REPORT

Peregrine Fixed Income Limited (in liquidation)

Peregrine Investments Holdings Limited (in liquidation)

Pursuant to the appointment by the Financial Secretary of Richard Farrant as Inspector under section 143(1)(a) of the Companies Ordinance (Chapter 32).

12th February 2000

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Introduction.

1. You appointed me on 23rd April 1999 to investigate the affairs of Peregrine Investments Holdings Limited (PIHL) and Peregrine Fixed Income Limited (PFIL), with effect from 3rd May 1999. This is my report, pursuant to the terms of reference you gave me, which follow this Introduction.

2. To help me do the work I recruited as advisors John Allen, formerly a senior lawyer in the Department of Justice with considerable knowledge of past inspections under the Companies Ordinance, and Vicki Fitt, formerly an executive director of the UK Securities & Futures Authority and an acknowledged expert on risk management. As John Allen, Vicki Fitt and myself are non-residents, we established a small office in Hong Kong, manned by Lene Hansen, seconded from the Securities and Futures Commission to act as general assistant, and Priscilla Leung, recruited to act as team secretary. It is fair to say this report is truly a team effort.

3. Your terms of reference directed me to consider the information in the report of the Securities and Futures Commission dated 1st May 1998, together with other relevant information in the possession of the liquidators of the companies, and information gathered from examinations of persons involved. The SFC report provided a good basis of documentary information, most of it collected before Peregrine was put into liquidation. The liquidators have sought to meet my requests for further documentary evidence, but have sometimes had difficulty retrieving the information I sought from the huge volume of material at their disposal and after so much time has passed. However, the liquidators were able to provide me with large volumes of emails during the key period of 1997, which have been highly valuable in providing a feel for the developing crisis. I also had access to the audit files of Deloitte Touche Tohmatsu, the companies' external auditors. I have relied more than I originally anticipated on examinations of the directors and persons most involved.

4. I received cooperation from those I interviewed, although it was not always easy for them to recall events which are now a minimum of two years in the past. I interviewed all the executive directors of PIHL, Philip Tose, Francis Leung, Peter Wong, and Alan Mercer. I did not interview the two non-executive directors (Professor Shang Qan Gao and Channing Fok), since it became clear they played no part in the events that led to the failure of the companies. I interviewed all except Anthony Loh of the directors of PFIL (Philip Tose, Francis Leung, Peter Wong, Andre Lee, John Lee, and Warren Allderige). In addition, I interviewed Catherine Sham, Financial Controller or PIHL, Helen Yiu, a senior manager in Group Market Risk Management, Mary Ballard, a senior internal auditor, Ivan Lee, head of credit research in PFIL, Stan Lee, manager of Group Credit Risk Management following the departure of Solomon Yiu, Rosa Wang, investment manager for the ABC investment fund, and Eliza Yuen, the Deloittes partner in charge of the external audit of the companies. Although I did not interview them, Anthony Loh, a director of PFIL and Juliana Wang, a fixed income expert advisor to Eliza Yuen, answered questions through correspondence. I also received statements from Fred Kinmouth, managing director of Peregrine Capital and a

member of Peregrine's Executive Committee, and Mansoor Khan, director of fixed income derivatives at PFIL.

5. I have benefitted from the advice of Miss Elizabeth Gloster QC in respect of my conclusions about the performance of directors, in relation to their statutory duties under Hong Kong law.

6. I have been conscious in undertaking my investigation that the SFC report to which I referred above has not been published. Some of the persons I examined asked if they could see it. This would require the consent of the SFC, and I considered asking for its permission to show parts or all of it to interviewees. With one minor exception, I decided against doing so. The SFC report reached no conclusion other than that an inspection under the Companies Ordinance should be made into the questions which you asked me to examine in your terms of reference to me. It had therefore served its purpose, and had no further relevance. It seemed to me there was a danger that my inspection might become side-tracked if persons I was examining sought to address points made in the report rather than answer my questions. This was accepted by interviewees.

7. However, because the SFC's report has not been published, I have felt it necessary to provide more background in relation to the particular issues you asked me to address than would have been necessary if more information was in the public domain. I have sought to keep this as brief as possible.

8. My report is divided into six parts:

- Part 1 sets the scene by providing a factual outline of relevant events and developments in approximate chronological order.
- Part 2 analyses what went wrong, and causes of the failure of the companies.
- Part 3 covers particular issues of your terms of reference not covered in Part 2.
- Part 4 considers the performance of key persons in relations to their duties.
- Part 5 considers whether disqualification of any of the Directors should be considered
- Part 6 considers policy recommendations for the future.

香港特別行政區政府
財政司 司長辦公室

FINANCIAL SECRETARY'S OFFICE
Government of the Hong Kong
Special Administrative Region

In the matter of the Companies Ordinance (Chapter 32)

In the matter of a company incorporated in Hong Kong and
In the matter of a body corporate incorporated outside Hong Kong
which had a place of business in Hong Kong

<u>Peregrine Fixed Income Limited</u>	**(in liquidation)**
<u>Peregrine Investments Holdings Limited</u>	**(in liquidation)**

In the exercise of the power conferred on me by section 143(1)(a) of the Companies Ordinance (Chapter 32) and pursuant to the Order of the Court of First Instance dated 22 April 1999, I, Donald Tsang, Financial Secretary of the Hong Kong Special Administrative Region, hereby appoint Mr. Richard Henry Farrant as Inspector with effect from 3 May 1999 to investigate the affairs of the above-named companies and to report thereon pursuant to that Ordinance and as I may direct.

(Donald Tsang)
Financial Secretary

Dated this 23rd day of April 1999.

In the matter of the Companies Ordinance (Chapter 32) ("the Ordinance")

In the matter of a company incorporated in Hong Kong and

In the matter of a body corporate incorporated outside Hong Kong which had a place of business in Hong Kong

<u>Peregrine Fixed Income Limited</u> **(in Liquidation)**

<u>Peregrine Investments Holdings Limited</u> **(in Liquidation)**

Appointment of Inspector by the Financial Secretary
Terms of Reference

Pursuant to an Order of the Court of First Instance dated 22 April 1999 Section 143(1)(a) of the Ordinance

To : Mr. Richard Henry Farrant of Lane Farm, Cherry Garden Lane, Maidenhead, Berks, SL6 3QG, United Kingdom.

Pursuant to your appointment as Inspector of Peregrine Fixed Income Limited ("PFIL") and Peregrine Investments Holdings Limited ("PIHL") and without any limitation whatsoever upon any and all of the powers in that behalf conferred upon you by the Ordinance, I hereby direct that you :

1. Consider the information contained in the report dated 1st May 1998 ("SFC Report") prepared by the Securities and Futures Commission ("SFC") on its inspection of the books, documents, accounts, information and records regarding PIHL, its subsidiaries (which included PFIL) and any company substantially under the control of the same persons as PIHL conducted under section 29A of the Securities and Futures Commission Ordinance

("s.29A Inspection") with particular reference to those matters set out in Appendix A hereto and, for this purpose, to:

(a) review all books, documents, accounts, information and records that were used or compiled by the SFC in the course of the s.29A Inspection and preparation of the SFC Report and that are in the possession of the SFC;

(b) conduct examinations of such books, documents, accounts, information and records in the possession of the liquidators appointed by the court in the liquidation of PFIL, PIHL and Peregrine Derivatives Limited ("Liquidators") as you may reasonably consider to be of assistance; and

(c) require any person, whether or not an officer or agent of PIHL or any of its subsidiaries (including PFIL) or any company substantially under the control of the same persons as PIHL (collectively "Peregrine Companies"), whom you consider to be in possession of any information concerning the affairs of any of the Peregrine Companies to produce to you any books or documents in such person's custody or power relating to any one or more of the Peregrine Companies; and

(d) conduct such examinations of persons as you may reasonably consider to be of assistance.

2. Draw your own conclusions, based on your consideration of the information contained in the SFC report and your assessment of the information obtained pursuant to paragraphs 1(a), 1(b), 1(c) and 1(d) above (hereinafter collectively referred to as the "Investigation") with respect to the following:

(a) the reasons and events that led to the collapse of PIHL and PFIL;

(b) whether the matters and transactions referred to in sub-paragraphs (ii), (iii), (iv) and (v) of paragraph 1 of Appendix A were made bona fide, at arm's length, or such as might be expected to be made at arm's length between persons not connected with each other, and in the normal course of business;

(c) whether full, adequate and timely provisions and/or disclosures had been made in respect of losses or potential losses arising from the Book (as defined in Appendix A) in the announcements of PIHL dated 26 October 1997 and 11 December 1997;

(d) whether full, adequate and timely disclosures had been made throughout the period 2 July 1997 and 15 January 1998 to shareholders of PIHL and PFIL, including the investing public, of the financial position, or changes in the financial position, of PIHL and PFIL arising from losses or potential losses on the Book (as defined in Appendix A);

(e) the knowledge and involvement of each director and senior management officer of PIHL and PFIL in the valuations of the aforesaid Book and the assessment of provisions for losses or potential losses and their disclosures;

(f) whether any director or senior management officer of PIHL or PFIL had, in relation to matters under sub-paragraphs (b), (c), (d) and (e) of this paragraph 2, committed any criminal offence or otherwise defrauded any creditor or been guilty of any misfeasance or other misconduct towards PIHL, PFIL or any members of PIHL or PFIL or had acted in any manner oppressive of any part of the members of those companies or that their members had not been given all the information with respect to the affairs of PIHL or PFIL that they might reasonably have expected;

(g) whether, any person (other than a director or senior management officer) who had advised or provided professional services to PIHL and/or PFIL in relation to any of those matters under sub-paragraphs (b), (c), (d) and (e) of this paragraph 2 had been in breach of or had otherwise failed to properly discharge such person's duties.

(h) whether any director or senior management officer had been in relation to matters under sub-paragraphs (b) ,(c), (d) and (e) of this paragraph 2, in breach of any fiduciary duties, negligent in performing his functions as a director or person in management or otherwise in breach of his duties of skill, care and diligence;

(i) whether it is appropriate for the Financial Secretary or the Official Receiver to consider on the grounds of public interest, making an application for a disqualification order against specified persons pursuant to section 168I of the Ordinance; and

(j) the lessons to be drawn, for financial institutions, for Hong Kong's regulatory and supervisory arrangements and for the Hong Kong system of regulation generally, as well as recommendations for reforms that would make improvements to the operation and regulation of Hong Kong's financial sector and would, consequently, prevent or minimise the likelihood of recurrence.

