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## WILL WE LEARN FROM THE BANKRUPTCY OF BARINGS BANK ?

by

**Yves-Marie Abraham**

Associate Professor, HEC Montreal

**Cyrille Sardais**

Associate Professor, HEC Montreal

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Report by Jacques Berthier

Translation by Rachel Marlin

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### Overview

How can one be sure that one is appreciated when one works in a bank ? The answer is by making a great deal of money for the bank. This is how the trader, Nick Leeson, became a star in the Singaporean subsidiary of Barings at the beginning of the 1990s. He made huge gains, but in fact his losses were much greater. He had found a great way of hiding the losses without anyone realising what was going on. No-one paid attention to the warning signals from outside the bank, and there were scarcely any alerts raised inside Barings. Why ? Because Leeson had made such a solid reputation for himself in the bank that no-one could possibly have imagined he was a fraudster (or 'imposter', to use the sociologist Goffman's vocabulary). Such misjudgement gives us food for thought, especially since the Barings' case closely resembles the Société Générale scandal at the beginning of 2008. Is it possible to prevent fraudulent dealings ? There are many reasons to make us doubt this.

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<sup>1</sup> This talk follows on from the article entitled "Pour une autre théorie de la décision, retour sur la faillite de la Barings (et de sa hiérarchie)" by the authors in the magazine *Gérer & Comprendre* (no. 92, June 2008). In light of the interest and current relevance of the article, the authors were invited to discuss this subject at the École de Paris. The *Club des Annales des mines* helped the École de Paris with the organisation and financing of this talk.

## TALK

**Yves-Marie Abraham :** On February 26th, 1995, Eddie George, the director of the Bank of England, officially announced the collapse of Barings following a series of unauthorised and unsupervised operations carried out by one of its traders<sup>2</sup>, Nick Leeson. Initially, losses were estimated at approximately £800 million, however it transpired that the real sum was £927 million, in other words, more than twice the equity capital of the company.

Thirteen years later, on January 24th, 2008, Daniel Bouton, the CEO of Société Générale, announced a loss of 4.9 billion Euros as a result of unauthorised operations carried out by Jérôme Kerviel, one of its traders.

There are three main differences between these two affairs.

In the case of Barings, everything took place in a very small subsidiary in Singapore, over 6,000 miles from the London office ; in the case of Société Générale, the event took place in the bank's chief trading room at the company's headquarters.

Whereas in 1995, people from the banking sector had been enthusiastic but lacked sufficient knowledge about derivatives<sup>3</sup> – a factor which Barings tried to use as an excuse for their collapse –, thirteen years later, a great deal of progress had been made in controlling financial mechanisms. Obviously, the Société Générale could not use this excuse.

Finally, as a result of the Barings affair, methods of monitoring events in banks were more carefully controlled, notably by creating a 'middle office' in order to control the work of traders in a much more direct and immediate way. The middle office is in the trading room between the traditional 'back office' and 'front office'<sup>4</sup>.

Despite this, and following the new scandal at the Société Générale, one might well wonder whether we have really learned any lessons at all from Barings' collapse.

### What went wrong at Barings ?

Nick Leeson came from a modest background in a suburb of London. He did not go to university, but dreamed of working in a bank. Having worked for Coutts & Company and then Morgan Stanley, he started in Barings' back office where he specialised in settling operations on derivatives, an activity which was relatively new at the time. He made a name for himself because of two remarkable achievements : in a very short space of time, he firstly administrated the handling of tens of thousands of outstanding securities (in Jakarta) which represented a potential loss of £100 million ; and secondly, he managed to identify how a fraud had been carried out and unmasked the guilty party.

#### *King Midas of the SIMEX*

Because he had become a successful specialist in the management of derivatives, he was one of the people Barings took on in their subsidiary, Barings Futures Singapore (BFS), in Singapore when it opened in 1992. His brief was to employ a group of traders working on the floor of the Singapore International Monetary Exchange (SIMEX), and to operate channels of communication between this team and traders operating in Japan, in order to take advantage of price fluctuations between these two places.

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<sup>3</sup> Derivatives : a contract between two parties, a buyer and a seller, which fixes the future financial flows of real or theoretical assets which may be financial (such as shares, bonds, Treasury bills, futures, currencies, market indexes, etc. ) or physical (agricultural or mineral raw materials).

<sup>4</sup> The *back office*, in charge of administrative and logistical functions related to sales, works with the *front office*, which is in direct contact with clients.

He proved to be very efficient and became general manager of this subsidiary in January 1993. He was voted Best Trader of 1994 by the SIMEX, and was not only heralded as a star in Singapore, but also in Barings. In 1994, he single-handedly made estimated earnings of £30 million out of a total of £50 million generated by his department. On February 24th 1995, he was promised a bonus of £450,000, in other words, nine times his salary and four times his bonus in the year before ! His superiors liked him because financially they also profited from his results. During this period, when Barings was not doing very well, he seemed to be a safe bet for the company.

### *The disaster uncovered*

When a considerable 'hole' was noticed in the subsidiary's accounts, Nick Leeson was called to a meeting on February 23rd 1995 at 3.30pm to explain this discrepancy. He arrived on time but he slipped away quite early on, on the pretext that he had to accompany his wife to hospital. The meeting continued without him.

