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COVERING UP TRADING LOSSES: OPPORTUNITY-COST ACCOUNTING AS AN INTERNAL CONTROL MECHANISM

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Covering Up Trading Losses: Opportunity-Cost
Accounting as an Internal Control Mechanism
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ABSTRACT

This paper analyzes the methods of loss concealment used by rogue traders in the Barings and Daiwa scandals. The analysis clarifies how and why these firms' top managers and home-country regulators deserve blame for allowing cumulative losses to become so large. The central point is that information systems that focus exclusively on cash flows tempt amoral traders to build "star" status for themselves by booking fictitious credits that generate a high level of accounting profits. Constructing opportunity-cost measures of profit imposes additional restraints on reporting activity. These restraints make it easier for higher-ups, auditors, and regulators to identify the true sources of accounting profit and to challenge counterfeit earnings.

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During 1995 and 1996, spectacular trading losses surfaced suddenly at Barings, Daiwa, and Sumitomo banks. In each case, firm executives told regulatory authorities that a single 'rogue' trader had accumulated and hidden hundreds of millions of dollars in trading losses over an extended period. Making use of memoirs, press reports, and documentation compiled in official investigations, this paper describes and contrasts the technology of loss concealment used in the Barings and Daiwa cases and probes the plausibility of top executives' and regulators' protestations of surprise and innocence.

Our analysis confirms the hypothesis that top executives and regulators were surprised by the size of accumulated losses, but shows that the longstanding nature of their blindness supports a charge of culpable ignorance. Worldwide banking-industry resistance to reporting opportunity-cost measures of performance facilitates top-management surprises. Precisely because this resistance impairs top management's ability to trace posted trading profits to their economic roots in the short run, it creates a managerial duty to employ more-informative auditing standards in longer-run internal and regulatory analyses.

Accounting itemization and valuation rules that designate losses on untraded or intangible items as mere 'paper' losses that need not be reported to outside stakeholders undermine accounting transparency and loss control not just externally but inside a bank as well (Moore, 1995; Hogan, 1996). Preserving leeway for a bank's top executives to engage in gains trading and to under-reserve for opportunity losses in their traditional book of business makes it staggeringly easy for innovative trading technologies to outrun adaptations in the information systems by which top executives routinely strive to measure and control the performance of traders they supervise.

To prevent an opportunity loss from passing through to the bottom line of balance sheets and income statements, double-entry cash-flow accounting requires only that the potentially nasty debit be offset by a specious credit to an inadequately monitored 'plug' account. For mounting trading losses to evade the periodic scrutiny of internal and external auditors, a trader need solve only two problems. First, the trader must devise uninformative ways of either burying or posting

each loss. Second, the trader must fund the loss by simultaneously booking offsetting trades or internal transfers that record an equal amount of cash or other credits in settlement or custody accounts that the trader (or a confederate) directly controls.

The core accounting technology for covering up a trading loss of x dollars is illustrated in Figure One. It is important to recognize that once mislabeled or unbooked losses become large enough for their exposure to ruin the trader's career, incentives push for going beyond simple cover-up. When trading volume is growing rapidly, an amoral trader can create stupendous accounting profits by booking specious credits far in excess of the loss. This Ponzi-esque accounting ploy serves to inflate the apparent contribution the faithless trader is making to the firm's overall bottom line. Booking a fictitiously high level of trading profits directly enriches the opportunistic trader at the same time that it enhances the trader's intrafirm executive standing. As long as the firm's information system does not insist on documenting the opportunity costs of trading activity, bureaucratic politics make it hard for suspicious or unfriendly superiors to tighten or even to enforce the system of disciplinary accounting controls and nominal trading limits under which a 'superstar' trader operates.

I. Creating Superstar Trading Profits at Barings

Proprietary trading by Nicholas Leeson destroyed Barings Bank. Leeson (1996) indicates that his accounting manipulation and unauthorized trading began by accident. As General Manager of Baring Futures Singapore (BFS), a remote subsidiary, he sought to spare overworked underlings from being punished for their trading mistakes.[1] To offset mistaken trades, which were aimed at arbitraging minute-to-minute differences in Nikkei futures prices between the Singapore and Japanese exchanges, Leeson recorded large unmatched trades in an Error Account, superstitiously numbered 88888. This settlement account had been placed under his control in July 1992 by the firm's London Office for the purpose of netting minor trading mistakes inside

[1] Official reports issued in Singapore and England offer no contradictory explanation for Leeson's alleged unauthorized activities.

Singapore books. The net position was to be closed each day and the net value of gains and losses incurred in negating the position were to be recorded as part of the Singapore unit's daily profit (Leeson, 38-39). This 88888 account -- and the authority to use it -- remained in Singapore even after the reporting system was revised to book all errors straight through to London.

Although never authorized to maintain open overnight positions, Leeson used Account 88888 to post losses from futures trading almost from the day it was created. On February 26, 1995 when Barings collapsed, the cumulative loss resulting from transactions in this account was S$2.2 billion or approximately US$1.5 billion. Other Baring Group companies provided S$2.1 billion, while the remaining S$100 million came from creditor banks. It is important to note that S$1.7 billion was actually remitted – S$1 billion in the last three weeks of Barings' existence alone – and S$400 million was "marked to market" payment from SIMEX for trades of the other Baring Group companies that Leeson's office simply retained (Lim and Kuang, Singapore Ministry of Finance Report, B ii, vii).

As his posted trading losses mounted, so did the difficulty Leeson faced in funding them. However, the funding methods Leeson describes in his book do not square entirely with the Singapore Report. Until the end of 1992, Leeson claims to have met margin calls from client float and that, at the end of each month he balanced Barings' profit-and-loss report by netting the loss against his own commission income (Leeson, 58, 46-47). The Singapore Report (30, 181) states that from July 1992, Leeson instructed the settlements staff to pass bank accounting entries at the end of each month, which would later be reversed, to debit "bank funds received/receivable" and credit "client account (88888)" to convert the deficit balance on that account to a small positive balance or zero, and reflect the deficit balance as funds receivable. Until October 1994, Leeson claims to have cooked the monthly profit-and-loss report by selling enough options at month-end "to bring in the same amount of premiums in yen as the loss sitting in the 88888 account" (Leeson, 61, 125). According to the Singapore Report (25), the premium collected from option trades could only partly fund other trades because SIMEX credited the premium received into

BFS's bank account, and at the same time debited a similar amount from the account as margin for the options.