3. Forthwith make an interim report to me (notwithstanding and in addition to your obligations under paragraph 6 herein) if in the course of the Investigation you shall come across any evidence or otherwise hold the view that an offence has been or is likely to have been committed;

4. Employ or engage solicitors, counsel, those with appropriate expertise in accounting bond issues/fixed income business and financial matters and other experts as you reasonably consider to be appropriate and for reasonable fees, such fees to be negotiated and agreed in advance to the fullest extent practicable, to assist you in your conduct of the Investigation;

5. With respect to your review of the books, documents, accounts, information and records referred to in paragraph 1(b) herein, seek the assistance of the Liquidators who may charge a reasonable fee, such fee again to be

negotiated and agreed in advance to the fullest extent practicable, for any assistance rendered in this connection;

6. Make an interim report to me on or before (90 working days from date of appointment) in respect of the fitness and propriety of persons registered in whatever capacity with the SFC;

7. Make a final report to me with respect to the Investigation and your conclusions on or before (six months from date of appointment) or as soon as practicable thereafter; and

8. Confer with the Secretary for Financial Services (or his representatives) on matters relating generally or in particular to the Investigation.

(Donald Tsang)
Financial Secretary

Dated this 23rd day of April 1999.

In the matter of the Companies Ordinance (Chapter 32) ("the Ordinance")

In the matter of a company incorporated in Hong Kong and

In the matter of a body corporate incorporated outside Hong Kong which had a place of business in Hong Kong

<u>Peregrine Fixed Income Limited</u> **(in liquidation)**

<u>Peregrine Investment Holdings Limited</u> **(in liquidation)**

Appointment of Inspector by the Financial Secretary
Terms of Reference – Appendix A

The matters in the SFC Report to which the Inspector is to have particular reference in the Investigation he is to conduct under these Terms of Reference are :

1. The valuation of and transactions involving or affecting inventory in the fixed income book of PFIL and subsidiaries thereof or of PIHL including Peregrine Asset Management (Hong Kong) Limited, Brisk Win Investments Limited and Peregrine Fixed Income Fund Limited, including fixed income debt, debt instruments, related financial derivatives, currency and interest rate swap transactions, options and credit derivatives as well as foreign exchange transactions (including foreign exchange options) conducted in related thereto (collectively, the "Book"), between 1 April 1997 and 31 January 1998 ("the Period"), with particular reference to:

   (i) the marking-to market of the positions relating to:

   - PT Steady Safe Tbk;
   - Tanayong Public Company Limited;
   - Robinson's Department Store; and
   - Sahaviriya OA Public Company Limited;

   (i) the sale and buy back of inventories by PFIL involving Infiniti Securities and PT Infiniti Finance as counterparties;

   (ii) the sale of inventories by PFIL to ABC Fund Limited;

   (iii) the taking, continuing, monitoring, valuing enforcing and reporting of collateral or security by or for the benefit of PFIL and PIHL to secure loans and debts on the Books, or the failure to do so;

   (iv) the giving, continuing, monitoring, valuing enforcing and reporting of guarantees, indemnities and loans by or for the benefit of PFIL and PIHL, or the failure to do so; and

(v) whether or not the valuations were reasonable and correctly reflected in each of the management and financial accounts of PFIL and PIHL produced during the Period.

Overview

Part 1. What happened?

1.1[1] This Part sets the scene for analysing what went wrong. It concentrates on background to the fixed income business, which was at the heart of the crisis which overwhelmed the Peregrine Investments Holdings Limited (PIHL) and subsidiary, Peregrine Fixed Income Limited (PFIL).

1.2 – 1.34 Peregrine was started in 1988. In its early years, it prospered by focussing on corporate finance and equities sales and research, expanding into other countries in South East Asia by means of joint venture companies. In 1994 it started a corporate fixed income business, and founded PFIL. Its success exceeded expectations. A feature of the business was a willingness to undertake large transactions in relation to Peregrine's own size, and it was often left with unsold portions of new issues. Its inventory of debt holdings and derivative positions grew.

1.35 – 1.50 Peregrine anticipated financial problems in Thailand in 1997 and moved to prefer Indonesia. In May 1997, PFIL committed to a package of transactions for Steady Safe, an Indonesian company, involving the provision of up to US$ 350 mns over five years. By early November, US$ 269 mns had been provided under this commitment. However, when the Indonesian Rupiah devalued in July, PFIL became generally pessimistic about Asian prospects, ceased to search actively for new business, and reorganised its management to reflect a new priority on retrenchment. The steep fall in the Hong Kong stock market and rumours against the Peregrine Group in September made management of the its funding more difficult. On 26th October, Peregrine issued a statement designed to restore confidence.

1.51 – 1.58 Almost immediately afterwards, talks were initiated with Zurich Centre Investments about arranging an equity injection into the Group. A conditional agreement to invest US$ 200 mns was announced on 17th November. On 12th December, PIHL announced talks with other potential investors, and on 16th December that First Chicago International Finance Corporation would subscribe US$ 25 mns.

1.59 – 1.67 Peregrine published a second statement of interim results on 12th December. These indicated that the US$ 60 mns provisions included in the announcement of 26th October continued to be adequate. The results were published against a background of market crisis in Japan and Korea – important sources of funds for Peregrine's business, and a. further deterioration of Indonesian markets. By 29th December, it was accepted that Steady Safe was in deep trouble, and on 8th January 1998, additional US$200 mns provisions were proposed to Zurich and First Chicago. They withdrew. The SFC stepped in to protect customers of the regulated businesses, and last minute attempts to arrange alternative emergency aid, including an

[1] This refers to the paragraph number in the main part of the Report

appeal to the Hong Kong Monetary Authority, failed. Provisional liquidators were appointed on 13th January to take charge of PIHL, and on 15th January to take charge of PFIL.

Part 2 What went wrong?

2.1 – 2.23 The proximate cause of Peregrine's failure was the crisis in Asian markets, which it would have been unreasonable to expect the directors to have anticipated. The scale of market movements, even in hindsight, seems extraordinary, and Peregrine was heavily associated with those markets. I believe Peregrine was not well prepared for the crisis. Although it had diverse sources of funds, planned its borrowing maturities, projected its cash flow frequently and had back-up lines of credit, it also had sizeable long term investments, and an inventory of trading assets which was much less liquid than it was assumed to be. It was unexpectedly slow to react to the gathering Asian markets crisis and to reduce its inventory of trading assets, which was as high as US$ 1.15 billion at the end of October 1997. Management was not as alert as it should have been to its own vulnerability. I believe the major underlying cause was inadequate infrastructure of good reporting and accounting procedures, risk management and internal audit. Underlying these deficiencies were management issues, and a culture which emphasised business generation over the provision of essential infrastructure, rather than seeing them as twin priorities which needed to be kept in balance.

2.24 – 2.80 An earlier and more clean cut transition of responsibilities for group risk management and internal audit functions might have generated less muddle and a more dynamic exercise of power. PFIL had significant problems with its reporting and accounting systems. The creation of the Executive Committee (EXCO)) structure was flawed, the PIHL Board ceased to be an active overseer, and Peregrine suffered from a lack of formal governance structure on which to build a solid system of procedures and controls. PFIL's management had wide discretion to incur risk as it chose, subject only to the personal oversight of Philip Tose. The practical result was a mindset whereby, provided Philip Tose and Andre Lee liked a transaction and it could be funded, it went ahead. Too little attention was paid to whether it was compatible with the rest of the Group's risk exposures, or whether it might prejudice the crucial assumption underlying the Group's funding that trading assets would be sold within 3 months. The PFIL Board rarely met formally, and responsibilities of different directors were unstated and unclear.

2.81 – 2.111 The Group's valuation policy was not formally documented and, although considered by management to be conservative, actually tended towards optimism. Dealers valued assets with no ready market without reliable independent verification. Provisioning policy was not documented, and it was unclear who had the responsibility to ensure adequate provisions were made. Peregrine's attitude to provisioning reflected its generally optimistic view of its business and the informal way in which it operated.

2.112 – 2.124 Peregrine measured market risk on a value at risk basis (VaR), but VaR based limits were only introduced in mid 1997, by which time it was probably too late to make a real difference. Stress testing would then have been more useful. Some stress testing was undertaken, but the scenario adopted was far too modest. What other stress testing was done was unsystematic and unrecorded.

2.125 – 2.153 Peregrine's Group Market Risk Management function had knowledgeable individuals, technically capable to withstand trader pressure and provide counterbalance, but there is little obvious evidence of their acting with much authority. The activities of its Group Credit Risk Management function (GCRM) were based on group credit risk procedures and policies which, although originally intended to apply to PFIL, never did so. GCRM staff were not supported by senior management in this matter, and had no authority. PFIL applied its own credit procedures, at the core of which was a credit committee. But PFIL's processes were weak in relation to documentation of procedures, limits, responsiveness to Group needs, credit approval and monitoring, records, and credit risk mitigation.

2.154 – 2.168 The procedures for internal audit were seriously flawed, in that two reports – one on PFIL – prepared in 1996 were never completed. As there was no alternative process of overall quality control, the Group had no reliable means of checking the quality of its own processes. Internal Audit in practice had no linkage into any senior management body. The draft report into PFIL described the issues it raised as "..highly significant and ..of a nature which exposes Fixed Income to major risk. Immediate corrective action is required." The reasons for non-completion of the report are disputed, but I believe it was suppressed. Nothing was done by way of quick follow-up review, and another audit of PFIL a year later, the findings of which strikingly overlap those of the previous year, was also not finalised.

2.169 – 2.178 In summary, Peregrine understood the rudiments of a control structure for fixed income business, but they were not effectively applied. The problems were known, but not sufficiently addressed. Peregrine, being smaller and less diversified, could not afford to take the same degree of risk as its international competitors. It was of the utmost importance that excellent risk management scrutiny and control informed, monitored and influenced the risk-taking activities of PFIL. That did not happen. If the directors had been better informed about the risks they were running, they might well have behaved differently, selling down bonds much more quickly, and have been much more cautious about entering into such an open-ended very large scale commitment to Steady Safe in May 1997. Steady Safe potentially represented over 35% of Group capital, and it was made alongside other large exposures to single counterparties, especially to another Indonesian group, APP/Sinar Mas. Together, these two exposures amounted to about three quarters of Group capital. That was hazardous and foolhardy.

2.179 – 2.181 More broadly, Peregrine was working its way through a major transition, from being a medium sized to a large business. The business base had broadened beyond the skills and experience of its founding management and it had grown too large for the initial hands-on style of management to cope with. Peregrine was a good deal of the way through the transition, but its management was not learning fast enough and it was all happening too slowly in relation to PFIL's superb business generating abilities.

Part 3 Specific issues covered by the terms of reference

Steady Safe

3.8 – 3.19 PFIL started dealing with Steady Safe in October 1996. In April 1997, its President came to PFIL to suggest financing an operational merger with Cita Marga Nusaphala (CMNP). Three tranches of debt issuance were envisaged, totalling some US$ 350 mns, with maturities of up to 5 years. Until marketable issues of debt could be arranged, PFIL would make temporary loans available, backed by short term promissory notes which it hoped to sell into the market. The deal was unusual for Peregrine, in that it became committed to supply funds over several months, with no special get-out clauses unless Steady Safe failed to meet its obligations under the mandate.