At 9.30pm, Barings' headquarters in London was informed that the BFS general manager had left a meeting which had been called to discuss the missing sum of £100 million, that he had not reappeared and that it was impossible to reach him.

The first reaction of Barings' managing director was to order a search of the subsidiary's offices because he feared an embezzlement. At 3am, three Barings executives arrived at BFS' premises. They quickly discovered that financial operations involving considerable amounts of money had been concealed, that these operations had already incurred losses and that they might create even greater ones. They also found quite clear signs of fraud in the drawers of Nick Leeson's desk such as scissors, glue, and scores of signatures. At dawn, they informed the general management about their findings.

### *The 88888 account*

In the days which followed, they noticed that on July 3rd 1992, on the orders of his London superior, and using a standard procedure, Nick Leeson had created an 'error account', account number 88888. He had not cancelled it despite his superior's request for him to do so. Worse still, this account had been registered as a client account on the SIMEX at the end of August 1992. Its official account bearer was Barings Securities London, one of the bank's entities. However, apart from the daily amount attributable to margin calls<sup>5</sup>, any information about this account which has been transmitted every day to London, had vanished since July 8th 1992.

### *Nick Leeson's unlawful activities*

It was from this date that Nick Leeson had started to use this account, both to enable him to make long-term speculations and to sell options<sup>6</sup> (extremely risky operations which he was forbidden to carry out). It was also used to conceal his losses because of his other position : in the mornings, as head of the front office he took part in transactions, and in the afternoons, he was the person in charge of the back office. In this way, he was able to ascribe any losses made to the 88888 account and any gains made to official accounts ! He was therefore guilty of forgery and use of false documents.

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<sup>5</sup> Margin call : on the derivatives market, the margin call corresponds to the obligation to supply the funds necessary and serves as a guarantee to the buyer or the seller that any potential losses can be covered.

<sup>6</sup> Option : a derivative which enables one to bet on the future price of a financial asset with a view to speculation or insurance.

## **An incomprehensible ‘failure’**

How was all this possible ? Two hypotheses immediately come to mind.

*Were Leeson’s superiors accomplices to this crime ?*

The first hypothesis is that Nick Leeson’s superiors had to be ‘in on it’. This presupposes that Barings accepted money which Nick Leeson earned for the bank, but this was never the case. Furthermore, during the lengthy investigations carried out in this affair by the Bank of England and by the Singaporean Ministry of Finance, the hypothesis of collusion on the part of his superiors was examined but, after a year’s investigation, was dropped due to lack of evidence.

*A brilliant fraudster ?*

The second hypothesis is that Nick Leeson was such a brilliant swindler that he had left no trace of his illegal activities.

In fact, there had been numerous warning signals : the Bank of England found nine. These included the considerable gains amassed by Nick Leeson which should have alerted his superiors, because his arbitrage activities, albeit very profitable, could not have made such substantial gains.

At the end of 1994, several managers at Barings were contacted by rival banks and by the Bank for International Settlements in Bale, Switzerland about persistent rumours concerning Barings’ positions on certain Asian markets, rumours according to which the positions adopted were so important that Barings would not be able to honour its commitments were the market to suddenly experience a downturn.

More importantly, there was written evidence. In September 1993, the SIMEX wrote an official letter to Nick Leeson’s superiors mentioning the 88888 account and reporting irregularities carried out by the team he managed. A similar letter was sent to Nick Leeson’s local superiors in Singapore in mid January 1995, followed at the end of January, by a third letter outlining the important significance of the positions managed by Leeson and asking Barings to confirm its capacity to honour the commitments taken by its star trader. In August 1994, an internal audit, which noted with surprise that Nick Leeson was responsible both for placing market orders (in the front office) and monitoring them (back office), sent a written report about this to Barings’ headquarters. At the end of January 1995 in a letter sent to Nick Leeson’s superiors, external auditors reported a discrepancy of £50 million in the BFS accounts for 1994. Finally, on February 1st 1995, in a letter sent to Barings, the Bank of England noted its concern that Barings’ commitments in Asia greatly exceeded the authorised limits.

*Our research question*

How was it possible that Nick Leeson’s superiors allowed him to continue to act freely until February 23rd 1995 despite these alarm bells ?

Most of the research workers who have looked at this case have not considered this question because they have concentrated primarily on the deficiencies of management in not reacting despite the monitoring systems functioning correctly.

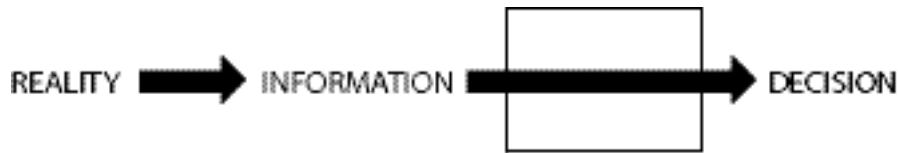
Only a few researchers have tried to take this factor into account, but their explanations regarding the enigmatic attitude of the management are very complicated and not very satisfactory. Why ? Because they are based on the current prevailing view that decision-making is essentially a process of information handling. For these researchers, the attitude of Nick Leeson’s superiors constitutes an enigma. We, however, do not consider it an enigma but an anomaly, to quote the distinction put forward in Thomas Kuhn’s *The structure of*

*scientific revolutions*<sup>7</sup>. This anomaly stimulates us to resort to another view of decision-making, or even to change paradigms. In any case, this is what we suggest.