Leeson claims that it was not until late in the game – from July 1994 on – that he had to book large fictitious trades and bogus cash transfers to placate London auditors and put off queries from SIMEX. But the Singapore Report (22-24, 175) tells us that to avoid detection of holding unhedged positions, Leeson would instruct floor traders to conduct "transfer trades," from the accounts of other Baring Group companies into Account 88888. The Report also indicates that from May 1993 until the time of the collapse, at Leeson's direction, line traders recorded fictitious transfer trades and adjusted prices and quantities to "give the impression that he had entered into perfectly matched profitable transactions". As these fictitious trades also reduced closing positions, they also reduced the total margins owed to SIMEX. The accounting tricks Leeson used are summarized in Figure Two.

Leeson strengthened the opinion higher-ups held of him by misrepresenting the profitability of his trading by sending forward a long run of falsified reports. Despite this spectacular record of misrepresentation and forgery, he was convicted and sentenced by the Singapore government to 6 1/2 years in prison for only two crimes: "deceiving the auditors of Barings in a way likely to cause harm to their reputation and to cheating SIMEX" (Lesson, 265).

Allegations of Supervisory Surprise

Barings higher-ups and British authorities blamed Leeson for the debacle, characterizing him as a 'rogue' who executed unauthorized trades. But, for tolerating suspicious cash transfers to Singapore, Barings management team and its government supervisors are ethically culpable. Although no evidence has surfaced that top managers acted in concert with Leeson, management and British regulators failed in their duty to institute an information and reporting system that could prudently monitor and control Barings global operations. Weaknesses in Barings control systems were categorical and extensive.

First, the firm's organizational structure was poorly articulated. It exhibited cloudy reporting lines and internal controls, failed to segregate control of trading and settlement, and embraced uninformative accounting standards. Each weakness underscores the value of an opportunity-cost information system.

In a characteristically British circumlocution, John Dare, Director of Barings plc, rationalized the lack of control over the rapidly growing offshore financial operation:

> "They [Barings global arm] were usually in a bit of a catching-up position because their business had gone through a few periods of quite rapid growth, when it is challenging, to say the least, to keep your controls on top of a business that is growing rapidly. There were times when I was aware that this was a strain; that the front office were marching faster than the back office." (Bank of England Report, p. 119)

Because adequate understanding of fast-growing operations is virtually impossible without an opportunity-cost standard, cash-flow accounting can all too easily support pyramid schemes.

Second, top management kept itself in the dark by disregarding rumors and market responses to them. For example, in late January 1995, outsiders questioned repeatedly the size of Barings net positions in Asia and its ability to meet margin calls. Inquiries from the Bank for International Settlements and the press were treated only as public-relations problems. Inside the firm, management locked itself into denial, refusing to test the contention that its Singapore positions were fully hedged.

Perhaps the greatest irony in the Barings tale is the unflagging respect for accounting transparency expressed by top managers, a condition which their own financial statements and operations never approached. After the shortage was revealed, Peter Norris, Chief Executive Officer of Baring Investment Bank and Director of Barings plc, excused the firm's complacency on the grounds that: "the rumours could be rationalised by the contrast of the *relative transparency of OSE* [the Japanese securities exchange], which published details of members' activity, and SIMEX, which did not" (BoE Report, p.137, emphasis added). This defense lamely begs two important questions. First, in the face of evidence that financial markets are informationally efficient, how could management content itself without testing the hypothesis that

such a significant market 'misunderstanding' could persist? Second, if it was aware of opaqueness in its Singapore operations, didn't it owe a duty to its customers and shareholders to overcome it?

Third, the self-proclaimed naiveté of the management of this 233-year old bank violated the duties of competence and care they owed their shareholders. Their professional ignorance of the open-outcry operations of SIMEX, and the overall business of the Singapore office cannot reasonably be used as a defense for failing to test the inordinate profits Lesson's 'riskless' trading activities were booking. A conscientious manager must trace the roots of supernormal profits to whatever unique capacities or quasi-rents they reflect. It is ridiculous to suppose – as Peter Baring, Chairman of the Board of Barings plc. asserted – "... that it was not actually terribly difficult to make money in the securities business" (BoE Report, p.199).

It is doubtful that the London office had no knowledge of the existence of the 88888 account until the bank's eminent collapse. To feign surprise is to admit incompetence. How could individuals of reasonable intelligence fail to notice entries that were growing dramatically for 2 1/2 years? The authors of the Singapore Report bluntly conclude that such a claim "gives rise to a strong inference that key individuals of the Baring Group's management were grossly negligent, or willfully blind and reckless to the truth" (ibid., B vi).

Beyond London's inability to reconcile Leeson's funding requests, there was direct evidence of the 88888 account's existence. It was included in the margin file (which contained initial and maintenance margin by account and currency) transmitted each day to London. Concerns about Account 88888 were highlighted in inquiries SIMEX sent to Leeson's supervisors. One letter, dated September 7, 1993, identified 15 specific breeches of SIMEX rules and attached a trade ticket from February 18, 1993 for Account 88888. Another dated January 11, 1995, referencing the same account, raised the possibility that Barings had violated exchange rules about financing customer margin. Follow-up letters on January 16 and 27, 1995 dealt with rules violations and Barings' ability to meet its financial obligations to the exchange. This correspondence destroys the credibility of management's claims to complete ignorance about

Account 88888.

Allegations of Supervisory Innocence

Barings' monitoring of its Singapore operation showed two weaknesses. First, it lacked proper controls and supervision. The most rudimentary accounting reconciliations and checks were never performed. Second, it allowed the status Leeson had achieved as a "lone star" and "turbo arbitrageur" to countervail efforts to monitor his activities (BoE Report, 49, 50). At critical junctures, the two weaknesses reinforced each other.