3.20 – 3.49 By 19th August, US$ 262 mns had been lent, but PFIL's exposure was down to US$ 50.5 mns because it had sold Steady Safe promissory notes into the market. As these matured and were rolled over, fewer new promissory notes were sold. By the end of September, PFIL had US$ 166 mns, and by 6th November US$ 269 mns. Meanwhile, the value of the CMNP shares which PFIL had as collateral was falling, from US$ 166 mns at the end of September, to US$ 62 mns at the end of November. Until the end of the year, PFIL's management regarded the exposure to Steady Safe as work in progress and no provisions were made against the possibility it might not all be repaid. By the end of October – the date for striking the second interim results, it was in my view untenable not to have made a provision, at an absolute minimum, of 20% – at least US$ 50 mns. At the beginning of January 1998, Philip Tose decided provisions of US$ 118 mns should be made.

Tanayong

3.50 – 3.77 Tanayong issued Asia Bond Notes, for which PFIL lead managed the international tranche. After a number of trades, Peregrine held about US$ 17 mns by May 1997. PFIL also had interest rate swaps with Tanayong. As the Baht weakened during 1997, PFIL grew concerned that Tanayong would not be able to meet its losses on these swaps, and negotiated their replacement by what was in effect a 25 year loan for US$ 89 mns. As at end October 1997, a minimum extra provision of 10%, equal to some US$ 1.4 mn, should have been made on the Note holding, and somewhere between 25% and 50% (US$ 22.25 mns to US$ 44.5 mns) on the swap "loan".

Robinson

3.75 – 3.100 PFIL lead managed a US$ 100 mns Floating Rate Note for Robinson. By July 1997, it held US$ 27 mns. It also had a highly leveraged currency swap. As 1997 proceeded and the Baht devalued against the Dollar, PFIL became seriously concerned that the swap would bankrupt Robinson. As with Tanayong, a close out and replacement of the swap with what amounted to a 25 year loan was negotiated, for US$ 68 mns. As at the end October, additional provisions of US$ 4.4 mns would have been reasonable for the Note holding, and a minimum of US$ 17 mns for the swap "loan".

SVOA
3.101 – 3.116 PFIL's dealings with SVOA were complicated, and PFIL knew SVOA was in trouble. It marked down its positions to values which do not seem unreasonable.

Provisions and disclosure
3.117 – 3.131 The directors, in judging the uncertainties attaching to the valuations of PFIL's exposures, took comfort from unrecorded unrealised profits on a number of open foreign exchange positions. I conclude these profits were no substitute for proper provisioning of PFIL's exposures at the end of October. The combined shortfall of provisions I identify as being needed at the very minimum against Steady Safe, Tanayong and Robinson would have all but absorbed PIHL's pre-tax profit declared in the 2nd interim statement published on 12th December 1997. As the provisions were inadequate, the disclosure of provisions was also inadequate. However, I unearthed no evidence that the directors knowingly failed to disclose facts to shareholders they knew to be true, and I judge they were conscientious in preparing the public statements made in the last six months of Peregrine's life. The fault lay in their judgements about valuations and provisions, not how they reported what they believed to be the facts.

3.132– 3.138 PIHL made seven major public statements in the last six months of its life, and I believe the directors were conscientious in their disclosures to shareholders.

Transactions with Infiniti Companies in Steady Safe promissory notes; and with the Asian Bond and Currency Fund (ABC)
3.139 – 3.149 There was no obvious economic justification for either party to the Infiniti transactions. I found no likely reason to explain these transactions, but I do not think this odd episode is important in relation to my inspection. I am satisfied transactions between PFIL and ABC were made at arm's length

Management of collateral, other security and guarantees
3.150 – 3.157 Collateral arrangements were potentially valuable for PFIL, but in several important cases they did not feature at all, and where used, poor execution and control meant they did not always provide the protection planned.

Part 4 Conclusions on the performance of senior management and their advisers

4.1 – 4.13 My findings on the matters which I have investigated do not include any findings of fraud or dishonesty by any of Peregrine's directors, managers or advisers. I interpret the evidence I gathered as indicating that all concerned consistently sought to further the interests of the Group and its shareholders. The failures I detected were all failures of performance rather than intention. I am critical of the following persons, whose conduct fell below the standard of competence which should have been shown, and who thereby breached their duties of skill, care and diligence:

4.33 – 4.48 **Alan Mercer** was a director of PIHL, Group Legal Counsel and Group Compliance Officer. He was company secretary of PFIL, but not a director. He took over responsibility for Internal Audit from Peter Wong early in 1997. I am critical of his performance in relation to his response to the draft findings and report of the 1997 PFIL internal audit;

4.49 – 4.77 **John Lee** was a director of PFIL, Group Treasurer, responsible for Group Market Risk Management from 1996 and for Group Credit Risk Management from March 1997. I am critical of his performance in relation to one aspect of Group Treasury; one aspect of Group Credit Risk Management; his role in provisioning decisions made for the purposes of the announcements of 26th October and 12th December 1997; and one part of the 1996 PIHL Annual Report;

4.77 – 4.101 **Peter Wong** was a director of PIHL and PFIL. He was the Group's Finance Director, and effectively the Group's chief operating officer, until he progressively handed functions over to John Lee and Alan Mercer. I am critical of his performance in relation to Group Credit Risk Management; Internal Audit; and one part of the 1996 PIHL Annual Report;

4.102 –4.126 **Andre Lee** was the Managing Director of PFIL. I am critical of his approval of the Steady Safe commitment; and his performance in relation to the 1996 PFIL internal audit;

4.127 – 4.157 **Philip Tose** was Chairman of PIHL and PFIL. I am critical of his oversight of Andre Lee; and his approval of the Steady Safe commitment, without wider consultation;

4.157 – 4.169 **Deloittes** were the auditors to PIHL and PFIL. Their review of the 2nd interim results statement published on 12th December 1997 fell well short of an audit. I have serious concerns about their work, but there is insufficient evidence to conclude that Deloittes were in breach of or had otherwise failed properly to discharge their duties.

Part 5 Disqualification as directors

5.1 – 5.15 I conclude it is appropriate for the Financial Secretary to consider making an application for a disqualification in relation to Philip Tose, Peter Wong, John Lee and Andre Lee.

Part 6 General lessons and public policy recommendations

Lessons and recommendations for financial institutions and their advisers

6.1 – 6.10 Peregrine's failure emphasises the importance of promoting the ability to spot and learn from mistakes as rapidly as possible. This is more about management culture and personal relationships than a set of policy prescriptions. Nevertheless, Peregrine has lessons for financial institutions and their advisers in the areas of corporate governance, risk management, the roles of internal and external audit and incentivising employees.

6.11 – 6.17 **Governance**. I recommend Boards of companies should discuss periodically their duties as directors, the practical consequences of these duties for each director and the objectives that arise, and the information required for each director to meet his objectives. This is recommended as good practice rather than as a compulsory requirement to be imposed on all companies or financial institutions. It would be a productive avenue for Securities and Futures Commission inspectors to explore when seeking to understand the governance and high level management practices in a regulated firm.

6.18 – 6.27 Risk management. I recommend the Group of Thirty report on derivatives as an excellent catalogue of good risk management practice for investment banking. It is essential to keep infrastructural development in balance with business generation and to recognise that good risk management is a *prerequisite* to doing investment banking. It is essential to ensure that good intentions to improve infrastructure lead to practical results on the ground. Regulatory inspections should be aimed at least as much at identifying whether firms properly adhere to their own policies and standards as to whether they adhere to standards imposed by the regulators. Marking to market should take account not only of the indicated market price for an asset, but also the circumstances of the holder of the asset. Where an asset is difficult to value, the acid test is to try selling it or a small quantity of it. Risk managers, auditors and regulators should not hesitate to demand that be done when they have concerns about valuation.

6.28 – 6.33 Internal audit. Internal audit needs strong senior management support. A key feature is openness. Internal audit work programmes and reports should be circulated to and monitored by senior executive management and non-executive directors. I recommend “risk maps” as excellent material for discussion in the Board about the risk profile set for the business. These observations are particularly important for companies in the middle stage of development (like Peregrine).

6.34 – 6.38 External audit. Auditors should meet the Board to present audit findings personally and offer comments, especially observations about systems and controls. The Hong Kong Society of Accountants may wish to consider an industry wide initiative to add value to audit work in this, and other ways. When auditors and regulators are given the opportunity to work together they should not lightly decline it.

6.39 - 6.42 Incentivising employees. High incentives for business generation need to be counterbalanced by counter-incentives for support and control staff to ensure its quality.

Lessons and recommendations for the system

6.43 – 6.54 Company law. I recommend a system of interim protection from creditors, as now being proposed in the Companies (amendment) Bill 2000. I recommend that all new company directors should be sent a “child’s guide” setting out in simple terms what is expected of them as directors.

6.55 – 6.62 Listing requirements. I recommend that listed companies should be required to have an Audit Committee of the Board, chaired by a non-executive director and with a majority of non-executive directors. I recommend that the Stock Exchange should consider if disclosure requirements could be framed for listed companies which would lead to a competition for excellence in disclosing risk management policies.

6.63 – 6.77 Financial regulation. I approve the decision not to rescue Peregrine; such rescues should be reserved to situations where monetary policy objectives are seriously at risk. I conclude the Peregrine case provides no evidence of a need to extend the reach of regulation and, without that evidence, I am strongly opposed to it. I recommend strengthening the powers of the Securities and Futures Commission to gather evidence from unrelated third parties when investigating listed companies and their affiliates. I recommend closer association between the SFC and Hong Kong Monetary Authority to use their respective skills and experience as efficiently as possible, especially in the area of market trading related risk assessment. I note that at some point the question of whether listing should continue to rest with the Stock Exchange or be transferred to the SFC will need to be considered.

Part 1. What happened?

Introduction

1.1. This Part of the Report provides a limited factual outline of relevant events and developments in approximate chronological order, in order to set the scene for analysing what went wrong, which is covered in Part 2. It concentrates on relevant background to the fixed income business, which was at the heart of the crisis which Peregrine faced in the second half of 1997 and its subsequent collapse. It is important to recognise that Peregrine was much more than the fixed income business, and that this outline is not a balanced account of the development of all of the Peregrine group's business activities.

Early years

1.2. Peregrine was the brainchild of Francis Leung and Philip Tose, who became disenchanted with their former employer, Citicorp, in 1988. (Appendix 1.1 contains brief biographies of the directors of the companies and certain other key officials mentioned in this Report.) In the four years since Citicorp had purchased Vickers da Costa, in which Philip Tose had been a senior partner, they had built its business as an investment bank, combining brokerage and corporate finance, but they suspected Citicorp's commitment to the business had waned following the 1987 market crash.