### Another view on decision-making

We refer to the work of Andreu Solé<sup>8</sup> who differentiates between the model of the transparent box and that of the black box.

#### *The transparent box*



In this model, reality, which is independent of the decision-maker, is nevertheless obvious to him. The right decision is one which initially consists of informing oneself about this reality. In a way, the decision-maker is a transparent box because, regardless of other elements, it is the information which will automatically determine the decision. It is a realistic, sequential and determining model.

According to such a model, the decision of Nick Leeson's superiors to allow him free movement until February 23rd 1995 is incomprehensible. They clearly had enough information to react much earlier.

#### *The distorting box*

Reading the works of researchers who have attempted to take into account the alarm signals, we noticed that their decision-making model was not as improbable as that of the transparent box. This prompted us to suggest an intermediary model which is just a sophisticated variation on the first model.



In this model, the decision is shaped by information concerning reality, but the decision-maker suffers from problems of perception, notably due to his psyche and because of his social interactions. These dimensions always create a risk of distortion of information and therefore decisions made from this information are more or less coherent.

The decision to allow Nick Leeson to continue to act freely still remains difficult to understand, even with this model. In our opinion, the most interesting author to comment on this event is Helga Drummond<sup>9</sup> who cites fourteen psycho-sociological factors in an attempt

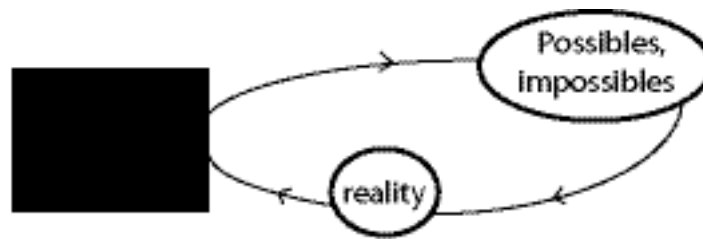
<sup>7</sup> Thomas Samuel Kuhn, *The structure of scientific revolutions*, 1962. French translation: éditeur Flammarion, collection Champs, (poche) 2008.

<sup>8</sup> Andreu Solé, *Créateurs de monde. Nos possibles, nos impossibles* (Éditions du Rocher, 2000).

<sup>9</sup> See : Drummond, Helga (2002). "Living in a fool's paradise : The collapse of Barings' Bank", *Management Decision*, London, Vol. 40.

to explain the attitude of Leeson's superiors, an attitude where, in the end, all links between the information and the decision have disappeared. This led us to a third model which Andreu Solé called the black box model and which we refer to as the 'imagining' box.

### *The 'imagining' box*



Whereas in the previous models, information more or less determines the decision, here this is not at all the case : the relationship between the decision and information is completely reversed. To start with, there is the decision-maker's black box. It is black because it is fundamentally inexplicable. Any decision emanating from the black box is the result of 'possibles' and 'impossibles' which the decision-maker chooses all the time in a non-conscious way.

According to Andreu Solé, a 'possible' is a conceivable, imaginable, thinkable event, whereas an 'impossible' is an inconceivable, unimaginable, unthinkable, inexpressible event.

Nick Leeson's superiors let him act freely until February 23rd 1995 because they had 'decided' subconsciously that it was impossible for him to be an impostor.

### **An unimaginable fraud**

**Cyrille Sardais :** Our idea was to look at the decision-makers of the time with empathy, by asking ourselves how was it possible for them to have been fooled like this, and why the signals which they certainly received did not prompt any reaction.

In order to imagine the world in which they lived, we chose to identify some of the 'possibles' and 'impossibles' which Nick Leeson's superiors chose. Of course, there is a problem in considering these people 'en bloc' as they did not all necessarily think the same thing, but our sources do not enable us to analyse them individually.

### *Nick Leeson's trading<sup>10</sup> talents*

For us, Nick Leeson's superiors were absolutely certain about three fundamental factors :

It was possible to earn a great deal of money purely by arbitrage (and impossible to become worried if one earned a great deal of money).

Arbitrage consists simply of buying and selling the same asset at the same time on two different markets, and taking advantage of the small differences in prices. It is an activity which earns money on a regular basis, but never amasses enormous sums. Objectively, it was impossible that arbitrage alone could bring in approximately 30 % of the profits of all Barings' trading activities. However, the Barings' managers thought it was possible.

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<sup>10</sup> Trading : activity of commercial transactions on the stock exchange.

In all the analyses made after the affair was uncovered, the investigators kept on asking people the same question 'Did you not find it surprising that someone carrying out the arbitrage earned so much money for the bank ?' Among the answers were the following :

- 'It's true that it was a surprise but a very nice one.' (Peter Baring) ;
- 'I told myself that Nick was in a period of grace and that everything he touched turned to gold.' (Ron Baker) ;
- 'He was able to earn \$10 million in a week solely by arbitrage on the SIMEX... There were Salomon Brothers and CRT with their computer systems and their years of experience and here he was, making more money than either of them ! It looked like turbo-arbitrage to me ! How did he do it ? Incredible !' (Mike Killian).