Internal Audit 1994

The Singapore operation received an internal audit during July and August, 1994. The auditors issued three recommendations. First, Leeson should no longer be responsible for both the back and front offices. Second, an independent risk management and compliance officer should monitor trading activities "to ensure that regulations are followed and risk limits observed" (BoE Report, 146). The auditors explicitly cited the "significant general risk that the controls could be overridden" by Leeson and that, as the key manager, he could "initiate transactions on the Group's behalf and then ensure that they are settled and recorded according to his own instructions." Third, the audit called for a comprehensive review of Singapore's funding requirements by Group Treasury in London and for establishing gross position limits on SIMEX to control funding requirements and exposure to market risk. None of these recommendations was followed up.

Moreover, the audit team's recommendations were restrained by cover-up activities. Prior to heading to Singapore, the auditors were told that: (1) Leeson had too dominant a role in the trading and settlements business of the Singapore operation; (2) Leeson's direct supervisor, Simon Jones, Director of Barings Futures Singapore and Chief Operating Officer, Barings South Asia, basically left Leeson "to his own devices"; (3) several senior managers within the Baring Group had little faith in Jones's management ability; (4) senior clerks would not likely speak up if

something was amiss in Singapore; and (5) the margin calls paid by London to Singapore were unintelligible to the point that it was not known on whose behalf the cash was being paid (Singapore Report, 41, 45). These concerns directed auditors to analyze an operation led entirely by a single individual – with basically no one to answer to – who requested large sums of money on a daily basis for reasons that no one understood.

Yet, the "task of reconciling the funds that were remitted to BFS [Singapore] from BSL [London] ceased to occupy the attention of the internal audit team" (Singapore Report, 42). In an early draft of the audit, there was a recommendation for a reconciliation between the SIMEX margin calls and the amount paid to Singapore from other Baring companies to identify discrepancies and to ensure the authenticity of all trades. They noted that fictitious house trades could be booked and extra margin called. When Leeson alleged that reconciliation was both unnecessary and cumbersome, a senior manager supported him and the Reconciliation of Margins was dropped from the report.

Although the auditors drew comfort from the "fact" that the Baring companies who dealt with BFS implemented their own reconciliations, they were unaware that no such reconciliations existed. Finally, not only was the internal audit kept from the external auditors, they were told that no such document existed when they requested it.

Funding of Margin Calls[2]

In late 1994, the format for US Dollar margin requests was changed, to provide more detail about where the money was being applied. But Leeson directed his staff, who knew the

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[2] Funding was dispersed through two equally flawed procedures - one for Yen, one for US Dollars (BoE Report, 97 - 100). At December 31, 1994, Leeson's office had received funding totaling US$350.6 million from London and Tokyo offices. The size of his requests increased substantially over the first two months of 1995, standing at US$1.18 billion at February 24, 1995. Yen requests could not be independently reconciled in London, even though the settlements staff used a software package to record and monitor futures and options transactions. This was because the London office received all its key information directly from Singapore. Even more disturbing, London was unable to reconcile the US Dollar requests to any trading records at all. The London staff seems to have filled Leeson's requests for funding blindly, without even attempting to distinguish trading for customer and house accounts.

total funding requirement necessary on any given day, to break down client and house positions arbitrarily. Suspicions raised in London about these requests were blithely dismissed as attributable to poor bookkeeping in Singapore. In internal correspondence dated December 28, 1994 to Brenda Granger (Head of Futures and Options Settlements), Tony Railton (Futures and Options Settlements Senior Clerk) stated, "The best case scenario is that Nick is calling for the right USD but is changing the wrong figures on his breakdown spreadsheet, worst case is that it's plain rubbish" (BoE Report, p.102).

Reconciliation issues languished until early January 1995 when management devised the 'Singapore Project' to 'formally' investigate margin funding to BFS. In a classic case of the fox getting control of the henhouse, Leeson captured this project. He was able to kill the initiative with a foggy memo for London.

The SLK Receivable

Leeson's suspicious funding requests should have raised a bright red flag in January 1995 once the Yen 7.778 billion (S$115 million) hole was discovered in Barings balance sheet by the external auditors, Coopers & Lybrand Singapore, C&L. This divergence between the general ledger balance for the SIMEX Yen settlement variation account and the balance of the same account as shown in SIMEX's combined margins and positions report, represented 20 percent of the gross assets of the Singapore office and 3.3 times its net shareholder's funds at December 31, 1994 (Singapore Report, 118, BoE Report, 158). Although this discrepancy cried out for a thorough and independent investigation to find and correct whatever systems weaknesses allowed such an error to occur, the shortage was not conscientiously investigated. Even if one ignores management's prior laxities, this amateurish investigation implicates management in Barings collapse.

This discrepancy came to be known as the SLK Receivable, based on Leeson's unsupported claim that it represented a trade receivable overdue from Spear, Leeds & Kellogg, an

American securities brokering firm. In fact, it represented the cumulated losses on Account 88888, and no such receivable existed.

Seven days passed between the time C&L first met with Leeson to discuss this discrepancy (January 27, 1995), and the time they signed off on it. They forwarded a final clearance to C&L's London office on February 3 despite the fact that four versions of the SLK story had been given. Two more versions of the tale surfaced later. In the version accepted by C&L, the Yen 7.778 billion represented refund of margin deposited with SLK for an OTC option trade arranged by Leeson between SLK and Barings Securities Ltd (in London). This story directly contradicted a handwritten note Leeson sent to his supervisors, which described the counterparties as SLK and Banque Nationale de Paris (BNP). In this version, the receivable represented a booking error in Singapore in which the maturity date was inputted as December 3, 1994 on the BNP leg, such that Singapore paid them Yen 7.778 billion on that date and were to be reimbursed by SLK on December 30, 1994, the expiration date. It was suspicious that the risk taken in the deal was said to originate as a favor to the contracting parties, but the deal offered Barings no profit. Other versions described the problem as either an operational error, a mistaken payment from Singapore to SLK, or as money due as settlement on maturity.