1.3. Philip Tose and Francis Leung started Peregrine in 1988 with Francis Leung moving across in September 1988, and Philip Tose joining in January 1989. Philip Tose brought Peter Wong with him from Citicorp. These three became the core of the new business. In the beginning Peregrine was purely an equity house, with Philip Tose handling sales and distribution, Francis Leung heading origination and Peter Wong in effect the chief operating officer, with responsibility for ensuring it all worked. However, Francis Leung soon started up a Corporate Finance division and focussed his attention on building this up.

1.4. The business became listed in July 1990, when the operating divisions of Peregrine Investment Holdings Limited were sold into Tai Shing International Holdings. This had been a Hong Kong listed company since October 1972. Tai Shing International Holdings was subsequently renamed Peregrine Investment Holdings Ltd. (PIHL). In preceding moves, Peregrine acquired a 37% interest in Kwong Sang Hong International, and Cheung Kong Holdings acquired a 15.5% interest in PIHL.

1.5. The core business of the growing group remained corporate finance and equities sales and research. But in the early 1990's it expanded into other countries in Southeast Asia by means of joint venture companies. Joint ventures were necessary to overcome local regulatory barriers on foreign financial companies, and to engage local expertise and contacts. Peregrine's control of the operations of these companies was tenuous, as most local regulations required strict separation and management independence.

1.6. The business prospered mightily. The starting capital of US$ 38 mns grew to US$ 447 mns by the end of 1992 and US$ 599 mns by the end of 1994. Corporate finance business in particular was buoyed by the introduction of Chinese company shares onto the Hong Kong Stock Exchange in October 1992. Return on equity was approximately 20% in 1992 and 1993.

1.7. As the business grew, steps were taken to improve management depth in Peter Wong's operational area. Alan Mercer was recruited from the Securities & Futures Commission (SFC) as a Group board director in charge of legal affairs and compliance. Catherine Sham was recruited from Conpress (HK) Ltd., initially as an internal auditor, but within a year was appointed Group Financial Controller.

1.8. However, towards the end of 1993 Philip Tose and Francis Leung believed they had reached a watershed. They believed it would not be long before the growth of Asian economies, and the opening up of China to investment banking services, attracted the major world investment banks to Hong Kong. Peregrine's size and limited business coverage would then be a severe competitive disadvantage. But it would take two years or so before the major houses were likely to commit to Asia on a large scale. Peregrine was generously capitalised for what it was then doing, and well positioned for much greater expansion. There was, therefore, a window of opportunity to broaden its business coverage and develop relationships so that it would have a head start in meeting the competition when it came, and Peregrine was well placed to exploit it.

1.9. They identified two options. They could continue to develop their existing business base, or broaden their coverage to become a fully fledged investment banking house by adding a fixed income business capability to their existing strength in equities and equity related corporate finance. They were attracted towards the second option.

1.10. They considered the most interesting area to be corporate fixed income business. They already had relationships with corporates through their equity related activities, and they could see that corporates could benefit from widening the choice of debt finance available to them beyond the provision of traditional forms of bank financing. They recognised that Peregrine was likely to be too small to be able to arrange finance for Asian governments, who would anyway be more likely initial targets for the major international houses.

1.11. They recognised that the skills required to do this would be difficult to find locally. They would need expert personnel trained in New York or London based houses, and it would be expensive to attract them to Hong Kong. They found what they wanted in Lehman Brothers.

1.12. Andre Lee, working in Lehman Brothers in Hong Kong, also believed passionately that there was a terrific opportunity to develop a business helping Asian medium sized companies raise money through issuing marketable debt rather than borrowing from banks. He wanted to apply to these companies the techniques used by the international investment banks for larger western and multinational corporations. His ambition was a natural fit with those of Philip Tose and Francis Leung, and he was hired in April 1994 to develop a fixed income business for Peregrine.

The development of the Fixed Income business.

1.13. Peregrine Fixed Income Limited (PFIL) was established in April 1994 as the corporate vehicle for the fixed income business. Its core was a management team of 14 persons whom Andre Lee brought with him from Lehman Brothers. Andre Lee became Managing Director. The new recruits were brought in on generous terms, with the potential for high bonuses if the business succeeded.

Impact on the group's infrastructure.

1.14. Philip Tose and Francis Leung were conscious of the risks for Peregrine of the diversification into fixed income business. This was intended to transform the group's business, and its potential ramifications were therefore far-reaching. It would disturb the existing staff, who could be expected to resent an influx of highly paid outsiders. It would require new operational systems and controls. Financing an inventory of fixed income positions would require much more sophisticated financing of Peregrine's own balance sheet, which would be provided by a new Treasury function. The fixed income business would need to be supported by a much greater capability to conduct foreign exchange and derivative transactions, and risk management would need to become much more sophisticated. Each one of these would be a significant management challenge.

1.15. These challenges began to be addressed at group level during 1994.

1.16. Philip Tose and Francis Leung decided that Philip Tose should take on senior management oversight of Andre Lee and his team. He provided the support and protection necessary to allow the team the space to make their mark in the group. By all accounts, the creation of the fixed income business was highly controversial, and its rapid success did not diminish the antipathy towards it from other parts of the Group. There was a culture clash between the well-established "English" business tradition of the existing business, and the more bracing "American" way of the new recruits. This continued throughout the remaining life of the Group. Philip Tose's sponsorship of the new business was necessary to keep this under reasonable control.

1.17. Soon after Andre Lee and his team set up shop in Peregrine, John Lee was recruited, also from Lehmans. He had been Lehman's chief financial officer in Hong Kong, and was felt to have the necessary skills in treasury management to complement the skills in business development which Andre Lee and his team had been recruited to deliver. It became Philip Tose's intention that John Lee, as he proved himself, should progressively take over most of Peter Wong's responsibilities. Peter Wong had expressed a long-term desire to retire to Australia, and his wife had already migrated there in order to establish her residency.

1.18. John Lee was recruited to be Group Treasurer, and reported to Peter Wong. He began a programme of broadening Peregrine's sources of funding, which continued until the summer of 1997 when the crisis in Asian markets precluded further diversification. In January 1996, he was appointed Head of Group Market Risk Management, taking this responsibility over from Peter Wong. Simultaneously, he began to report direct to Philip Tose, rather than Peter Wong. In early 1997, he became Head of Group Credit Risk Management, again taking over the responsibility from Peter Wong.

1.19. Peter Wong's background was in stockbroking, which had no need for sophisticated trading risk management techniques. Before John Lee began his progressive take-over of Peter Wong's existing functions, Peter Wong had strengthened his management team, in order to develop modern risk management controls on a group wide basis. Helen Yiu was switched from Financial Control to develop group market risk monitoring and controls, having previously been recruited from the Mitsubishi Corporation in London. Solomon Yiu was recruited from Citibank to develop a group credit risk monitoring and control regime. Reports on market risks started to be made to senior management on a group wide basis in 1995. At the end of 1994 and in the first half of 1995 a group wide credit risk management policy was developed and documented. However, it was not supported at senior management level and partially replaced. It was never applied in PFIL, which developed its own policies and control mechanisms, including a credit committee of its senior management, chaired by Andre Lee.

1.20. Financial control was strengthened by the creation of a separate Product Control group in 1996. Its original function was to prepare profit and loss account reports for management. But the more important task in the context of my inspection was to ensure that the marking to market and valuation of the group's trading inventory and positions was accurate, by checking the prices put on them by the traders against other sources of information. Mark Cohen was recruited from Credit Suisse First Boston in New York to develop the function, but he left in April 1997, and it took time to recruit a replacement for him with the required skills. This was achieved in October 1997, but the new recruit could not join until January 1998. In the interim, Catherine Sham was appointed as caretaker manager, in addition to her duties as Financial Controller.

1.21. Internal audit was also strengthened. Adam Robinson was appointed Head of Internal Audit, having been recruited from the Anglo-Chinese Investment Bank some years before. His remit covered all aspects of Peregrine's business, and audits of PFIL's business were undertaken in 1996 and 1997. However, Internal Audit's authority was limited by a lack of proper procedures for ensuring that audit reports were fully considered at Board level. In a meeting on January 26th 1996 of the Managing Directors on the Executive

Committee, instructions were given to prepare a Board resolution requiring internal audit to report to them in future, but nothing was put to the Board and internal audit reports were never circulated to the Managing Directors as a group. Final reports of the two internal audits into PFIL, in 1996 and 1997, and another into Peregrine's Treasury department conducted in 1996, were never issued, apparently because disagreements between the auditors and business managers were not resolved. Peter Wong handed on his responsibility for Internal Audit to Alan Mercer early in 1997.

1.22. Peregrine's arrangements for senior governance were reformed at the end of 1995. Management was reorganised onto a business product basis, regardless of location, and the Board slimmed down to four executive and two non-executive directors. An Executive Committee (EXCO) was created to ensure good coordination between the business product divisions and the overseas operations, notably the joint ventures in other Asian countries. The managing director of each business product division and head of each significant overseas business or office sat on it, initially 22 persons in all. The idea was that EXCO would become the management body responsible for driving the group's business forward, and the PIHL Board would supervise and review EXCO's performance. It was intended to recruit additional non-executive directors, with relevant investment banking experience, but this never happened. As the executive directors sat on EXCO, and one of the two existing non-executive directors was resident in China, the Board of PIHL as a body ceased to play an active part in governing the affairs of the group.

1.23. An inner cabinet of EXCO was also created of the PIHL Board members, business line managing directors, and John Lee. This was called EXCO MD's.

Building PFIL

1.24 In so far as PFIL was concerned, the plan was that the new fixed income team should develop the infrastructure and capabilities needed to control and operate the new business during 1994, and only begin to pursue business actively when this had been done in 1995. In fact, business began to flow actively during 1994 when PFIL executed one large transaction as well as a significant number of smaller ones. The large deal was arranging an issue of convertible bonds by Hutchison Deltaport, worth approximately US$ 275 mns. Originally it was regarded internally as an equity transaction, but PFIL was brought in when difficulties arose. It was very successful and boosted confidence in the new fixed income team. Thereafter, fixed income business grew rapidly.

1.25 Andre Lee's plan was to target Asian companies which were becoming mature enough to contemplate raising funds through debt issuance, and then nurture the relationship with these companies as they developed further and became good prospects for more sophisticated financial management techniques. At the start, debt issuance would require the creation of an Asian corporate bond market – a major challenge – but he felt the time was ripe for it. His ambition had parallels with the junk bond market which had developed spectacularly successfully in the USA in the 1980's.

1.26 In order to create the market, he needed to develop a research capability to identify corporate borrowers who would be attractive to investors, an information service and distribution capacity to attract those investors. To generate new issues, he needed the corporate finance skills necessary to structure financing programmes for his clients, skills in derivatives trading so that the interest rates and currencies of new issues could be matched to clients' needs, and the ability to finance an inventory of tradable debt issued by his corporate customers to PFIL until it could be sold on to investors. Behind all this, of course, he needed the infrastructure to manage the whole process and control the risks involved.