It was impossible or apparently inconceivable that Nick Leeson was anything other than an excellent trader.

He was the one who, after all, carried out the greatest number of activities on the SIMEX in 1994 and had the biggest profit in the whole structure. The only criterion on which a trader is judged is his results, and his were exceptional. As others commented,

- 'We just need about ten Nicks to save the bank.' (Mike Killian, a manager) ;
- 'The only opinion we had about Nick's work was : For heaven's sake ! Let him get on with it !' (Andrew Fraser, another manager) ;
- 'We thought of him as an angel sent from heaven.' (Fernando Gueler, who later had to calculate the losses made by Nick Leeson) ;
- 'He was a kind of Midas. Everything he touched turned to gold [...]. It was as if he was able to make the markets move by himself.' (a trader on the SIMEX).

It was possible that Nick Leeson was poached by Barings' rivals.

In James Baker's 1994 internal audit report, he wrote 'Even though there is a strong sense of cohesion in the team, the loss of Nick Leeson to a competitor would result in a strong erosion of the profitability of Barings Futures Singapore.' Clearly, his superiors had absolutely no desire to upset him, for fear of losing the goose that laid the golden egg.

#### *Nick Leeson's personality*

His superiors also made hypotheses about Nick Leeson's personality. Mary Walz, an executive at Barings, said 'People asked a few questions, but to go any further would have meant that we presumed Nick was a crook.' They did indeed ask themselves whether Nick Leeson could be a thief or a crook but they 'decided' that it was impossible for him to be an impostor.

The internal audit report, published nine months before the discovery of the facts, states 'On the other hand, there is a more generalised risk : these controls could be misused by the general manager, Nick Leeson. As the person in charge of both the front and back office, he is in a position to place market orders on behalf of the group and to ensure the registration and settlement as he sees fit.'

Thus, the managers were aware, but what was the risk ? They considered that the only possible risk was that the general manager embezzled money for himself. This is why the Barings managing director in London ordered a search of the Singapore office on the evening of February 23<sup>rd</sup> 1995. What was discovered turned out to be much worse.

#### *Nick Leeson's activities*

Nick Leeson's superiors' greatest mistake was to assume that there was necessarily a client behind a client account. Yet this error was logical because on the one hand there are the bank's own accounts, and on the other, client accounts which the bank manages in its capacity as a broker.

His superiors also judged that it was impossible for Nick Leeson to carry out risky operations or to conceal losses. In order to do so, he would have had to manipulate the bank's own accounts, whereas the only accounts to which he had access were the arbitrage accounts.

Actually, he did not use the arbitrage accounts for this purpose. He pretended to be a broker acting on behalf of a client when officially placing orders, by writing options and selling derivatives in the name of the 88888 account. This is what allowed him to carry out this brilliant fraud, a fraud which allowed him to make all his losses vanish, and to carry out risky operations - the worst possible nightmare for the bank's managers. Alas, there was indeed a client behind this account : Barings itself !

### **'Invisible' alarm signals**

Let us try for one moment to put ourselves in the position of these managers and see how, with these 'possibles' and 'impossibles' they could have interpreted the different signals they received.

#### *Letters from the SIMEX about the 88888 account*

Poor client ! The bank has made input errors regarding placement brokerage orders which Nick Leeson will have to correct. Of course, these errors must stop, but he certainly does bring in a great deal of money for the bank, and, poor thing, he works so hard !...

**Yves-Marie Abraham :** Another consequence of these 'impossibles' was that Nick Leeson himself was asked to reply to the first two letters from the SIMEX about the irregularities on the 88888 account which were discovered by the auditors. His boss simply signed this letter.

#### *The internal audit report*

**Cyrille Sardais :** The internal audit report showed that the problem was that the same person was in charge of both the front and the back office, even though Nick Leeson's activities were strictly supervised. It is almost inconceivable that he might hurt the bank just by arbitrage, as well as the fact that the monitoring on these accounts is very strict both in-house and externally. In any case, since the subsidiary is profitable, there is no cause for concern. The internal audit report is not thought to have suggested that anything was wrong.

Actually, the controls were carried out very frequently, and, once the positions judged to be much too risky as a result of the margin calls sent to Nick Leeson and to Barings, Nick Leeson was forced to input funds in order to cover these calls and to convince his superiors of the legitimacy of his operations.

#### *External concerns*

What was the Baring management's reaction when they were contacted by the Bank for International Settlements at the end of 1994, regarding a major problem concerning Barings' positions in Asia ? 'We were very worried, not about the positions themselves, but what the market might think about us because of the rumours circulating about Barings which said that we had taken huge positions and that we had a client who was not going to be able to cover the margin calls. Our major preoccupation was our image and reputation.'

When, a few weeks later, the SIMEX, which knew that the client in question was Barings, sent Barings a letter stating 'you hold very important positions in Singapore', the Barings' management received this information and thought, in an unbelievable misunderstanding, that the bank was holding them for a client without realising that the client was Barings itself !