In accordance with C&L's efforts to document the SLK receivable, Leeson faxed forged cut-and-pasted confirmations. One fax, supposedly from the Managing Director of SLK, stated that the outstanding balance would be paid February 2, 1995. This document had the header "Nick and Lisa" in its upper right hand corner because Leeson sent this fabrication from his home fax machine. As evidence that the money was received from SLK, Leeson produced a photocopy of a bank statement, with the payee omitted, showing such a deposit. In reality, the amount shown was transferred from another Barings account. Leeson also forged a fax stating that London had approved the transaction.

Contradictory testimony has been offered by various parties among Barings' management about who knew what, when. But the flow of contradictory stories demanded a detailed inquiry. Since the SLK transaction was entirely fabricated, London first learned of it from the auditors.

The concern this initially drew from some individuals was quieted by assurances that the matter was being handled "at the highest levels" (Singapore Report, 121).

A premium of Yen 7.778 billion implies that the capital risk of the option was approximately S$1 billion (US$690 million). It could not reasonably be conceived that SLK would enter into a trade of this magnitude, especially since Barings' Credit Unit believed that SLK "had minimal substance, a net worth $2 [million] or $3 million (BoE Report, 129).[3] Not only was SLK never contacted directly, when Brenda Granger offered to contact SLK, she was directed not to do so. Additionally, no one knew where Leeson would have gotten the money to make such a payment, as Singapore had no external funding source of its own. The same conclusion is reached in the Singapore Report, which states, "We find it inconceivable that the question of where or how Mr. Leeson had been able to obtain S$115 million to make this payment had not arisen…" (135). The effort to rationalize this incident as an 'operational error' supports the hypothesis that higher-ups in London mired themselves in an explicit or implicit conspiracy of concealment. The failure to test the rationalization by insisting on documentation indicates negligence or malfeasance by Barings top management.

Covering-Up SLK

Supervisors' claims to innocence are further undermined by their documented attempts to keep information about the SLK transaction from appearing in the external audit report and internal management letter. They profess to want suppression not just to protect the reputation of the Singapore operation. They confess to wanting to protect the office from 'unwarranted' regulatory intervention and Leeson from unnecessarily harsh disciplinary action. Such characterizations translate into a cover-up.

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[3] This valuation is not correct, as SLK had net worth of US$268 million at September 30, 1994. The true value still makes the point: SLK could not have supported a trade of this size. Furthermore, the only counterparty review (prepared by London's Credit Unit on June 11, 1993) established a Futures and Options limit of US$5 million. (BoE Report, 129)

We have hypothesized that top management's assignment of superstar status to Leeson interfered with the proper handling of the investigation into the SLK receivable. This is evidenced by actions taken by some members of the team to deter efforts initiated by others to investigate it, denying others direct access to Leeson, and the direction Peter Norris gave to Leeson that he need not address a series of pointed, written questions submitted by the Group Treasurer, Anthony Hawes.

The contention that management's attempts to protect its star trader only appear extraordinary in hindsight is easily dismissed. In the face of repeated reconciliation problems, it is extraordinary that no disciplinary action was taken against Leeson. It is also extraordinary that he was in line to receive a substantial bonus: nearly four times larger than his previous year's bonus. Finally, overt actions taken to suppress the flow of information to Barings' ALCO and in the Audit Management Letter trump all claims of managerial innocence. Even though London management viewed the SLK issue as an extremely serious matter, and knew of it by January 30, the problem was intentionally held out of discussion at ALCO until February 8. Even then Norris downplayed its significance. It was explained as having arisen from an operational error due to a misposting, or a "non-transaction," and the secretary was directed to keep the minutes very brief and exclude all details (Singapore Report, 131). The issue was discussed, but not minuted, at the February 13 ALCO meeting.

In a meeting with C&L London on February 9, management made a concerted effort to keep the SLK Receivable from being mentioned in the Audit Management Letter. The impetus for this action was the allegation that it would cause regulatory problems with SIMEX for the Singapore office. False and misleading information was provided to the external auditors at this juncture. The cover story centered on the version that designated BNP as the counterparty to the transaction, contrary to the explanation C&L London had received just three days earlier in the clearance letter from C&L Singapore, which described the trade as a transaction between SLK and Barings Securities Ltd.

Had top management looked to install opportunity-cost accounting procedures rather than to ride the coattails of a single trader's 'profits,' the shortage would have been quickly exposed.

The Final Discrepancy

Anthony Railton was assigned in early 1995 to Singapore to improve the information channels to London. Less than two weeks after the SLK issue first came to the attention of London management, he realized, "If you close out all the positions there is absolutely no way on God's earth that you could actually return all the yen" (BoE Report, 10). By February 17, he had discovered a 14 billion yen discrepancy between the margin funds remitted to Singapore and total sum of funds held by that office.

His arrangements to meet with Leeson were repeatedly postponed. Not until February 23 was he able to sit down with Leeson and the Director of the Singapore operation, Simon Jones, to discuss this enormous, unreconcilable amount. Leeson excused himself from the meeting almost as soon as it began. Claiming that he was going to visit his wife in the hospital, he fled to Thailand. Given that Railton had informed London of Leeson's evasions and the size of the discrepancy he uncovered, Leeson's departure for any reason should have been unacceptable.

While they waited for Leeson to return, Jones, Railton, and the Financial Controller for Barings Securities (Singapore) tried to resolve the discrepancy. In the process, the confirmation documents from the SLK Receivable were reviewed. The tampered bank statement and the confirmation from SLK, with the "Nick and Lisa" header, were recognized at that time as forgeries. Jones testified that rather than jumping to conclusions, he just called it a night at 9:30 p.m. His only action that night was calling the Managing Director of Barings Asia Pacific, James Bax, to alert him that Leeson had not returned. Railton reported the problem to his superiors in London after Jones had left.

