



Case Study: Nick Leeson and Barings Bank

Perhaps romanticized through its foreign intrigue and visions of a rogue trader fleeing to international waters on his yacht, the case of Nick Leeson and Barings is simply one of a system that failed to align corporate risk taking goals with incented and implicitly “approved” behavior.

Leeson had escalating risks and hidden losses (over US\$1.3 billion) that took down the oldest bank in England. The demise ultimately came from excessive trading positions, which came about from a sense of ‘approval’ of his trading activity that came about because of the lack of management discovery about his initial losses and that in the middle of the mounting real losses, the Barings Board discussed what steps they might take to protect Leeson’s market share from their competitors, not how they might provide better oversight to his office.

Humans have been demonstrated to show an extraordinary tendency towards loss avoidance. We don’t want to realize losses, so we tend to let them build. It is a widely known oddity of probability theory that in a fair game, if you keep doubling your bets, you will always come out ahead. Yet, unlike trading houses and banks, this mathematics game is not constrained by liquidity or capital.

As losses on previous trades mounted, Mr. Leeson kept increasing the size of his trading

positions, waiting for the market turnaround that would more quickly return his trades to profitability.

Leeson was able to hide his losses, because he controlled and cheated the reporting system from his office. To keep his secret from management, he created a fictional trading account #88888 in which he could place offsetting trades that seemed profitable. The losses became so large that he had to resort to taking activities “underground”.

Ultimately, while he was able to beat internal systems, when he reached the real-world liquidity constraints from his counterparties, he faced an end to the game and so too did his employer.

Barings was shut and Leeson went to jail.

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