1.27 By the end of 1995, the first full year of its operation, PFIL was, according to the Group annual report, exceeding expectations. It employed more than 80 persons, and raised over US$ 9 billions for Asian corporates. Its pre-tax operating profit of US$ 20 mns represented almost 15% of total group operating profits. Its research publications were well regarded and widely circulated. It was a decided success.

1.28 1996 saw further dramatic growth. By the end of that year, it employed 165 persons, and had raised US$ 22 billions for corporates. Its pre-tax operating profits, at US$ 49 mns, represented over a third of the group total. Its Asian debt research was winning prizes, and the credit research team produced over 300 documents covering 8 Asian countries.

1.29 The first half of 1997 was no less successful. PFIL's operating profits for the six months ending 30th June 1997 were US$ 35 mns. (US$ 70 mns on an annualised basis), and the number of employees grew to 220. This was the high point. From then on, Peregrine was increasingly affected by the developing crisis in Asian financial markets.

1.30 As PFIL's business grew, the Group's inventory of debt holdings and derivative positions also grew. The Group's portfolio of assets held for trading purposes was US$ 330 mns at the end of 1994. At the end of 1996 it had grown to US$ 937 mns. The contract value (or notional principal amount) of the group's derivative positions was US$ 27.4 billions at the end of 1996, 30% of which matured beyond one year. This is not to say that Peregrine was exposed to the risk of loss remotely near to this figure; the net replacement value of these contracts if all customers failed to meet their obligations was little more than US$ 100 mns.

1.31 A feature of the business was a willingness to undertake large transactions in relation to Peregrine's own size. In 1995, PFIL undertook a US$ 175 mns three-year floating rate note issue for Citra Marga Nusaphala Persada (CMNP), an Indonesian toll road operator. (Appendix 1.2 contains a list of debt issues arranged by PFIL). In 1996, PFIL arranged a US$ 1 billion Asian currency note programme with APP, an Indonesian pulp and paper company, and a US$ 200 mns floating rate note issue. A US$ 200 mns floating rate note was arranged for Dharmala Intuitama International, an Indonesian conglomerate. These were sizeable in relation to Peregrine's group capital resources of US$ 750 mns (growing to US$ 900 mns in 1997).

1.32 PFIL was often left with large chunks of the debt issues which it arranged for its customers. This is not unusual, but normal practice is to sell these on as rapidly as possible. PFIL continued to hold sizeable residual holdings of a number of them in mid 1997, when the Asian crisis took hold, long after their date of issue. Nevertheless, they continued to be regarded as tradable assets, and were indeed sold whenever a suitable opportunity arose. In mid 1997, US$ 134 mns of debt inventory had been held for more than 3 months, representing almost 17% of the total. Of this, US$ 46.5 mns had been held for more than 6 months.

1.33 This is a sensitive issue. One of the keys to continuing success in a fixed income business is to avoid becoming stuck with an issue. Fixed income business is about maintaining a flow of new transactions, not financing a stock of investments. While times are good, carrying old stock may not matter too much, but when markets deteriorate, the danger is that the value of the stock falls, while the need to sell it to raise cash rises.

1.34 Peregrine's funding strategy assumed that the holding period of its inventory of trading assets was no more than three months. The strategy was vulnerable when the assumption was invalid.

Transactions with companies mentioned in my terms of reference.

1.35 PFIL commenced business with Sahaviriya OA Public Company and Tanayong in 1995, and with Robinson Department Store PCL in early 1996. All three were Thai companies, and PFIL arranged loans and derivative transactions with them. These are described in detail in Part 3 of this Report. Although not as large as some of the other business deals transacted by PFIL, they became troublesome and difficult to value. Peregrine still had substantial exposures to these companies when it collapsed in January 1998.

1.36 PFIL started dealing with Steady Safe, an Indonesian taxi and bus company, in October 1996, when it issued Indonesian Rupiah denominated commercial paper worth approximately US$ 500,000 on behalf of Steady Safe. It issued a further 12 batches of Steady Safe paper, in the form of promissory notes or medium term notes in the following months up to May 1997. In all cases, Peregrine sold the notes in the market within a short time of issuance. By the end of May 97, the total amount of Steady Safe paper in the market amounted to approximately US$ 50 mns.

1.37 By then, Peregrine had an established working relationship with Steady Safe, and was in the advanced stages of structuring a substantial financing package to fund a business expansion programme. This package had two stages. Stage 1 involved raising US $150 mns. to repay a loan to a syndicate of banks, led by The Hongkong and Shanghai Banking Corporation Limited (HSBC). The original loan by HSBC had been for the express purpose of helping Steady Safe to finance a fleet of taxis, buses and ferries. The second stage was to finance the purchase of shares in CMNP. The two companies had operating synergies and the intention was effectively to merge them. The proposal was that Steady Safe should purchase 21% of the shares of CMNP, following which the senior management of each would become involved in the day-to-day running of the other.

1.38 The two stages were linked as the covenants attaching to the HSBC loan would not allow Stage 2. Therefore, Peregrine would need to provide the means to retire that loan. The structure and timing of the financing package was the subject of much negotiation through the earlier part of 1997, between Steady Safe and Peregrine, and also within Peregrine. PFIL's credit committee considered the deal, and all the necessary signatures were obtained. This culminated in a signed mandate between Peregrine and Steady Safe dated 29th May 1997.

1.39 The mandate envisaged three tranches of debt issuance on behalf of Steady Safe through 1997, totalling in all some US$ 350 million, of maturity up to 5 years. Moreover, the mandate provided for short-term bridging finance to Steady Safe pending the successful launch of the longer-dated debt structures. So long as Steady Safe met the terms of the covenants it gave, PFIL was obliged to provide the funds. For Peregrine, it was unusually open-ended, in terms of duration of the commitment to finance Steady Safe.

The Asian crisis and its effects on Peregrine

1.40 Although there were intimations of fragility in some Asian financial markets as early as 1996, the crisis is generally reckoned to have started in mid-May 1997, when there was a speculative attack on the Thai Baht, and Thailand's largest finance company, Finance One, failed. On 19th June, the Thai finance minister resigned. Soon after, the central bank suspended 16 Thai finance companies, and at the end of June the Baht was allowed to float, promptly devaluing by 13%.

1.41 Peregrine's management had anticipated problems in Thailand, and in the first half of 1997 had sought to reduce the volume of new transactions for Thai corporates. It favoured Indonesia as being in much better economic health, and that was one reason why Steady Safe was attractive. However, in July, the Indonesian Rupiah began to be affected, and its official trading band was widened from 8 to 12%.

1.42 Peregrine's senior management became generally pessimistic about Asian prospects around this time, and Andre Lee ordered active searching for new business for PFIL to cease. The concern was about the likely quality of new business rather than Peregrine's own financial condition, and Andre Lee's instructions did not extend to turning away attractive business offered to them, or stopping work on transactions already in the pipeline. In the interim results statement for the six months to end June 1997, published in early September, it was anticipated that the fixed income business "... is likely to see a generally more difficult trading environment but opportunities will undoubtedly come from the restructuring of company balance sheets." (Appendix 1.3.)

1.43 Andre Lee initiated a reorganisation of PFIL staff in August to reflect his new priorities for the firm. PFIL had been managed on a pure business line basis. It was now reorganised into 4 teams. Team 1 became responsible for solving potential credit problems; team 2 for existing businesses – origination, bond trading, sales, derivatives and foreign exchange; team 3 for developing stronger domestic fixed income business; and team 4 for market risk trading.

1.44 Meanwhile, funds began to be drawn down under the Steady Safe mandate of 29th May. The first substantial loan to Steady Safe was made on 19th June. It was a US$ 100 mns bridging loan pending an issue of medium term Floating Rate Notes, backed by promissory notes, maturing at the end of July. The Notes were successfully sold on to other purchasers.

1.45 The chronology of the series of transactions with Steady Safe is covered in some detail in Part 3 of this Report, which also explains their commercial logic. In brief, work on the floating rate note was not finished at the end of July and the bridging loan was rolled over. Further issues took place in August, such that by 19th August Peregrine had issued US$ 262 mns of Steady Safe promissory notes. As the issues matured, new ones replaced them, but Peregrine was unable to sell them into the market. By 6th November, Peregrine held them all, and its total claim on Steady Safe was US$ 269 mns. The originally envisaged longer-dated debt structure was never achieved, and Peregrine had not been able to reduce its exposure by early January 1998, when PIHL and PFIL were put into provisional liquidation.

1.46 The Baht stabilised towards the end of July, but then began to sink steadily during August and September. By the end of September its dollar value was 11% below its end of July level, itself some 23% below its pre floating level at the end of June. These changes in value had substantial effects on the value of PFIL's swaps with Thai customers, including Tanayong, Robinson and SVOA. Although they became highly profitable to Peregrine, realising the profits depended on the ability of the customers to pay. In some cases, this became a major source of concern within PFIL.

1.47 Peregrine had very little business in Malaysia, so was unconcerned by the weakness of the Ringgit. More ominously, the Indonesian Rupiah began to move down in August and by the end of September had devalued against the US dollar by 29% compared with its mid July level.

1.48 Two other developments in September made life more difficult for the group. The Hong Kong stock market began a steep fall towards the end of September, and by 28th October was over 44% below its value at the beginning of August. PIHL's share price fell more than the market average, by 61.18% in the same period. But the fall in share prices also reduced Peregrine's ability to fund itself by stock lending, as the value of the stock it lent fell. New stock lending generated less cash. Old stock lending had to be topped up by providing additional collateral, or cash had to be returned to borrowers, thereby creating a funding drain.

1.49 The second development was a series of rumours that Peregrine had sustained losses from the fall in Asian markets, which during the remainder of the year became more extreme. Peregrine had always been a controversial business. That was almost guaranteed by its lofty ambitions and short but hugely successful track record. Its association with the Asian market place, which was increasingly in crisis, now made it a natural object of suspicion. The rumours disturbed Peregrine's counterparties, and became a very serious concern to management. Kroll Associates were hired to seek their source, without success. Peregrine decided that in view of the very heavy fall in the Hong Kong stock market, and the rumours, a public announcement should be made to clarify its financial position.

1.50 In a public announcement on 26th October (Appendix 1.4), the directors estimated that losses and provisions in the equity products and fixed income businesses since the half year had caused net profits after tax to fall by 30% compared with the published half year result. The directors included US$ 35 mns new provisions in these estimates, on top of the US$ 25 mns which had been made in the half year to end June 1997. They noted that shareholder's funds were higher than they had been at the start of the year, despite Peregrine having brought back its own shares since the beginning of July to support its share price. All major bank relationships and credit lines remained in place. The announcement stated that no discussions at that date were taking place with any other party with a view to it taking a substantial shareholding in Peregrine. Finally, in order to provide further comfort, it promised that a second statement of interim results would be made by mid December in respect of the 10 months to end October, and that the group's year end would be brought forward by one month to end November. This would enable the audited annual accounts to be published before the end of January 1998.