The news that Leeson had not returned reached London at 3:30 p.m. local time. This was, allegedly, the first time that Norris learned of the discrepancy. He gathered a team of other top managers to "investigate whether unauthorized payments had been made to third parties, as it was feared that Mr. Leeson may have embezzled money and disappeared" (Singapore Report, 153). He also advised Hawes, who was due to arrive in Singapore at 2:30 am local time (6:30 p.m. in London), of the task at hand in London and directed him to return to Leeson's office with Railton

to conduct a parallel review of the records. The concern expressed about embezzlement proved short-lived. In what would be an amazing bit of detective work given the understanding of the situation Barings' officers claim, Railton, Hawes, and Bax, identified Account 88888 as the cause of the discrepancy within 90 minutes of their arrival at Leeson's office, around 4:30 am local time. Even more amazing is the fact that Norris, working in London with incomplete documentation was able to conclude that the problem was one of unauthorized trading around 7 p.m. London time, without having to wait for the three men to arrive at the Singapore office. By mid-morning in Singapore, Hawes sent a note to ALCO "identifying Account 88888 and describing, with a substantial degree of accuracy, the nature and causes of the problem and the resulting exposures faced by the Baring Group" (Singapore Report, 154).

Leeson operated without line or head-office supervision. He controlled all accounting reports out of Singapore. He defiantly acted against direct orders given by ALCO in late January and February 1995 that "positions should not be increased from current levels and when possible reduced pending further instructions…" (BoE Report, 125)[4] Until the last, no one stopped Leeson from continuing to double his exposures, gambling that the market might move in his favor and eliminate his losses. The evidence supports the hypothesis that, from mid-1994 on, the maintenance of a loose structure over the Singapore operation was intentional. This means that Barings management chose to gamble, too. Unfortunately for Leeson, and Barings, the market moved against their positions, collapsing the house of cards that had been used to balance Barings accounting capital.

II. Burying Trading Losses at Daiwa

At Daiwa, as in Barings, a trader who operated out of a subsidiary office far from firm headquarters ran up unacknowledged losses. Also as at Barings, higher-management checks and

[4] As further evidence of a cover-up, upon returning from a visit to Leeson, Norris directed ALCO on February 20 that the positions should not be reduced and should be left to run to maturity in March 1995 (Singapore Report, 144).

balances on the settlement of trading activities were distressingly incomplete.

Most of Daiwa's $1.1 billion in trading losses were funded by the simple expedient of not booking out of custody the transfer of the particular securities that were sold at a loss, as depicted in Figure 3. Leeson controlled the posting of net settlements; conspiring with colleagues, Toshihide Iguchi controlled postings to the custody account. Iguchi's unprofitable trades moved the securities physically out of Daiwa's vaults, but their departure was simply not booked. From an accounting point of view, this simple fraud served to transform losing trades into accounting 'nonevents.' Each unbooked trade became the accounting equivalent of a tree falling in a foreign forest far beyond earshot of the firm's Osaka headquarters.

Three other significant differences emerge. First, the duration of the fraud at Daiwa was four times longer than that at Barings. Second, Daiwa's regulators and top management in the home country admitted their involvement in the cover-up. Third, while the losses at each institution were of similar magnitude, Leeson's activities caused Baring's collapse; Iguchi's fraud led to Daiwa's expulsion from operating in the United States, but did not induce the bank's demise.

The Scandal Unfolds

> "The events at Daiwa point to a disturbing picture of illegal conduct, cover-up, deception, and inefficiencies. This picture includes collusion and cover-up by a foreign bank, its senior managers, and inadequate supervision by its home country supervisors and U.S. regulators."
>
> Alfonse D'Amato, in hearings held by the Committee on Banking, Housing and Urban Affairs of the U.S. Senate, November 27, 1995

According to their official testimony, Baring's management had the misfortune of discovering Leeson's losses after he had abandoned his office and fled the country, at which time it was too late to save the bank. The Iguchi dealings came to light under less climactic circumstances. After twelve years of unauthorized trading of U.S. Treasury obligations that

cumulated to $1.1 billion in losses, Toshihide Iguchi, Executive Vice President of The Daiwa Bank, Ltd, articulated his activities in a July 17, 1995 thirty-page confession letter to Daiwa President Akira Fujita. On August 8, Fujita informally notified Yoshimasa Nishimura, Banking Bureau Chief of the Japanese Ministry of Finance (MoF) about the losses. Daiwa did not inform U.S. regulators of the scandal until September 18, when it formally reported the losses to the Federal Reserve Bank of New York (FRBNY). Japanese regulators also received formal notice on that date.

Once informed of the scandal, U.S. authorities acted quickly – Iguchi was arrested on September 23 and Cease and Desist Orders were issued jointly by the New York State Banking Department, FRBNY, the Board of Governors, and the FDIC on October 2. These orders severely limited the activities of both the bank and Daiwa Trust Co., and called for an independent CPA firm to conduct a forensic review of the $1.1 billion in securities trading losses, to prepare a complete reconciliation and verification of bank assets, and to perform a comprehensive audit of internal controls, custody business, risk-management, and management information systems for both Daiwa and Daiwa Trust (Senate Hearing, 54)[5].

The U.S. Attorney initiated a criminal investigation of Daiwa while examiners from the appropriate U.S. regulatory arms scrutinized the records and reviewed past examinations of Daiwa Bank and Daiwa Trust. Authorities soon learned that it was not just Toshihide Iguchi who had misled them. Daiwa management had actively concealed information and filed falsified reports – and this was not the first time. Worse yet, the MoF had misrepresented its knowledge of Daiwa's affairs.

Allegations of Managerial Surprise

Our analysis of the Barings collapse impugns managerial claims of surprise and innocence. Claims of top-management *innocence* are not even offered in the Daiwa case. Daiwa took a critical, lead role in concealing Iguchi's losses. Revelation of this role led to the resignation of

[5] The Banking Department retained Arthur Anderson for this purpose on October 13.