A few days later, when the letter from the Bank of England arrived informing them that Barings' commitments in Asia had reached three times the authorised limit and asking Barings to lower its positions, the bank promised to do this but there was no sense of urgency



because these were only arbitrage operations. At the worst, Barings thought it was going to lose a few pounds here and there, but there seemed to be no cause for any concern.

Obviously the missing £50 million which quickly became £100 million started to become a problem. It was linked to the margin calls. As the losses started piling up, so did the margins calls and Nick Leeson could not finance them any more.

### *Epilogue*

On January 17th 1995, an earthquake claimed 6,000 lives in Kobe, one of Japan's major industrial cities. The Nikkei index collapsed in the days which followed. This exacerbated Nick Leeson's losses and led to his downfall because he had banked on the stability of this index. If the earthquake had not happened when it did, or if Nick Leeson would have been able to reverse his position just after the earthquake, today we would have been talking to you about a Nick Leeson, 'hero of the Far East', managing director of Barings London, the man who earned the greatest amount of money on the derivatives markets in Asia in the 1990s.. Instead, because he decided that he could no longer remain an impostor, he fled Singapore on February 23rd 1995 and ended up in prison, What might have been !

### **What next ?**

Even though our work concentrates on the problems, we have tried to put forward possible solutions.

#### *A little more humility*

This case show that we should be more humble by recognising that we are generally incapable of spotting frauds, and the people likely to be impostors. This is relatively probably so in the case of Jérôme Kerviel (Societe Generale), and undoubtedly so for Nick Leeson. There is contempt for these vulgar little arbitragists who "do not even have university degrees, have no standing, and who, on the face of it, appear to be incapable of causing a great deal of damage, but who hold the cheque-book in the back office".

We should also show some humility about our capacity to implement control systems which keep us safe from dangers created by the deregulation of financial markets. What Nick Leeson was able to do would have been impossible fifteen years earlier, when the banks either acted as brokers or operated own-accounts. He took advantage of a loophole because he was involved in both brokerage and trading, which therefore enabled him to use the brokerage to do the trading. Without this deregulation, the fraud would not have been possible. Let us be clear : it is the deregulation which created the conditions for the fraud. Nick Leeson's superiors had not moved on from the previous 'impossible' rules where brokerage and trading did not communicate because they are two different worlds.

Société Générale is coping well because it is a deposit bank whose financial resources are kept afloat by the savings of millions of clients. If this had not been the case, Société Générale would be dead like Barings. This worries me. If Jérôme Kerviel was able to lose 5 billion, he could equally easily have lost 50 billion, and, in that case, not only would Société Générale have collapsed but so would the clearing system and the entire French financial system. We have to admit that we are not able to control all of this and that we have to act accordingly.

#### *A little less control ?*

Another possibility is to envisage reducing controls. This may appear provocative, because after the Barings scandal, most people wanted more controls. Let us not forget that control is not only technical, but also social. In these institutions, this sort of control acts not only as a carrot – the bonuses can be colossal –, but also as a stick – all the employees know that they can be sacked overnight. It is therefore very powerful, with all the harmful effects which one

can imagine. Nick Leeson knew he would be sacked if he made losses, so he made sure that they never appeared.

As for technical control, one should be careful not to put too much faith in it, because this is precisely what impostors know how to misappropriate. Nick Leeson used his knowledge of the control system of his bank well enough to slip through the net, and it appears that Jérôme Kerviel did so too<sup>11</sup>.

### *Imagine first ; control later*

One can only control what one imagines needs to be controlled. In some ways, our system of control is a concrete manifestation of what we consider 'possible' and 'impossible'. We should start by revising these aspects, rather than saying 'we need more control', and ask ourselves whether it is really impossible for the danger to come from routine, non-risky activities. Arbitrage is considered to be the less risky part of a bank's trading activities and yet this is where the fraud took place twice.

One should also be wary of supposing that it is impossible for the danger to come from a trader who has no stature. Nick Leeson was a mediocre – or even a very bad – trader, but his deception was brilliant and he worked very hard so that it could not easily be detected. He spent his days doing disastrous trading and his nights doing extraordinary back office work<sup>12</sup> !

One must not forget that the banks' control system are very efficient in spotting thefts, embezzlements and many other things like this, but not for spotting fraudsters.

### *Questioning what we think is certain*

Reconsidering what we judge 'possible' and 'impossible' poses several questions.

How should we reconsider them without causing ourselves such anxiety that we are prevented from making a decision ? Ever since I read Christian Morel's excellent book<sup>13</sup>, I assess all the risks when I fly and consequently I do not enjoy my flight so much !

At the same time, are not the managers being paid precisely to worry for others ? Barings' employees and shareholders undoubtedly regret that their managers were not sufficiently worried !

Who is going to do it ? It would be pointless to ask one's management committee to give their opinion on their superiors' mindset because they know that they would merely agree with each other and one would go round in circles. If one employs an external consultant who knows the sector's best practices, the result will be the same : one will simply reinforce what we know and keep the circle turning. The 'king's fool' is perhaps a solution : this is someone who dares question what others take for granted and who protects us against ourselves.

When should this take place ? Should it be when people are confronted with impossible contradictions which prevent them from taking action ? Or when everything seems totally normal ? This, according to Erving Goffman<sup>14</sup>, is a clear sign that one should start getting very worried...

