCM did not aggregate exposures to common risk factors.

Long Term Capital Management (LTCM)

What Type of Risk Failure?

Market risk.

Liquidity risk.

Model risk.

Need for transparency of hedge funds.

The U.S. Federal Reserve was very willing to bailout LTCM. This may encourage other hedge funds to act recklessly in the future.

Metallgeselschaft AG (MG)

What Happened?

In 1991 MG hired Arthur Benson to head its venture into the energy derivatives world.

In 1992 MG entered into forward contacts to sell 160 million barrels of oil over 10 years at a fixed price.

To hedge its exposure to rising oil prices it used a stack hedge strategy in the amount of 55 million barrels of short dated delivery month futures contracts.

To complete the hedge MG entered swap contracts to receive floating and pay fixed energy prices in the amount of 110 million barrels.

Metallgeselschaft AG (MG)

Throughout much of 1993 oil prices fall.

MG gained on paper on its long dated forward contracts but realized massive mark to market losses on its derivatives hedge due to margin calls.

In December 1993 MG cashed in its positions, due to mounting margin calls, at a loss of $1.5 billion.

Metallgeselschaft AG (MG)

Why did it happen?

Huge positions in futures market created an enormous amount of risk.

At one point MG had a position equivalent to 85 days worth of the entire output of Kuwait.

Hedge did get rid of market risk but created a liquidity crisis when prices dropped and the hedge lost money.

MG did not have enough money to maintain positions.

Forward positions not marked to market while hedge positions were. This created a cash flow mismatch that was compounded by the maturity differences in tenor of the forward and hedge positions.

Metallgeselschaft AG (MG)

Oil market went from normal Backwardation to Contango.

Ironically the hedge was against rising oil prices but dropping prices is what was MG's undoing.

German accounting method [lower of cost or market method [LCM]] contributed to woes as MG had to record losses on futures positions.

The market-place got alarmed and MG's margin requirements increased due to bad looking books in Germany.

Benson tried to use a put strategy to mitigate losses but implemented it too late.

Metallgeselschaft AG (MG)

Breakdown in communication between parent company and MG. MG did not explain the economics of their positions.

Metallgeselschaft AG (MG)

What Type of Risk Failure?

Liquidity risk.

Model risk.

Supervisory board could have used recommendations of the G-30 study on derivatives.

Orange County

What Happened?

In early 1994 Orange county treasurer Robert Citron used a variety of techniques to leverage $7.5 billion in funds into $20 billion in investments.

Citron essentially bet that short-term interest rates would stay low compared to medium term rates.

In February 1994 the U.S. Federal Reserve began the first in a series of short-term interest rate rises.

By December 1994 the county declared bankruptcy after suffering losses in the amount of $1.6 billion.

Orange County

Why did it happen?

Citron had been very successful with his strategy in the past, generating sizeable profits for the fund in an environment of declining interest rates. In 1994 the interest rate climate in America began changing to one of increasing rates.

Citron used reverse repo agreements to use securities the fund had already purchased as collateral on further borrowing.

The fund ended up highly leveraged and exposed to margin calls for more collateral if the market value of the original collateral fell.

Orange County

Citron also purchased $2.8 billion of structured derivatives including inverse floaters whose coupon value fell as interest rates rose.

With rising rates the fund ended up in a liquidity trap as it was faced with greater calls for collateral from the counter parties of its derivatives transactions.

There was no informed and independent risk oversight of Citron's activities and its complex structure made it difficult to understand the inherent market risks.

No one correlated Citron's hey day of extraordinary profits to the fact that he must be taking enormous risk.

Orange County

Limited financial reporting for Citron’s web of financial instruments.

Merrill Lynch was blamed for directing Citron to risky and unsuitable securities and ended up paying a $400 million settlement to the Orange County.

Orange County

What Type of Risk Failure?

Liquidity risk.

Market risk.

Credit Lyonnais (CL)

What Happened?