Daiwa's president and other top executives, the conviction of the former general manager of Daiwa's New York office, and arguably to the investigation and prosecution of corruption at MoF. Furthermore, Daiwa pled quilty to charges of conspiracy to hide the trading losses, the misprison of a felony, falsification of bank books and records, wire fraud, conspiracy to conceal material information from the Federal Reserve, and obstruction of a bank examination for its direct role in the coverup.

Allegations of managerial *surprise* were nevertheless put on the table. We contend that Daiwa's management cannot reasonably claim ignorance of Iguchi's trading losses. Daiwa maintained so lax a supervisory framework for so extended a period and embraced a corporate culture so insistent on the internal handling of criminal indiscretions as to implicate top management in willfully covering-up illegal activities.

Cover-up at Daiwa Trust

On October 9, shortly after having received the Cease and Desist orders, Daiwa informed the Banking Department of an earlier cover-up of $97 million in losses incurred by the Daiwa Bank Trust Company during 1984 - 1987. The losses resulted from unauthorized trading activity which came to the attention of Daiwa Trust in 1984, when they posted $31 million of unrealized losses in off-balance sheet trading in U.S. Treasury bonds. Those losses ballooned in the wake of authorized trading, undertaken by officers of Daiwa in hopes of recouping the original loss. By September 1987, those losses had reached the $97 million figure. To hide the losses from regulators, they were assigned to a newly established nonbank corporation in the Cayman Islands. By 1994, the losses were zeroed out and the non-bank corporation was dissolved. Senior management at the home office in Osaka instructed Daiwa's U.S. management "not to disclose the losses to federal regulators" (Board Report, 10).

Daiwa's U.S. operations included two branches in New York City, five other branches, seven agency offices, and 14 representative offices in 11 other states, but only Daiwa Trust had FDIC-insured deposits. Although the FDIC had primary responsibility for supervising Daiwa

Trust, its responsibility was shared with the New York Banking Department and the Federal Reserve. Because losses were wholly absorbed by Daiwa, the deposit insurance fund bore no financial burden.

Still, the insurance fund was exposed to risk by these patterns of loss concealment. This transgression was not uncovered by U.S. monitoring procedures. U.S. knowledge of this affair surfaced in the belated notification initiated by Daiwa officials. This notification appears to have been forced on Daiwa by references to the matter in Iguchi's confession letter.

In testifying as chair of the FDIC, Ricki Helfer stated that Daiwa and Daiwa Trust "concealed a pattern of unsafe and unsound banking practices and violations of law over an extended period of time dating back to 1983." (Senate Hearing, 39). In addition to unauthorized trading, this pattern included "significant deficiencies in internal controls for monitoring compliance with laws and regulations and risks" and the "long-term, conscious effort by senior managers to deceive regulators concerning losses stemming from trading activities" (ibid., 38). Instead of reporting the losses and unauthorized trading to U.S. authorities, as they were legally required to do, senior management falsified the records and financial statements of Daiwa Trust to conceal the activities.

Concealment: Within Daiwa and Within the Ministry of Finance

Neither shareholders, the public, nor U.S. regulators were privy to that information possessed by high-ranking officials at Daiwa and the MoF for nearly two months. U.S. investigators later learned that Iguchi's confession and subsequent communications with Daiwa officials "urged concealment of the bank's losses, concealment of [his] own crimes from U.S. authorities, and counseled the bank as to how it might reorganize its affairs in a manner that would escape U.S. regulatory authority and for a period" (Court transcript, 34). Iguchi also "participated in the bank's efforts to delay disclosure and otherwise to fail to conform to its responsibilities under American law" (ibid., 34). It was Daiwa's duty to report the losses to U.S. regulators. In violation of U.S. law, Daiwa maintained secrecy, and knowingly filed a false Call

Report with the Federal Reserve. In violation of its own regulatory duties, the MoF endorsed this response.

On October 19, 1995, Toshihide Iguchi pled guilty to six counts of misapplication of bank funds, falsifying bank books and records, forgery, and money laundering. He admitted conspiring with the "senior management of Daiwa to conceal the losses of the New York branch… and deceiving Federal Reserve examiners during the course of their examinations of …Daiwa" (Board Report, 8). For his crimes, Iguchi was sentenced to 48 months in prison and was ordered to pay the maximum allowable fine of $2 million and $570,000 in restitution to Daiwa for two separate incidents of embezzlement dating to 1988. Judge Lewis Kaplan acknowledged the gravity of those crimes when he sentenced Iguchi in December 1996; "There is no question that this was a crime of historical dimensions and potentially world shattering implications. It threatened the stability of an enormous bank in a world economy that today is so complex and interdependent that the degree of that complexity and interdependence is probably quite literally beyond human comprehension" (Court transcript, 30).

Daiwa

Daiwa's tenure in the U.S. is a record of deceit. Besides the cover-up at Daiwa Trust, the bank had a long history of misleading U.S. regulators. The Federal Reserve first examined Daiwa's New York branch in November 1992. One year later, branch management admitted to examiners that "it had purposefully deceived them about the location of the branch's securities trading operations in 1992" (Senate Hearing, 33). The deceit included physically moving traders from the downtown office to the midtown office and disguising the trading room as a storage area. The MoF had not authorized trading at the downtown office. Daiwa sought to mislead the Fed to prevent it from notifying the MoF that trading was taking place at an unauthorized location.

In November 1993, over a year and a half before Iguchi confessed, Daiwa alerted the Fed of Iguchi's dual role as senior vice president in charge of custodial services and securities trading

at the branch. When examiners criticized the conflict of interest inherent in allowing one individual to hold both positions, a senior official at Daiwa's downtown branch submitted written confirmation that Iguchi's duties had been separated. That official also indicated that the traders were relocated to the midtown branch, to comply with the MoF's directives. Both statements were false. The bottomline is that Daiwa had been alerted to the dangers in Iguchi's responsibilities and lied about remedying the situation. Compounding their involvement, management intentionally deceived foreign and domestic regulators about other aspects of the bank's trading activities.