Plans for new investors in Peregrine

1.51 Almost immediately after the announcement, talks were initiated with Zurich Centre Investments (Zurich) about arranging an equity injection into the Group. Zurich had been in discussion with Peregrine since June on a joint direct investment fund. It was suggested that instead of investing in the fund Zurich should invest directly in Peregrine itself. After further discussion and a week of initial due diligence work by Zurich and its professional advisers Donaldson, Lufkin, Jenrette, London & Global and Price Waterhouse, it was announced on 17th November that Zurich had entered into a conditional agreement to invest US$ 200 mns in Peregrine in the form of convertible preference shares (Appendix 1.5).

1.52 Under the agreement, three directors would be nominated by Zurich to the board of PIHL, and together they would constitute a blocking minority for certain key operational matters, including budgets, business plans, material capital transactions and share repurchases. The agreement was conditional on the consent of PIHL's shareholders, necessary government and regulatory permissions, and the Stock Exchange, and on no material adverse change in the condition of the group having occurred since execution of the agreement on 16th November.

1.53 Another announcement was made on 12th December (Appendix 1.6). This stated that PIHL was in discussion with other potential investors about their participation in the issue of convertible preference shares, which would enlarge the quantity of new capital being raised by Peregrine. This was followed by a further announcement on 16th December that First Chicago International Finance Corporation (First Chicago) would subscribe to US$ 25mns additional preference shares on the same terms as Zurich (Appendix 1.7). The shareholders would also be asked to approve a mandate for the directors of PIHL to issue up to US$ 70 mns additional preference shares to other qualified institutions within six months.

1.54 Peregrine's motivation for the Zurich deal was twofold. Philip Tose and Francis Leung recognised that the Asian markets were in such turmoil that Peregrine, as a relatively small player strongly associated with Asian markets, needed the shelter of a strong partner. Zurich was a subsidiary of one of the strongest insurance groups in the world. First Chicago was a subsidiary of the eighth largest US bank holding company. The matter had been made more urgent late in November when Peregrine received a credit rating by the US National Association of Insurance Commissions (NAIC) of 3, one below the coveted "investment grade", which had been its target. NAIC had been concerned about Peregrine's earnings volatility and the likely impact of currency and market volatility in Asia on future earnings. This rating closed off the prospect of substantial yen funding from two Japanese based houses.

1.55 But the agreement also partially met a longer-term strategic ambition to team up with a much stronger player, in order to face the competition from the major world investment banks, such as Merrill Lynch and Goldman Sachs. Peregrine had, in fact, previously sought to strengthen its competitive position through a strategic alliance with outsiders. In the summer of 1997, Francis Leung, with Philip Tose's approval, had sought permission from the People's Republic of China to invite a major Chinese financial institution to take a stake in the group. The business logic was to establish Peregrine as a home based player in the Chinese market, able to build on its considerable potential in the same way as the American houses had been able to build their international business on the back of a huge domestic business base. The discussions foundered as the Asian crisis took hold in mid summer.

1.56 Although Zurich was not Chinese, its ambitions seemed to Philip Tose and, after initial suspicion also Francis Leung, to complement Peregrine's needs. It wanted the capability to find good investment opportunities in Asia and had the resources to invest, while Peregrine had a proven track record in identifying and developing such opportunities, but needed the resources to be able to exploit the market it had developed.

1.57 The directors apparently felt more positive about the liquidity of the group for much of November. The negotiations with Zurich progressed well. They had started to sell down PFIL's inventory as fast as possible, and managed to sell US$ 260 mns during that month.

The Indonesian Rupiah had stabilised, following agreement between the IMF and Indonesian government for a financial support package at the end of October. Work on arranging the Steady Safe refinancing seemed to be proceeding.

1.58 This confidence evaporated towards the end of November. The Rupiah began to slide again, and fell another 8% in the last two weeks of November. It accelerated in early December and by the middle of that month was almost 40% below its level a month before. But events in Northern Asia were more disturbing. On 24th November, Yamaichi Securities Co. Ltd. the fourth largest brokerage in Japan, was closed by the Japanese authorities, amid strong rumours that more Japanese institutions were in danger of failing. Japan was an important source of funding for Peregrine, and it was clear Japanese institutions would need to withdraw funds placed with others in order to meet their own needs for cash.

The SFC inspection and the second interim results statement

1.59 Meanwhile, the Securities and Futures Commission (SFC) began an inspection of the Peregrine group. This was not a routine inspection. The SFC's concern was that problems in PIHL and PFIL, which were not regulated, might have an adverse impact on those businesses within the Peregrine group which were regulated. The Stock Exchange of Hong Kong was also concerned about PFIL, because of the knock-on effects of any problems there on PIHL, which was a listed company. Senior officials of the SFC and the Stock Exchange visited Philip Tose and agreed that, despite not being a regulated company, the valuations of PFIL's bond inventory and derivative book should be reviewed.

1.60 The review did not proceed easily, and requested information was slow to arrive, or did not arrive at all. Discussion about valuations took place, but no agreement was reached. The review had not finished by the time the interim results for the 10 months to end October 1997 were published. Indeed, the review was never formally completed, although the information gained from it was material to the decision by the SFC to restrict the regulated business of the Peregrine group following the collapse of the negotiations with Zurich and First Chicago on 8th January 1998.

1.61 The results for the 10 months to end October were published on 12th December (Appendix 1.8). Although not audited, Peregrine's auditors, Deloittes, had written to PIHL directors reporting that in their opinion the interim results had been prepared using accounting policies consistent with those adopted by the Group in its financial statements for the year ended 31 December 1996, and that they were not aware of any material modifications that should be made to the interim results as presented.

1.62 The results indicated that the provisions of US$ 60 mns included in the announcement of 26th October continued to be adequate. Pretax profits for the 10 months stood at US$ 96 mns, compared with US$ 132 mns for the first six months of the year to 30th June. The group anticipated continued difficult business conditions, but noted that with the proposed injection of US$ 200 mns from Zurich, its capital structure and liquidity would be improved.

End game

1.63 Peregrine's liquidity was under increasing pressure. Its credit lines, which had been US$ 141 mns at the end of October, of which less than 25% were drawn down, had fallen to US$ 59 mns by early December, two thirds of which had been drawn down. By now, Peregrine must have been highly dependent on the comfort for its bankers of the forthcoming Zurich deal. The addition of First Chicago, announced on 16th December, no doubt helped maintain the bankers' confidence.

1.64 However, Asian markets were taking another lurch for the worse. The Indonesian Rupiah had been falling since the start of December, by 10% in the first week, and a further 16% in the second week. It then steadied at the end of the second week. In mid December, Zurich suggested to Philip Tose that it considered a provision should now be made against Steady Safe, the suggested figure being US$ 50–75 mns. Philip Tose and Francis Leung, having talked further to Zurich, considered this was a negotiating ploy to gain a reduction in price of its participation in the group, and decided to await the results of PFIL's continuing work on the financial reconstruction of Steady Safe. This depended on a rights issue being made by Steady Safe, which required the consent of Bapepam, Indonesia's financial markets regulator. In the meantime, Philip Tose declined to approve circulation within Peregrine of its management accounts for November, pending consideration of further provisions.

1.65 The rights issue had been an integral feature in the planned financial reconstruction of Steady Safe from the very start of Peregrine's provision of finance. PFIL had been assured by Steady Safe's executives and, apparently, by Bapepam officials, that regulatory consent would be a formality. In the event, Bapepam refused to give a decision by the time a general meeting of shareholders was held on 29th December, and so the issue could not proceed.

1.66 The abandonment of the rights issue left PFIL's plans to refinance its loans to Steady Safe in tatters. It was now clear that the loans to Steady Safe were very doubtful, and Philip Tose decided to propose a provision of US$ 118 mns should be made against the exposure, when final discussions with Zurich and First Chicago started on 8th January. In addition, he proposed a further US$ 82 mns should be made against other exposures.

1.67 Events moved quickly from then on. When Zurich resumed negotiations on 8th January, it demanded a renegotiation of the whole deal. Peregrine had no option but to agree. However, First Chicago apparently considered that the revised terms were unsustainable and withdrew. The withdrawal meant that a conditional offer from them of much needed further credit also fell away. The Stock Exchange and SFC were informed, leading to the

SFC requiring a cessation of all regulated business by the Group, until it could be reassured about its future viability. Various parties were approached for emergency aid, including the Hong Kong Monetary Authority, but no liquidity support could be arranged sufficiently quickly, leaving the directors no option other than to apply to the court for the appointment of provisional liquidators. On 13th January, provisional liquidators were appointed to take charge of PIHL. On 15th January they were appointed to take charge of PFIL.

Part 2. What went wrong?

Introduction

2.1. How was it that a business that seemed to be on top of its world in mid 1997 had collapsed just six months later? This is the subject of this part of the report.

2.2. I should say at the outset that I believe its management and staff were without exception exceptionally ambitious for Peregrine, and highly committed to its success.

2.3. The proximate cause of the Group's failure was unquestionably the crisis in Asian markets, in the sense that if the crisis had not occurred, there is no reason to think that the group would have failed in early 1998.

2.4. It would be unreasonable to expect the directors to have anticipated what happened in the second half of 1997. Although in mid 1997 problems in individual markets were being talked about, it would have been a very brave prophet who would have forecast the severity of what actually occurred over the next six months. I am not aware of anyone who did so. This was unlike other market crises in recent years, which have either been severe but short lived, or limited to individual countries.

2.5. The scale of market movements, even in hindsight, seems extraordinary. On 12th January 1998, when PIHL was put into provisional liquidation, the Thai Baht was worth 44% of its US dollar value on 30th June 1997; the Indonesian Rupiah 27%; the Malaysian Ringgit 54%, the Filipino Peso 60% and the Korean Won 51%. The share indices of these markets fell by 52, 56, 45 and 39% respectively. The Hang Seng index fell in the same period by 46%.

2.6. Peregrine was heavily associated with these markets. It had enjoyed the benefits of this association while these markets and the economies underlying them were regarded as Asian tigers. In the second half of 1997 it suffered from the same association, as the markets turned severely bearish.

2.7. Had the Zurich and First Chicago participation proposals not failed at the last moment, liquidation would almost certainly have been avoided. Their completion would have much improved Peregrine's prospects of meeting heavy funding requirements coming up later in January. I think all the parties were genuinely committed to complete, until the further round of currency devaluations in the first week of January

2.8. Nevertheless, the goal of business is to prosper, and that requires survival. Shareholders of public listed companies such as PIHL have a right to expect the directors to do all they can to ensure that. Investment bankers are supposed to be experts in financial markets. In my view, it is reasonable to expect them to control their business so that a crisis in financial markets, even if not anticipated, does not result in unplanned closure. The fact that a number of other Asian banks and finance houses either closed or were rescued does not in my view alter what it is reasonable to expect.