In 1987 Jenn Haberer, a man with excellent political connections, was appointed CEO of CL. He then embarked on a plan to turn the national institution into a global banking powerhouse.

To fulfill his ambition Haberer had the Bank make a series of questionable investments with little oversight.

By 1993 Haberer was fired and CL had amassed massive losses due to bad loans, bad investments and a recession in Europe.

In 1997 the cost to French tax payers to bailout CL was estimated at around $20-30 billion.

Credit Lyonnais (CL)

Why did it happen?

CL financed or directly invested in a series of hugely costly real estate projects that never paid their way. These deals included Canary Wharf in London.

CL took significant equity positions in businesses as well as making loans creating wrong way exposure.

CL entered into a $1.3 billion dollar deal to purchase MGM film studios with Italian financiers of questionable integrity. The deal went bust and CL ended up selling MGM back to its original owner at a billion dollar loss.

Credit Lyonnais (CL)

Fallout of the first gulf war in 1991 brought an end to the economic boom in Europe, creating financial distress for many of CL's ventures and loans.

CL entered into a Junk bond deal with an American insurance company that ended up being very profitable. CL was not authorized to own insurance companies in America and ended up in legal trouble over this deal with U.S authorities to the tune of billions of dollars.

CL lacked systematic controls over risk taking and reporting.

CL invested in many businesses it did not understand.

Credit Lyonnais (CL)

During an investigation into CL’s losses in 1996 two separate fires destroyed records crucial to the investigation.

Because of Haberer’s political connections the bank was allowed to conduct its activities with far less risk oversight and due diligence than was prudent.

Credit Lyonnais (CL)

What Type of Risk Failure?

Credit risk.

Regulatory risk.

Operational risk.

Bankgesellschaft Berlin (BgB)

What Happened?

In 1994 BgB was created by merging the publicly owned Landesbank Berlin, Berlin Hypo Mortgage Bank and other public financial institutions with the private Berliner Bank. A hybrid of public and private institutions is unusual for Germany.

BgB had close ties to the Christian Democrat political party.

BgB embarked on an ambitious program of growth by aggressively investing in real estate.

Bankgesellschaft Berlin (BgB)

BgB created closed real estate funds that were available to Berlin's political and banking elite. BgB provided guarantees eliminating most of the risk to the favored investors in these funds.

BgB then extended the ability to invest in similar property funds to the general public.

In 1995-96 BgB made loans to the tune of hundreds of millions of Euros to property development company Aubis AG. Two businessmen that have strong links to the Christian Democrat party control Aubis.

In 1999 the Berlin and East German property market went into free fall.

Bankgesellschaft Berlin (BgB)

In late 2000 there were rumors that the bank was incurring large losses.

In 2001 BgB reported a loss of 1.65 billion Euros for 2000.

By 2002 BgB's public stake is put on the block due to the mounting losses. The German taxpayer is expected to bail BgB to tune of between 3.7 and 8 billion Euros.

Bankgesellschaft Berlin (BgB)

Why did it happen?

BgB was vulnerable to weak controls and conflicts of interest

There was no clear risk reporting and accountability by public subsidiaries to the bank's supervisory board management.

Loan portfolio was not diversified. Too much exposure to real estate in one region.

Poorly controlled loan approval process.

Poor recovery rates on bad loans.

Politicians and bank risk management do not mix well.

Bankgesellschaft Berlin (BgB)

What Type of Risk Failure?

Credit risk.

Concentration risk.

Operational risk.

Continental Illinois (CI)

What Happened?

In 1976 CI embarked on aggressive program of expansion by investing heavily with commercial and industrial clients with high concentration in the energy sector.

CI also invested heavily in developing countries in Latin America.

CI became one of the 10 largest banks in the U.S.

CI did not have a large retail client base and depended heavily on the wholesale market for funding.

In 1981 a recession in the energy sector began.