The deception of U.S. regulators continued through 1994. During a joint Fed-state examination in September 1994, branch management submitted an organization chart that showed Iguchi to be responsible only for custodial services, with another officer responsible for securities, investments, and trading.

Following Iguchi's confession and an investigation designed to size his trading losses, Daiwa decided to delay disclosure to U.S. regulators, but "the suggestion by some senior Daiwa management to conceal the losses completely, ... was however ultimately rejected" (Board Report, 7). In the two months before U.S. authorities were notified, Daiwa's management persisted in the scheme to avoid detection of the losses. General Manager Masahiro Tsuda and Iguchi sold securities and falsified bank records to meet interest payments on missing securities. "These actions were known to and acquiesced in by Mr. Tsuda's superiors at Daiwa" (Board Report, 10). In addition, on July 31, 1995, Daiwa filed its Call Report for June 30 and its parent foreign bank financial report, without reflecting the misappropriation of securities from Daiwa's custodial accounts. Even on September 21, after having notified U.S. supervisors, Daiwa filed a revised Call Report for June 30 which was also misleading.

The facts indicate that Daiwa's deceptive handling of the $1.1 billion in losses incurred by Iguchi was not exceptional. Daiwa's actions exhibit a dangerous cycle of failing to control its traders followed by accounting trickery and outright falsification and forgery to hide the losses and keep regulators in the dark. While top management may not have known of Iguchi's losses

prior to his confession, Daiwa's leadership violated their duties of diligence to shareholders and regulators. It bears responsibility for initiating and maintaining a supervisory structure that virtually invited traders to try to recoup embarrassing losses. The startling lack of checks and verification in Daiwa's information and monitoring system allowed Iguchi's scheme to continue for 12 years.

On November 2, 1995, one month after issuing the Cease and Desist orders, the Federal Reserve, NY Banking Dept. and the FDIC announced Consent Orders terminating Daiwa's U.S. operations. Daiwa was given until February 2, 1996 to end its operations and leave the country. Also on that day, a 24-count indictment against Daiwa was issued by the U.S. Attorney. Charges included "conspiracy, mail and wire fraud, obstructing the examination of a financial institution, falsification of bank records, failure to report felonies, and the affirmative concealment of felonies (Board Report, 4). Masahiro Tsuda was also indicted. He was arrested and charged with "conspiracy to deceive the Federal Reserve by concealing the bank's $1.1 billion trading loss, making false statements to the Federal Reserve, making false entries in the books and records of Daiwa, and the misprison of a felony" (ibid., 9).

For its criminal role in concealing Iguchi's trading losses, Daiwa pled guilty on February 28, 1996 and was ordered to pay a $340 million fine. Tsuda pled guilty to one count of conspiracy on April 4, 1996 and was sentenced in October to two months in prison and fined $100,000.

Judge Kaplan underscored Daiwa's negligence at Iguchi's sentencing; "Daiwa has manifested extraordinary culpability both with respect to [Iguchi's] scheme, ... and otherwise. ...Daiwa bank has acted with exceptional contempt of U.S. law and U.S. regulatory authority. It has refused to cooperate with U.S. authorities to this date. It has little claim on the sympathies of an American court" (Court transcript, 36).

Ministry of Finance

The MoF violated its duties as well. The ministry admits to being informed of Daiwa's losses in August 1995, a fact it temporarily denied when U.S. authorities were notified in September. Far from sharing the information with U.S. supervisors, or encouraging Daiwa to do so, it instructed Daiwa to conduct an internal investigation. During Daiwa's prosecution in U.S. courts, bank officials stated that their failure to make full and prompt disclosure of Iguchi's losses was due in part to the "grave concerns regarding the impact of reporting of the losses at the time would have on the Japanese economy, as expressed to Daiwa on August 8, 1995 by the Japanese Ministry of Finance..." and that "MoF's comments reinforced Daiwa's own business decision to delay disclosure" (Board Report, 7,8).

High-ranking MoF officials initially defended the ministry's handling of the Daiwa case, but on October 12, Finance Minister Masayoshi Takemura telephoned U.S. Treasury Secretary Robert Rubin to apologize and acknowledged that the ministry's reporting was insufficient (Reuters).

At an October 16 hearing, James Leach, Chairman of the House Committee on Banking and Financial Services, expressed "Congressional dismay" about the lack of timely notification about Iguchi's substantial losses from both Daiwa and the MoF. He stated that "… it is impossible not to register deep concern over this brief, but significant financial cover-up" (House (1), 2).

The seriousness of the Daiwa scandal and the indignation expressed by U.S. authorities underscored the MoF's double-dealing. In a November 22 letter to Neil Levin, Vice Minister of Finance Kato conceded that the MoF should have encouraged Daiwa to "expedite its investigation so that the MoF would have been in a position to report earlier to regulators in this country..." and that their delay in reporting "might not be consistent with the spirit of the [Basle] Concordat" (Senate Hearing, 51).

The MoF's advice to Daiwa to conduct its own investigation prior to informing U.S. regulators was attributed to cultural and supervisory differences that exist between the two

nations. U.S. regulators were sympathetic to such differences, and often deferred to Japanese procedures. Neil Levin confirmed that the Banking Department relied heavily on Japanese banks' home offices, the MoF, and the Bank of Japan, in the belief that Japanese authorities closely supervised all branches in the U.S. He stated that the Department routinely deferred to "Japanese sensibilities regarding internal control and audit matters generally and the Japanese use of self-inspection in particular" (Senate Hearing, 52). He expressed the Banking Department's naive opinion that "the Japanese did not understand the American system of tight internal controls and the need for audit coverage" (ibid.). Japanese citizens' subsequent disillusion with the corrupt behavior of MoF officials shows that it was a mistake not to pursue and correct the audit weaknesses that the Department uncovered in its examinations. The Banking Department and other U.S. regulatory agencies were indefensibly complacent in their examination of Japanese banks.