2.9. Most of the directors disagree with me, believing I expect far too much. Even if they are right, I have concluded that Peregrine was badly prepared for the crisis. Better infrastructure and risk management would have in all probability enabled the Group to survive, as it is unlikely it would have overstretched itself so far, thereby leaving it exposed in a difficult climate. More of the bond inventory could have been liquidated more quickly, and it is possible that the Group's life would not have become so wholly dependent on the participation of Zurich and First Chicago. They in turn might have been more prepared to participate, reassured about Peregrine's existing exposure to the crisis, although better risk management would not have helped reassure them that Asia would provide good prospects for business generation in the near term.

2.10. If it had survived, Peregrine would certainly have been severely affected by the crisis. I am sure it would have ceased to be profitable, and probably would have incurred sizeable running losses over a prolonged period. It would probably have become a shadow of its former self. But this is very different from the unplanned collapse that actually occurred.

2.11. Philip Tose, Peter Wong, Alan Mercer and Andre Lee fundamentally disagree with this approach to taking account of the Asian crisis. They believe the illiquidity of the markets in which Peregrine operated was so fundamental that it was bound to have overwhelmed Peregrine, and that in the circumstances the directors and management cannot be held to account. They believe that I have placed insufficient weight on what they hold to be the fact that the second largest economy in the world, Japan, and its banking system, were on the brink of total collapse by the end of 1997. The Hokkaido Bank and Yamaichi Securities collapse were the tip of an iceberg and represented an unprecedented break with the past. Top tier financial institutions had never before been allowed to fail by the Japanese Government. This caused international and Japanese lenders to reassess and pull back from their Asian exposures during December 1997. Beyond that, they believe I have put insufficient weight on the key issue of the liquidity crisis throughout Asia in the second half of 1997, which was of such severity that it went far beyond the safeguards that any internal control system could have provided.

2.12. I believe it would be hard to convince participants in the markets and the shareholders of financial institutions that management should not be held to account for unplanned closure, unless, conceivably, the conditions were such that the central authorities were prepared to intervene to stabilise a systemic crisis. Even then, one would expect the management to be replaced. Although central support was given to financial institutions in other Asian countries, the Hong Kong authorities were not prepared to intervene when approached by Peregrine in January 1998; and the markets easily survived Peregrine's closure. Be that as it may, as I have stated above, I believe Peregrine and its management failed a lesser test: that of being well prepared for the crisis. I have no doubt it is reasonable to expect that.

Liquidity

2.13. Peregrine closed because it ran out of cash. It could not realise assets or close out derivative positions to generate cash fast enough to meet maturing liabilities.

2.14. I noted in Part 1 that John Lee, following his appointment as Group Treasurer in 1994, broadened the funding base of the Peregrine Group. Peregrine had diverse sources of funds, and care was taken to ensure that too much of its borrowing did not mature at the same time. In addition, there were back up lines of credit, available to take care of unexpected imbalances between cash inflows and outflows. John Lee placed great store on achieving an acceptable credit rating from an established rating agency, and achieved that when in March 1997 the Japan Bond Research Institute (JBRI) rated PIHL unsecured short term debt as A 2 and long term debt as BBB+. This was an important achievement, because Japanese institutions were a major source of funding for Peregrine.

2.15. In order to manage its funding the Treasurer's Department prepared cash flow projections looking up to 12 months ahead. These were produced daily, sometimes more frequently if the position appeared to change within the day. The results were circulated in large and complex spreadsheet reports to other key directors.

2.16. The usefulness of these projections depended, of course, on the accuracy of information about the business, and in particular on the realisability of the group's assets and derivative positions. Peregrine recognised it had some US$ 600 mns. long term investments in Kwong Sang Hong (its property affiliate), in the overseas joint ventures, and in a portfolio of direct investments. It assumed these investments could not be realised in time to contribute to a funding imbalance. It assumed that assets held for trading could be realised promptly, if necessary, by being sold at or near their balance sheet value.

2.17. It did not work out that way. By the beginning of January 1998, despite Peregrine being desperate to raise cash, 60% of PFIL's remaining bond inventory of US$ 700 mns had been held for more than three months. Much of the rest represented Steady Safe paper, which was equally unsaleable. These were all represented in the accounts as being trading assets.

2.18. I find these very telling statistics in explaining why Peregrine failed. When Zurich and First Chicago left the field, it had no room for manoeuvre left. Its trading assets were untradeable. They represented a liquidity illusion.

2.19. Peregrine's dependence on secured borrowing also became a vulnerability. At the end of September 1997, just under 50% of its borrowings depended on the value of securities it had provided as collateral. As the markets deteriorated and the value of these securities fell, these borrowings had to be repaid, or additional collateral provided. Obtaining more collateral proved impossible, and by January 1998 secured borrowing had fallen disproportionately to approximately 14% of the Group's total funding

2.20. Peregrine was, of course, not alone in finding that formerly liquid assets had become illiquid as the Asian crisis deepened. It had been particularly affected by events in Japan and Korea, the markets of which had previously been reliable suppliers of finance, both to itself and to its customers. It would be unreasonable to expect Peregrine's management to have forecast such severe tightening of liquidity in these markets. But it is reasonable to expect management to be able to react to the unexpected. I am satisfied that John Lee's improvements to the Group's overall liquidity management and profile represented adequate preparation for unexpected developments. But they depended on a crucial assumption; that the Group's trading assets could be sold promptly. That turned out to be wrong for too many of the assets generated and held by PFIL, whose quality was lower than the management had thought.

2.21. Although the proportion of trading assets which had been held for more than three months increased rapidly in the last three months of 1997, the total of assets held for more than three months had always been high. Throughout the period from April 1997 onwards (I have not been able to find reports between June 1996 and April 1997) the total of trading assets held for more than three months exceeded US$100mns, or 10% of total trading inventory. This contravened Peregrine's own rule that trading assets must be turned over within three months. By the end of September 1997, the proportion had reached 20%. By this time I would have expected the Group to have been paying very close attention to its liquidity, as many Asian markets were under evidently under severe strain. But the total inventory was allowed to rise sharply during October, from US$ 700 mns to US$ 1.15 billion, far more than the additional exposure to Steady Safe taken on during this period.

2.22. The detailed figures appear on the next page.

Summary of Fixed Income Aged Inventory Report

Date	***91-180 days (USD mill.)***	*as % of Total Inventory*	***>180 days (USD mill.)***	*as % of Total Inventory*	***Total Aged (USD mill.)***	*as % of Total Inventory*	***Total Inventory (USD mill.)***
24/11/95	**40.29**	*9*	**42.11**	*10*	**82.40**	*19*	**438.89**
12/1/96	**43.02**	*10*	**12.74**	*3*	**55.76**	*13*	**449.29**
26/1/96	**55.76**	*12*	**14.74**	*3*	**70.5**	*15*	**461.72**
23/2/96	**24.65**	*7*	**15.07**	*5*	**39.72**	*12*	**341.54**
15/3/96	**17.85**	*5*	**10.86**	*2*	**28.71**	*7*	**418**
19/4/96	**99.02**	*24*	**6.66**	*2*	**105.68**	*26*	**415.33**
31/5/96	**97.88**	*24*	**0.67**	*0*	**98.55**	*24*	**407.39**
(Reports not found for this period)							
25/4/97	**113.67**	*9*	**33.59**	*3*	**147.26**	*12*	**1217.4**
23/5/97	**106.91**	*10*	**36.89**	*4*	**143.8**	*14*	**1059.62**
20/6/97	**87.58**	*11*	**46.52**	*6*	**134.1**	*17*	**795.39**
31/7/97	**85.61**	*7*	**58.04**	*5*	**143.65**	*12*	**1258.4**
29/8/97	**79.95**	*7*	**41.08**	*3*	**121.03**	*10*	**1189.29**
2/10/97	**62.17**	*9*	**79.36**	*11*	**141.53**	*20*	**700.82**
31/10/97	**206.06**	*18*	**80.11**	*7*	**286.17**	*25*	**1151.45**
27/11/97	**155.55**	*22*	**99.47**	*15*	**255.02**	*37*	**691.60**
31/12/97	**268.09**	*38*	**144.36**	*21*	**412.45**	*59*	**694.21**

Source: Internal Peregrine Aged Inventory Fixed Income Reports prepared by Group Market Risk

2.23. I find this pretty compelling evidence that Peregrine's management was not as alert as it should have been to its own vulnerability, and was initially slow to react to the warning signals. I believe the major underlying cause of both was inadequate infrastructure of good reporting and accounting procedures, risk management, and internal audit. Underlying these deficiencies were management issues, and a culture which emphasised business generation over the provision of essential infrastructure, rather than seeing them as twin priorities which needed to be kept in balance. Peregrine's outward face was impressive, and I have no reason to doubt the genuineness of that in relation to much of the business. However, behind the impressive business generating capabilities of the fixed income business, the infrastructure was quite a mess.

Infrastructure Management issues.

2.24. In its early years, Peregrine's top management was Philip Tose, Francis Leung and Peter Wong. Peter Wong was effectively responsible for all infrastructure, while Philip Tose and Francis Leung were responsible for business generation. They were a long standing team, having worked together at Vickers da Costa and Citibank. Peter Wong was effectively the Chief Operating Officer, and his integration in the top team meant infrastructure was accorded high priority.

2.25. That balance in the top team was disturbed by the creation of the fixed income business. This was not only a new business, but a much more complex one. It required more extensive and sophisticated infrastructure, in almost all respects. Peter Wong's lack of experience of this business was a handicap, and infrastructure began to be managed less well by the top team. Peter Wong's grasp over this area was never secure and his standing in the group's management team suffered as the managers of the fixed income business came increasingly into prominence and acquired more influence.

2.26. It is possible that Peter Wong's lessening ambition and increasing desire to retire may also have disturbed the balance. Whether or not this was a factor, Peter Wong became less recognisably a powerful Chief Operating Officer.

2.27. The process of transferring Peter Wong's responsibilities to John Lee and Alan Mercer, both recently recruited in response to the creation of the fixed income business and regulatory problems, was almost bound to be tricky. It was done gradually on purpose, to allow the newcomers to become acquainted with the business, its operation, and the markets in which it operated; to allow existing senior management to assess and build confidence in John Lee's capabilities; and to allow a sufficient overlap to ensure a safe transition. Even so, good intentions and promising initiatives in relation to infrastructure were often sloppily and incompletely executed. Although there were many sensible initiatives, and capable people were brought in to drive them, the results were seriously flawed, as I describe later in this Part of the Report. In my view, this was in part caused by the process of transition of Peter Wong's responsibilities to John Lee and Alan Mercer.