Continental Illinois (CI)

In 1982 Penn Square Bank failed, causing concern about CI due to its partnership with Penn in a risky lending program to the energy sector.

Mexico defaulted on its debt in 1982 further impairing CI's credit portfolio.

Interest rates began to raise compounding CI's problems.

In 1984 CI was shut out of domestic and international wholesale funding market due to rumors of insolvency.

CI was faced with a liquidity crisis and the FDIC and OCC stepped in to bail CI out for fear that its collapse could generate a national financial crisis.

Continental Illinois (CI)

The FDIC put aside the $100,000 limit to CI's creditors and depositors.

The FDIC spent $1.1 billion to bail CI out and ended up with an 80% stake in CI. CI was essentially nationalized.

7 years later the FDIC sold the last of its equity stake in CI, bringing the rescue saga to an end.

<u>Continental Illinois (CI)</u>

<u>Why did it happen?</u>

CI did not diversify its loan portfolio and there was too much exposure to one sector.

CI did not expand its retail client base which represented only 20% of its funding.

The process for underwriting loans was inadequate.

Continental Illinois (CI)

What Type of Risk Failure?

Credit risk.

Concentration risk.

US Savings and Loans

What Happened?

In the 1970s deregulation of interest rate markets coupled with inflation created a volatile interest rate market.

Deposit interest rate ceilings were eliminated for S&Ls between 1980-81 so that they could compete for depositors' funds.

S&Ls started offering rates on deposits that were at or above market rates.

S&Ls started to both lend to and invest in risky real estate deals.

An unsustainable funding gap developed between short-term liabilities and income on long tern assets.

US Savings and Loans

This was exacerbated by an environment of increasing short-term interest rates.

The level of insured deposits was raised from $40,000 to $100,000.

In 1986 the real estate bubble burst in some regions of the U.S. because of the passage of the Tax Reform Act. This act removed federal tax incentives to invest in commercial real estate.

Scores of S&Ls begin to fail because of their heavy exposure to the real estate market.

US Savings and Loans

Between 1986 and 1995 the clean up bill of the S&L crisis by the financial industry and the taxpayer was estimated at $153 billion.

US Savings and Loans

Why did it happen?

Loosening of solvency and risk capital regimen for S&L industry.

Accounting practice of supervisory goodwill for acquiring thrifts gave to rosy an impression of S&L firms.

Concentration of loan portfolios in the real estate sector.

Lax S&L regulators.

Regulators lacked the resources or political will to close insolvent S&Ls as there were too many.

No proper risk management infrastructure at most S&Ls.

US Savings and Loans

Out-right corruption.

US Savings and Loans

What Type of Risk Failure?

Credit risk.

Market risk.

Concentration risk.

Regulatory risk.

Operational risk.

WorldCom

What Happened?

Between 1991-97 WorldCom, under the stewardship of CEO Bernie Ebbers, became a major player in the telecommunications industry by completing 65 acquisitions.

Share price went from pennies a share to over $60.

WorldCom paid $35 billion for MCI in 1997 - $16 billion more than the second highest bid.

WorldCom had $41 billion in debt from acquisitions.

WorldCom’s board approved sweetheart loans to senior executives and to Ebbers personally in the amount of $341 million.

WorldCom

Citigroup made loans to Ebbers and in return Ebbers made Citigroup the lead underwriter on a $5 billion dollar WorldCom bond issue.

Ebbers became personally friendly with Citigroup's telecommunications analyst, Jack Grubman.

Grubman started hyping WorldCom's stock.

WorldCom suffered losses from not properly integrating its slew of acquisitions. The company hid these losses using fraudulent accounting practices and through the fog of complicated accounting associated with continued acquisitions.

WorldCom

In 2000 the U.S. government did not allow WorldCom to purchase Sprint and the acquisition carousel came to a screeching halt.

In 2001 the technology bubble burst.

Cynthia Cooper, an internal auditor at WorldCom, blew the whistle on the fraudulent accounting practices.