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<sup>11</sup> See Helga Drummond's excellent essay entitled "Did Nick Leeson have an accomplice ? The role of information technology in the collapse of Barings Bank", *Journal of Information Technology* (London, 2003), Vol. 18.

<sup>12</sup> In fact, he started his back office activity in the afternoons as the Singapore stock exchange closed very early.

<sup>13</sup> Christian Morel, *Les décisions absurdes* (Gallimard, Bibliothèque des Sciences Humaines, 2002).

<sup>14</sup> Erving Goffman, *Relations in public* (Basic Books, New York, 1971).

## DISCUSSION

### The trap of the 'impossibles'

**Christian Morel :** *Representation errors are strongly influenced by collective mechanisms. Here are a few examples.*

*One of the two engines of an aeroplane catches fire in flight. The co-pilot turns off the one which is working by mistake, but interprets a gesture made by the captain as confirmation that the engine on fire has been turned off. As a result, both find the reduction in vibrations normal, whereas it is in fact due to the aeroplane's loss of altitude. Neither ever imagined it was possible to commit such an error. They influenced each other in a negative way.*

*The designers of Nasa's Challenger shuttle thought it was impossible for there to be cold spells in Florida. Consequently, the shuttle's booster joints had not been built to withstand low temperatures. However, on launch day, it was very cold, and the engineers knew that the joints would not withstand the cold. Nasa management did not want to cancel the launch in the absence of any data proving that the joints would not function, data which the engineers did not have as they were so convinced that it was impossible for it to be so cold in Florida. It was this collective mechanism which was at the origin of the catastrophe.*

*Imagine a group of ten people, seven of whom say that something is impossible, and three who say nothing. Why? Because none of the three people dares to speak, believing that he is the only one who thinks that it is possible. Consequently, it appears that the group's opinion is unanimous.*

*In extremely reliable organisations, a great deal of emphasis is put on collective mechanisms, precisely to correct or to make representation errors impossible. Korean Airlines reduced the number of accidents on its flights once it was decided to authorise the co-pilot to tell the captain if he thought that the captain was obviously committing a representation error.*

**Cyrille Sardais :** In fact, our 'possibles' and 'impossibles' are in general shared collectively. Links between the individual and the group are fundamental and are a source of strength. One starts to create a world and then gradually one uses the events which take place to consolidate it until it is solidified. Unlike children, for whom nothing is normal and everything is a source of wonder or question adults convince themselves collectively of what they consider to be normal and what is not.

**Yves-Marie Abraham :** This is exactly what happened at Barings, as a result of this practice of collective confirmation of events without anyone ever asking one or two awkward questions which might have changed the course of events. In finance, it is impossible not to be happy when one makes money, but in the case of Barings, one should have done the opposite, and started worrying. If modern finance, as a scientific discipline, has taught us only one thing, it is that there are no big profits without big risks (or without big fraud, one might add!).

While I was studying this scandal, I often thought about the Andersen fairy tale, 'The Emperor's New Clothes', in which two crooked tailors persuade the emperor and his court that the clothes which they are going to make him will only be visible to intelligent people. When a young child sees the emperor 'dressed' in his 'clothes', he spontaneously says 'he's naked!'. No-one had dared to say so, for fear of appearing stupid.

### The king's fool

**Question :** *The child in this example is the 'king's fool' which you suggest as a possible solution. However, unless these sorts of people benefit from a well established social status, they cannot last in our organisations because organisations eliminate the heretics and clowns so that such fools cannot distort decisions.*

**C. M. :** *The problem is that one should not only alert people about the error, but translate the error into the language of those who commit it, so that they also can understand it. For example, in the case of the Challenger, the engineers said that, because of the cold, things*

were not going to work, but having been surprised by the cold, they had not carried out any tests. The managers did not listen to them because they could not prove it scientifically, in other words, using Nasa's scientific and technological language.

**Andreu Solé** (professor at HEC) : *The last fool in Europe was at the court of Frederick II. Like all kings, he tried not to be greatly influenced by courtiers. With this in mind, the role of the fool was created, a different function from that of a although there is an element of overlap. Who did he choose to be his fool ? Having closed a university which opposed him and forced the person who had the greatest influence in this university to live like a homeless person, he summoned him to his palace two years later to tell him 'Now, you are my fool.' He was his own man, without superiors, but he drowned his freedom in alcohol !*

*Did you know that there is a fool at L'Oréal ? Immediately after he took up his position in 1988, Lindsay Owen-Jones, the CEO, asked one of his executives to be his fool. He was free and without any superiors. For example, when the idea of establishing the company in China was in everybody's thoughts, the fool said 'But why do you want to go to China ? To be like everyone else ?' Now, there's a way to inject some freedom at the highest possible level. Kings felt the need to do this, and this historical perspective perhaps allows us to ask questions which are more in keeping with what we are currently experiencing, at a time when there are mercenaries who have undoubtedly less freedom than ten years ago.*

### **Inherent risks in problems**

**Q. :** *You often talk about control, but this word covers two very different concepts, verification and mastery. Six months before the American subprime mortgage crisis hit, a writer described the mechanism in detail, and he was not the only one to predict what was going to happen. We were still unable to deal with the situation.*

