INSTITUTE OF ACTUARIAL & QUANTITATIVE STUDIES

Class: TY BSc

Subject : Risk Management & Investment Management -1

Chapter: Unit 3 Chapter 1

Chapter Name: Case Studies – Financial Disasters

Topics to be covered

1. Financial Disasters

2. Operational Risk
    1. Chase Manhattan & Drysdale Securities
    2. Kidder Peabody
    3. Barings
    4. Harshad Mehta Case
    5. Ketan Parekh Case

2.3 Barings Bank

What Happened?

- Jack Leeson, a relatively junior trader at Barings Bank , was supposed to be running a low-risk, limited return arbitrage business for Barings in Singapore but was actually taking increasingly large speculative positions in Japanese stocks and interest rate futures and options. The incident involved the loss of roughly $1.25 billion due to the unauthorized trading activities.

What was the cause?

- Leeson disguised his speculative position taking by reporting that he was taking the positions on behalf of fictitious customers. By booking the losses to these nonexistent customer accounts, he was able to manufacture fairly substantial reported profits for his own accounts, enabling him to earn a $720,000 bonus in 1994.
- He worked hard at creating false accounts and was able to exploit his knowledge of weaknesses in the firm's controls. This was a deliberate fraud with a lot of management disregard to oversight.

2.3 Barings Bank

What could have been done better?

- Barings' management ignored every known control rule and failed to act on myriad obvious indications of something going wrong. This could have been easily avoided.
- Leeson functioned as head of trading and the back office at an isolated branch. Even when auditors' reports warned about the danger of allowing Leeson to settle his own trades, thereby depriving the firm of an independent check on his activities, Barings' management persisted in their folly. Equally damning was management's failure to inquire how a low-risk trading strategy was supposedly generating such a large profit.

Result:

- The size of the losses, 1.25 billion $, relative to Barings Bank's capital along with potential additional losses on outstanding trades forced Barings into bankruptcy in February 1995.
- The Dutch bank, ING bought it out for a nominal $1 valuation while a lot of Leeson's colleagues lost their jobs in the process.

2.4 Harshad Mehta Case

What Happened?

- Harshad Mehta and other brokers found a workaround built on trading in government securities, colluding with banks, circumventing RBI rules, getting their hands on bank funds and diverting it to the stock market . Mehta used this money temporarily in his account to buy shares, thus hiking up demand of certain shares (of good established companies like ACC, Sterlite Industries and Videocon) dramatically, selling them off, passing on a part of the proceeds to the bank and kept the rest for himself. This resulted in stocks like ACC (which was trading in 1991 for ₹200/share) skyrocketing to nearly ₹9,000 in just 3 months.

What was the cause?

- Up to the early 90's banks in India were not allowed to invest in the equity markets. However, they were expected to post profits and to retain a certain ratio (threshold) of their assets in government fixed interest bonds. This led bank managers to engage in methods to inflate profits.
- Bankers ignore a July 1991 circular by RBI which restricted transactions of BR(banking receipts) due to their rampant misuse. This allowed them to collude with brokers like Mehta to boost profits.

2.4 Harshad Mehta Case

What could have been done better?

- RBI and Central Government laws for banks should have been more grounded in reality and aligned in the same direction. This would have reduced temptations for bankers to meet over-ambitious targets through illicit methods.
- Also, oversight on traders, especially ones taking such large positions should have been more strident, both from the regulators and lenders.

Result:

- The Janakiraman Committee estimated the size of the scam at Rs 4024 crore, which in today's terms amounts to more than Rs 24,000 crore. The CBI charged Mehta specifically with 72 criminal cases (bribery, cheating, forgery, criminal conspiracy and falsification of accounts) and over 600 civil action suits by banks and institutions pertaining to monies he owed them.
- Harshad Mehta died in custody at age 47 while a report released by the Office of the Custodian on 8 January 2016, the Harshad Mehta family owns assets worth Rs 1,723.84 crore and has total liabilities of Rs 16,044 crore.
- The stock market and government banks suffered serious credibility issues in the aftermath with a lot of retail investors losing their life savings on the market. The stock market took more than 2 years to pickup from those lows.

2.5 Ketan Parekh and MMCB

What Happened?

- Parekh artificially rigged prices of certain chosen securities (informally referred to as K-10 stocks), using large sums of money borrowed from banks including the Madhavpura Mercantile Co-operative Bank(MMCB), of which he himself was a director. The directors of these unheard of companies provided funds to him to exponentially boost the share prices of these companies which came crashing down after a RBI investigation and some moves by the bear cartel of BSE.

What was the cause?

- Ketan Parekh purchased large stakes in less known small market capitalization companies, and jacked up their prices through circular trading with other traders, and collusion with these companies and large institutional investors.
- Co-operative Banks, like MMCB, cannot invest more than 5% of their loanable fund in equities. Yet he borrowed around Rs 900 crore from the bank.
- Ketan Parekh also was involved in a lot of arbitrage trading between Calcutta Stock Exchange (CSE) and BSE.

2.5 Ketan Parekh and MMCB

What could have been done better?

- Ketan Parekh was himself a director at MMCB which lent heavily to entities directly associated with him. This was a clear case of conflict of interest and should have been avoided.
- The regulations at CSE were deemed inadequate by the joint parliamentary committee(JPC) which gave abundant chances to anyone looking to commit a fraud.

Result:

- A 30 member Joint Parliamentary Committee (JPC) investigation ensued which found that Parekh had been involved in circular trading throughout the time period from and with a variety of companies, including Global Trust Bank (GTB) and Madhavpura Mercantile Cooperative Bank (MMCB).
- MMCB closed down in 2012 following the scam as more details were unearthed.
- Bank of India which was recovered Rs 1800 crore from Parekh's associates in 2018 while Parekh was barred from trading until 2017 and served a two years rigorous imprisonment sentence.