In 2002 WorldCom declared bankruptcy and amended its books that reflected a profit of $10 billion in 2000 and 2001 to a loss of $73 billion!

WorldCom

Why did it happen?

Difficulties merging and integrating new companies.

Difficulties accounting for financial aspects of acquisitions.

Under-utilization of infrastructure and redundancy.

Questionable accounting practice of moving all loses to one quarter so future quarters would show a profit.

Over-inflated value of intangible assets like goodwill with the acquisition are MCI.

Handling of accounts receivable was also questionable painting a more rosy picture than what existed in reality.

WorldCom

Improperly accounted for operational expenses as capital expenses in violation of GAAP.

Ebbers financed acquisitions and loans with stock. This resulted in margin calls when the stock price dropped.

WorldCom's external auditors, Arthur Anderson, were incompetent.

Conflict of interest between World Com and Citigroup.

Ebbers too personally friendly with telecommunications analyst at Citigroup.

WorldCom

What Type of Risk Failure?

Operational risk.

California Power

What Happened?

Between 1996-98 California deregulated its wholesale electricity market in the hope of reducing high prices.

At the same time caps were placed on what utilities could charge its retail customers.

California power suppliers were not constrained to sell to the California market but could sell to the highest bidder in any location.

In an environment of deregulation the wholesale price of electricity was prone to volatile movements. When there were huge spikes in the price the utilities were unable to pass this expense on to their retail customers.

California Power

This resulted in three California utilities filing for bankruptcy in 2001. The disparity between what two of the companies could charge for electricity and what they paid for it reached $1.1 billion.

California Power

Why did it happen?

No new power generation plants were constructed despite increases in demand.

Environmental issues made the construction of new power plants difficult.

The price of natural gas began to increase.

Unusually long dry season in the U.S. northwest reduced generation supply by hydroelectric producers.

California Power

What Type of Risk Failure?

Regulatory risk.

Market risk.

Political risk.

Bankers Trust (BT)

What Happened?

In 1994 BT was sued by four of its major clients - Federal Paper Board Company, Gibson Greetings, Air Products and Chemical and Proctor and Gamble.

All but Proctor settled out of court for $93 million.

Reputation of BT was severely damaged

Bankers Trust (BT)

Why did it happen?

BT prided itself on being a leader in marketing innovative financial derivative instruments.

BT advised its clients to engage in complex derivative transactions.

When the clients lost large sums of money as a result of these transactions they blamed BT for exploiting their lack of understanding of how the derivatives actually operated.

Proctor took a position in a derivative transaction with BT that bet on U.S. interest rates reaming stable or declining.

Bankers Trust (BT)

The U.S. Federal Reserve raised rates repeatedly in 1994.

In its suit Proctor claimed that BT failed to fully inform it of the risks in the transaction.

Poor stakeholder management on BT’s part.

Bankers Trust (BT)

What Type of Risk Failure?

Reputational risk.

Riggs Bank

What Happened?

From 1994-2002 Riggs Bank facilitated the money-laundering of millions of dollars by Augusto Pinochet, former President of Chile.

Riggs hid the existence of Pinochet accounts from the office of currency control (OCC) bank examiners for 2 years.

From 1995-2004 Riggs facilitated the money-laundering of hundreds of millions of dollars by Equatorial Guinea (E.G) government officials and their families.

Riggs facilitated funds transfers from offshore shell companies set up by the president of E.G. to accounts in jurisdictions with bank secrecy laws.

Riggs Bank

Riggs failed to identify a number of E.G. accounts when subpoenaed.

Riggs Bank

Why did it happen?

Bank regulators did a poor job - the OCC in particular.

Riggs had a dysfunctional anti money-laundering (AML) program.

Conflict of interest when OCC regulators are hired by Riggs.

Deficiencies at Riggs Bank AML program identified but ignored.

Riggs Bank

What Type of Risk Failure?

Operational risk.