*As a long-term forecaster, I work a great deal with things which are 'very improbable', rather than with the 'impossible', which is unusual. There are methods which allow groups or managers to envisage the very improbable, but I am not sure that their implementation is in line with standard procedures of decision-making.*

**C. S. :** The historian, Paul Veyne<sup>15</sup>, makes the distinction between risk, uncertainty and the unknown. Risk is when one knows the probability that something will happen to us (such as falling into a crevasse when crossing a glacier) ; uncertainty is when one knows what might happen to us but one does not know the probability ; and the unknown is when one does not even know what might happen to us, such as when one arrives for the first time on another planet. One can manage risk, perhaps uncertainty (if that !), but certainly not the unknown. In the case of Barings, the managers thought they could manage the standard risks but they found themselves, without really realising it, in the unknown, a new planet, one of deregulated finance where a broker could also be a trader.

### **Was the hierarchy an accomplice ?**

**Q. :** *You have done a painstaking job on the official documents, but you presupposed that the managers told the truth. I think that they preferred to appear foolish rather than dishonest. I also think that these managers, who should have saved the bank, in fact adopted the strategy 'damned and be damned'. They knew that Nick Leeson was certainly not very honest, but twenty years ago, when the trading floor still worked at the Stock Exchange, a trader with his handful of orders, played for himself, his client and the bank which employed him. Since he was not paid enough, he put operations he had made for his client and vice versa on his own account from time to time. This helped him earn a little more money. Medium-sized fraud was institutionalised, it was part of the salary, dare I say.*

*But the bank was not doing well. We know that when a bank is worth -10, it will accept a project which earns 20 with a 10 % probability and which loses 100 with a 80 % probability because it is the only way to survive. Therefore, I consider that it was possible that the Barings' managers thought that the situation was critical. They sincerely hoped that it would right itself without knowing how this might come about, but they were aware that if they did*

<sup>15</sup> Paul Veyne, *Comment on écrit l'histoire* (Le Seuil, 1971).

*nothing, they were dead. Consequently, they might as well attempt to do something rather than do nothing, such as allowing Nick Leeson all the freedom he wanted...*

*The subprime crisis was a consequence of the abolition of the Glass-Steagall Act in 1933 which established an incompatibility between the role of the deposit bank and that of the merchant bank. In 1986, the American lobby obtained this deregulation to allow the merger of Citycorp with Travelers Group, in order to create Citigroup which, in the end, suffered the most from this crisis. If one wants to avoid problems, regulations are fundamental. The roles of broker and trader must be compartmentalised so that an internal control for each of these is naturally put in place.*

*Finally, I must emphasise that the people at the SIMEX did not do their work properly by accepting supplies of equity from Barings when there were margin calls : they should have asked for Treasury bonds. The SIMEX is equally guilty in this affair.*

**Y.-M. A. :** The SIMEX, a private company, was also criticised for never having exchanged information with its Japanese rivals (which would undoubtedly have been sufficient action to uncover the fraud), and having communicated with the Barings' headquarters too late. Apart from very clear faults of internal management, one can also question almost all the authorities involved in this affair.

As for the deregulation, it also allowed the merger between the merchant bank, Barings Brothers, and a stock exchange company, Barings Securities, which literally was able to pump the funds of the merchant bank, making it bankrupt, which was impossible five years earlier.

**C. S. :** As far as the complicity of the hierarchy in this affair is concerned, Barings managers knew very well that Nick Leeson was making mistakes, and they thought – wrongly – that he was embezzling money for himself. They were certainly accomplices in the sense that they gave him too much room for manoeuvre, and accepted his explanations without batting an eyelid, but they were not accomplices in the fraud itself. On the evening of February 23rd, they were as surprised as anyone to discover what had taken place. They only realised what had happened on the morning of February 24<sup>th</sup>. On the 26th, the bank had collapsed. They had never been in a situation to say to themselves 'there are huge losses, we shall risk everything to try to save things.' When they did eventually think of this, the game was already over.

### **The impostor**

**Q. :** *How can you say that Nick Leeson is an impostor ? To say that someone is an impostor, one must first agree on the assessment criteria. In the world of finance, the principal criterion of appreciation is often the amount of money earned, but no-one ever asks the question about the risk taken in order to earn it. And yet this is the factor we should use to assess things objectively. When an impostor is uncovered, there is a tendency to clear the name of other people. However, they are also responsible because they made the fraud possible. And when they then say that they have been swindled by a brilliant person, this does not help us to learn for the future.*

*We get to a point where we are in a mindset which is a bit frightening, because I fear that it will end up by being counterproductive in the final analysis of what could be done to improve things.*

**C. S. :** But this theoretical analysis is undoubtedly one which permits the least excuse for the managers. They were taken in by a brilliant impostor, but their 'possibles' and 'impossibles' are the result of their own decisions. From this point of view, they are completely inexcusable and carry the responsibility of the collapse of Barings. Other people in their place would have taken other decisions and reacted differently. This is undoubtedly the only approach which takes the managers seriously by considering them free and responsible.