Iguchi's cover-up depended on an extremely simple ploy. Daiwa management should have seen through the deception quickly. It is hard to suppose that management could remain unaware of Iguchi's activities until his confession, given that Iguchi's activities spanned twelve years and entailed the falsification of at least 30,000 trade documents. Much like the Barings case, a credible capacity to profess ignorance may be read as proof of laxity in the execution of supervisory duties to pursue safety and soundness. These duties are owed to shareholders and to home-country and host-country regulators alike. Daiwa management perpetuated an atmosphere of secrecy and concealment that facilitated looting and gambling and justified the institution's ultimate expulsion from the United States.

Regulatory Response

<u>*U.S. Supervisors*</u>

> "It is extraordinary that the Daiwa problem was missed for more than a decade in standard Federal Reserve exams. It would appear that more comprehensive examinations may be needed of foreign institutions, particularly those from countries lacking U.S. standards of transparency and regulatory discipline"
>
> Chairman James Leach, in hearings held by the Committee on Banking and Financial Services of the U.S. House of Representatives, October 16, 1995

U.S. regulators dismissed red flags that called for thorough investigation. This directly questions whether regulators fulfilled their duty to maintain the safety and soundness of the financial system in the U.S., and public confidence therein. In congressional testimony, Greenspan, Helfer, and Levin identified numerous areas where their agencies could improve examination procedures and offered the same explanation for past shortfalls. They acknowledged that examiners failed to pursue suspicious incidents but rationalize this on the basis of: a purported supervisory framework of trust between regulators and financial institutions, impairments in the capacity of examiners to detect outright fraud, parallel failures of external auditors to detect the cover-ups, and transitional costs of adjusting to the Foreign Bank Supervision Enhancement Act of 1991 (FBSEA) which mandated a significant increase in examinations.

Greenspan stated, "With the benefit of *hindsight*, there were some clues that were missed in the examination of Daiwa. With a more robust follow-up, the problem might have been found sooner. …Nonetheless, the bottom line is that we did not succeed in unearthing Daiwa's transgressions where we might have" (Senate, 30, 31; italics supplied). Directly addressing concerns about internal controls and risk-management systems raised by the Barings and Daiwa incidents, Greenspan continued, "Both cases demonstrate the need, once serious deficiencies in internal controls are identified, to ensure that relevant books and records are reconciled and verified in an expeditious and thorough manner" (ibid., 31).

Levin echoed, "With the advantage of perfect *hindsight*, one must conclude that there are areas where all regulators, including the Banking Department, can and must do a better job" (ibid., 49; italics supplied). Specifically addressing Iguchi's trading activities, Levin stated, "In *retrospect*, however, the Banking Department's scrutiny of the matter once it was apprised of the true nature of his activities was inadequate" (ibid., 53; italics supplied).

Finally, discussing Daiwa Trust, which was examined ten times between October 1984 and January 1994, Helfer stated, "In *hindsight*, there were sizable increase in holdings of U.S. Treasury bonds between March and June 1987, … , when bank management booked the securities that covered previously unbooked positions stemming from undisclosed trading losses" (ibid., 8; italics supplied). She also noted that such an increase could be noted under current pre-examination planning techniques, initiating closer scrutiny.

Each of these regulators allege that Daiwa's transgressions were only visible in hindsight. But disturbing incidents occurred that should have served as the catalyst for further investigation, most notably Daiwa's 1993 admission that it lied to the Fed during its examination. When questioned by D'Amato about the Fed's lax response to this criminal act, Greenspan asserted that the transgression did not appear to undermine the quality of the initial examination. He did admit, that "In retrospect, I think that whenever you realize that an institution says one thing that is clearly untruthful, the probability is that there are more untruths, which should have been a signal to us to examine further. At the end of the day, we did not, and in retrospect, that was a mistake" (ibid., 15).

If we delete the words "in retrospect," Greenspan's statement acknowledges that U.S. authorities were remiss in not following up troubling signals. Given the 12-year duration of Iguchi's scheme, U.S. regulators ought to have importantly restructured their information, monitoring, and incentive systems to minimize the chance that a similar experience might recur.

Officials in Japan

To their credit, Japanese authorities have proved far less accepting of the culture of regulatory cover-up than their counterparts in the U.S. Tokyo prosecutors have identified potentially corrupt links between financial institutions and regulators at the MoF and Japanese central bank. They have seized MoF and central-bank records without warning. Their investigation has resulted in arrests and resignations that challenge longstanding codes of corporate ethics. Prosecutors have charged (or, in a case terminated by suicide, prepared to charge) regulatory officials and even a parliamentarian with accepting bribes from institutions that taxpayers expected them to regulate.

III. Asian Values vs. Anglo-American Ethics

In both scandals, the Asian responses have put the governmental inquiries in the corresponding Western country to shame. The Bank of England Report on the Barings debacle assigns far too little blame to British managers and regulators for accepting defective data at face value. Similarly, in the Daiwa scandal, U.S. regulators made light of their nationals' own mistakes. They targeted no new reporting or administrative controls and took no disciplinary action against lax government officials. In view of the appointment of independent prosecutors for transactions whose financial consequences were small, it is striking that no independent prosecutor was asked to investigate influence peddling in either the S&L insurance mess or the Daiwa scandal.

Figure One

Manipulating a Bank's Incremental Income Statement to Conceal a Loss

Mislabeled Trading Loss:	-x
Specious Credit:	+x
Incremental Net Accounting Income:	0

Figure Two

Leeson's Accounting Schemes

Trading Losses Posted to Account 88888		-x
Margin Calls on Trading Position at α percent		$-\alpha x$
Funding From: Leeson's Commission Income (Feb. to Dec 1992) Premiums From Selling in-the-money Options (Dec. 1992 - Oct. 1994) Transfers requested from London (From 1993 on)	$+(1 + \alpha)x$	
Incremental Net Accounting Income Posted in Singapore		0

Figure Three

Daiwa's Accounting Scheme

Trading Revenue on Selected Securities (Posted as Other Revenue)	+x
Custody Account for the Same Securities (Not Debited)	
Surplus Available for Funding Other Losses	+x

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