**Q. :** *Would you say the same about the Société Générale managers ?*

**Y.-M. A. :** For us, Nick Leeson was an impostor from the moment he produced positive results, whereas in fact he had accumulated only losses. He succeeded in presenting himself as one of the stars of the bank whereas he ended up destroying the bank.

In reading the works of the sociologist Erving Goffman on 'frame analysis'<sup>16</sup>, one comes to the conclusion that we are all impostors. For example, some of you around this table are undoubtedly starting to get tired and are pretending to listen to me. Deception is everywhere !

**Q. :** *Nils Brunsson<sup>17</sup> considers that hypocrisy is part of the essential functioning of organisations, which includes fraud in everyday circumstances.*

**Y.-M. A. :** Erving Goffman also said that reality escapes us, and William Thomas, another American sociologist, said that we are condemned to live on hypotheses. An impostor plays with these hypotheses which is very worrying because by comforting them, he takes advantage by doing the opposite, in other words something other than that which we expect. Erving Goffman takes the following example : on the battlefield, the impostor is the one who acts as if he is dead ; he tries to comfort the person who attacked him in his hypothesis that he did indeed kill him.

In reality, I am very pessimistic because in my opinion one can do nothing in the face of an impostor, simply because he constantly uses 'weapons' against us which allow us to exist in our everyday world.

### **Twilight of the enlightenment**

**Q. :** *Your work seems to me to be a twilight episode of the religion of enlightenment. It effectively shows three defeats of reason : the fraud of Nick Leeson was made possible by the increase in new information technologies ; the Barings' managers were fooled like absolute beginners ; and the guilty person was particularly intelligent.*

*In the face of such defeats, the only current remedy is the principle of precaution. But why did we grasp this catastrophic solution which consists of abstaining from doing anything when we are ignorant ? It is because we have lost our imagination, the magic, the sacred, the categories of pure and impure... If Nick Leeson had been an elected representative, a priest or an aristocrat, he would not have done this because by doing it, he would have lost much more than what he could have hoped to gain : he would have been dismissed from where he was. The emergence of religious fundamentalists is perhaps a response, even though it is a clumsy or even a brutal one, to this twilight of enlightenment.*

### **Remarks by Andreu Solé**

**A. S. :** *There is a strong link between my colleagues' talk and my research. Here are some brief remarks on some important phrases.*

*'Language creates reality.' If one keeps repeating that Nick Leeson is a star who is capable of earning a great deal of money for the bank, then one creates a collective reality, and, consequently, one has to be extremely sure of oneself to persuade people to think anything different.*

*'The world already exists even before one starts thinking.' This is the opening phrase of Merleau-Ponty's work entitled 'Phénoménologie de la perception'<sup>18</sup>. When I think, I am already in a reality which I do not see and in this reality, I become restless. For example, this reality is the way in which I look at my children or I listen to my students.*

*'We are beings who have an imagination' (Paul Valéry). The 'possibles' and 'impossibles' come from neither experience, nor analysis, nor reason. It is the constant work of a non-conscious imagination. This is paradoxical because, by definition, the imagination is the formation of conscious images. The September 11<sup>th</sup> investigation committee came up against a big conceptual problem. About ten people, with a small amount of imagination, managed to carry out these attacks whereas huge amounts of data were right under our noses. How does*

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<sup>16</sup> Erving Goffman, *Frame analysis : an essay on the organisation of experience* (London, Harper & Row, 1974).

<sup>17</sup> Nils Brunsson, *The Organization of Hypocrisy : Talk, Decisions and Actions in Organizations* Copenhagen Business School Pr; 2<sup>e</sup> edition, 2003.

<sup>18</sup> Maurice Merleau-Ponty, *Phénoménologie de la perception* (Gallimard, 1976).

*one cope with this ? The human imagination is fundamental ; information only comes afterwards. All the intelligence services (in the police, the army, and so on) ask questions like this.*

*After the Société Générale affair, politicians and people directly concerned let it be known that this will happen again, without suggesting any sort of serious remedy. As far as I am concerned, I wrote an article entitled 'Do we really want to avoid financial follies ?' In fact, no-one wants them, because in order to get to that point, one would have to follow Aristotle's recommendation : 'prevent the bad art of creating riches', or, in other words, 'make sure that money does not make money'. And yet, for us, 'it is impossible not to want money to make money !' As long as we do not raise questions about this, we will endure financial follies which will lead to even more unemployment, poverty and cynicism. I sent my article to all the big French daily newspapers. Not one published it...*

Presentation of the speakers :

Yves-Marie Abraham : associate professor at HEC Montreal. He is a teacher and researcher in the sociology of economics. Before obtaining a PhD in management science from HEC Paris, he studied classics and then sociology at EHESS Paris (École des Hautes Études en Sciences Sociales). He was also worked for the SOFRES group (polls and research) as an engineer in marketing studies for a number of years specialising in internal corporate surveys.

Cyrille Sardais : associate professor at HEC Montreal. His research is based on problems facing managers in relation to leadership and decision-making. Having graduated in history from EHESS Paris (École des Hautes Études en Sciences Sociales) and then from HEC Paris, he wrote his PhD thesis on Pierre Lefauchaux, the first CEO of Régie Renault, and attempted to write it from both a manager's and an historian's point of view.

Translation by Rachel Marlin (rjmarlin@gmail.com)