John Lee

2.28. John Lee was recruited in 1994 as Group Treasurer, reporting to Peter Wong. However, when he took over responsibility for group market risk management in January 1996, his reporting line changed, and from then on he reported direct to Philip Tose. It is usual for the treasurer of a business to report to its finance director, who takes overall responsibility for the financial security of the business. Peter Wong was finance director, but John Lee no longer reported to him. Other key executives, such as Andre Lee and Catherine Sham, looked increasingly to John Lee for advice and guidance on financial matters other than treasury management. Peter Wong began to be sidelined on financial matters, but, although always willing to help, John Lee did not regard them as his responsibility.

2.29. Peter Wong was in charge of the group credit risk function, and oversaw the creation of a group credit risk policy at the end of 1994 and first half of 1995. But in December 1995, John Lee recommended and Group Treasury was mandated by EXCO to establish a Group level committee to approve new equity and debt underwriting commitments. (Appendix 2.1). The mandate of this committee is not clear, as EXCO gave it no terms of reference. But the EXCO minutes describe its function as follows: "In relation to our group risk this is largely a data consolidation exercise. Once the data is consolidated, it needed to be passed onto business managers so that they were appraised of exact risk in each area of business they were involved. Information flow crucial. It was noted the management information system within Peregrine were very poor." So far as John Lee was concerned, this did not imply a general responsibility for group credit management. So far as Peter Wong was concerned, new business undertaken by PFIL was now beyond his responsibilities. The muddle as to who was responsible for a vital constituent of proper risk management was not resolved until John Lee took overall charge of Group Credit Risk Management in 1997.

2.30. In November 1996, John Lee was mandated by EXCO MDs to take over responsibility for group credit risk procedures. But, although Peter Wong sent an email to EXCO MDs at the end of January 1997 confirming the change as having occurred on 1st January, it was not formally ratified by EXCO until March 1997. John Lee acknowledged he was in charge of group credit management from March 1997, but found it so under-resourced when he arrived (exacerbated by the simultaneous departure of its manager) that in practical terms he could not begin to extend its remit to PFIL until he had recruited more experienced staff. He reached agreement to take over PFIL's credit assessment team in August 1997, but it did not actually occur until December 1997. Philip Tose, Peter Wong and Alan Mercer assumed group credit management was operating in the way desired by John Lee, and claim they were given no hint that that might not be the case. However, it should have been clear to Philip Tose, at least, that John Lee was dissatisfied with Group Credit Management's ability to police the taking of new commitments, since he lobbied Philip Tose to insist on all new commitments being pre-cleared by Group Credit Management before the September 1997 and planned January 1998 EXCO meetings. To judge from my interviews and subsequent correspondence with key top executives, they had differing views on what Group Credit Management should have been and what it was doing during 1996 and 1997.

2.31. By 1997, it was becoming difficult to identify Peter Wong's responsibilities with those which are typically associated with being a finance director. In particular, although he remained responsible for Product and Financial Control, others, including Catherine Sham, looked more to John Lee at group level for assurance about valuations and provisions. Philip Tose definitely did so in relation to PFIL's provisions. Unfortunately, John Lee, while always willing to respond to requests for guidance, did not regard himself as generally responsible for these areas. The result was confusion, with no one accepting that they were definitely responsible.

2.32. It is clear that John Lee was slowly assuming important functions from Peter Wong. Both told me it was understood that in due course he would take over Peter Wong's remaining responsibilities for infrastructure. But in the meantime, in hindsight, it was clearly a messy transition, and, because John Lee was not on the PIHL Board, risk management was not directly represented on it. John Lee was thereby handicapped in dealing with powerful business heads, especially Andre Lee, who was personally very influential with Philip Tose.

Alan Mercer

2.33. Peter Wong's responsibility for legal and compliance functions at PIHL board level were taken over by Alan Mercer, who was recruited from the Securities and Futures Commission (SFC) in 1993, after Peter Wong had been reprimanded by the SFC in relation to share trading by Peregrine Brokerage. Although appointed a director of PIHL, Alan Mercer did not have the same personal influence with Philip Tose or Francis Leung as Peter Wong, emanating from the latter's long partnership with them.

2.34. There was no lack of clarity about Alan Mercer's intended function. In his legal role, he was Company Secretary for some subsidiaries, including PFIL, and was secretary of EXCO and EXCO MDs. Both he and Philip Tose told me his compliance responsibilities were exclusively in relation to compliance with external regulations, including those applying to the operations overseas. He was not responsible for internal control policies or procedures, or for checking transactions for compliance with them. As PFIL was not regulated, he had no compliance responsibilities in relation to its business at all.

2.35. Peter Wong continued to be responsible for internal audit until he handed it over to Alan Mercer at the beginning of February 1997. As Peter Wong conceded, the internal audit role presented less of a potential conflict of interest with Alan Mercer's compliance responsibilities than Peter Wong's more operational ones. With the benefit of hindsight, it is a pity the transfer did not occur earlier.

Concluding observation

2.36. I cannot be sure whether infrastructure issues would have been better managed if there had been a more clean-cut and rapid transition of Peter Wong's duties as de facto Chief Operating Officer to his successors. But there might have been less muddle, and a more dynamic exercise by John Lee and Alan Mercer of the power that came with their new responsibilities. The impression I have gained of the management of infrastructure issues is that John Lee and Alan Mercer felt nervous about taking on PFIL, and were unsure of their ground with Philip Tose, who was known to favour Andre Lee's opinion on most matters.

Reporting and accounting systems

2.37. Good risk management requires reporting and accounting systems which deliver accurate information promptly. However sophisticated they are, risk measurement techniques are useless, or positively misleading, if based on inaccurate information.

2.38. The basic reporting system in PFIL involved traders inputting the details of their transactions into a front office system known as "JeeJee". The JeeJee system produced trade tickets, which were then used by the operations and settlement staff to monitor and settle the transactions (Appendix 2.2 gives an overview of the network of systems).

2.39. There were a number of problems with this process. JeeJee had been developed in early 1994 to manage a certain volume of straight bond and swap transactions. It was intended as an interim solution, to complement the central VAX system and rectify its worst deficiencies in terms of functionality for PFIL's business generators and traders. The number and diversity of the transactions being undertaken by PFIL soon outstripped JeeJee's ability to record them effectively. For example, bond coupons, certain cash flows and options could not be captured accurately. This inflexibility extended to cancellations and amendments. Once the details of the trade were input, changes could not be made and cancellations and amendments were done "off-line", vulnerable to being missed. Settlement problems became quite frequent.

2.40. The information contained in the trade tickets produce by JeeJee had to be input manually into no less than six different reporting and accounting systems. This was time-consuming and prone to human input error, particularly as many of the operators were not experts in fixed income products. The six systems were manual databases, supporting large spreadsheet reports, which were themselves time-consuming to maintain and susceptible to human input error. Only one of these systems was specifically designed for fixed income business.

2.41. These vulnerabilities needed to be countered by strong operational and procedural back up. This was not much in evidence in relation to PFIL's business, although this was often the responsibility of group operational units rather than PFIL itself. Daily reconciliations of the trade tickets and the trade details were often not performed, and the software program intended to match certain details between JeeJee and the main accounting "VAX" system was unreliable.

2.42. This is not to say that no effort was made to remedy the matter. As a first measure, PFIL purchased and developed software systems for each area of business it was engaged in. Internal correspondence reveals that no less than four groups were involved in attempting to resolve the problems, and cope with rapidly increasing business volumes. But progress was limited. A lot of money was spent on the development of other systems, for example, CATS, ADS, FNX, FENICS and Principia, but they often failed to realise the potential hoped for them, or required extensive customisation. In some cases, systems were initially used inconsistently and then rejected, despite repeated requests by management to utilise them.

2.43. This piecemeal approach was probably not the best way to meet the infrastructure needs of the fixed income business, and may have reflected Peter Wong's inexperience in this area. Andre Lee commented to me that money spent on systems by PFIL had to be approved in every case personally by Peter Wong, and he was difficult to convince that large sums should be spent on software. Later the strategy changed. Following a review of systems by external consultants, Charles Hung was recruited towards the end of 1996 from Merrill Lynch as head of IT, to build up the Group's in house capability. In 1997, he became responsible for meeting all business needs throughout the Group, in coordination with business heads. The aim so far as the fixed income business was concerned was to develop a more comprehensive system, integrating the needs of front and back offices, linking trade input, processing, risk analytics and settlement in one package. A joint team from PFIL and Group IT was formed.

2.44. A more comprehensive system was not commercially available that could handle foreign exchange, derivatives, and fixed income together, so it was decided to focus efforts on upgrading the Principia system for derivatives, and to purchase a front to back office solution (FNX + Gloss) to replace JeeJee. The final plans were fixed in March 1997, and implementation scheduled at the end of the year. As with any sophisticated financial software, Gloss and FNX needed a great deal of customising to support PFIL business requirements. Implementation was running behind schedule when the Group collapsed.

2.45. The accounting area fared somewhat better than the operations and front office areas, although that is hardly praise. A number of systems were successfully brought on board. Nevertheless, the accounting goal of monthly inter-company reconciliations was never achieved and at the time of the liquidation a full Group wide reconciliation had not been achieved for over a year.

2.46. In summary, PFIL had significant problems with its financial and accounting systems. They were resource-intensive to maintain, prone to inaccuracy, unintegrated, and vulnerable to manual manipulation. Errors that were detected could not be reliably amended and the structure lacked consistently applied control procedures.

2.47. The situation was summarised well in the 1996 PFIL internal audit draft report: "There have been sustained efforts to enhance the control process and framework to keep pace with the escalating risk profile of the business. However, the progress to date has been slow because of a fragmented, untailored system platform as well as the support functions being overloaded by voluminous transactions and unresolved operational issues." (Appendix 2.3.)

2.48. While I recognise the difficulties involved in establishing systems, and that Peregrine was far from alone in having difficulties, the two major problems it encountered were that the systems were not designed to deal with many of the products traded, and the volumes traded rapidly escalated beyond system capacity. Prudent risk management would have established up front that the systems were capable of supporting the trading of these products, and were scaleable.

Risk management

Introduction

2.49. When Peregrine started its fixed income business in 1994, it had little more than a clear vision about its goals and a team of fixed income specialists recruited from Lehman Brothers, a much larger and more diversified US investment bank. The established businesses of Peregrine were corporate finance and equity brokerage, and some senior personnel were not at all keen on the idea of Peregrine moving into this new field, which gave rise to some initial and on-going tensions within the Group. However, although he had no background in fixed income, Philip Tose was strongly supportive, and hugely impressed by Andre Lee.

2.50. At that time, the South East Asian fixed income markets were in their infancy. It was Peregrine's dream to open them up, and to become the premier outfit in them. In doing so, it had a clear idea where it wished to position itself – which counterparties it would woo, and what kinds of deals they could offer. But it did not have the financial resources of the major international investment banks, who were its potential competitors. Its advantage lay in getting into the business first, and building a presence that would be difficult for subsequent entrants to dislodge, despite their greater financial muscle.

2.51. Initially, PFIL had limited competition. The upside was that it could win more business; the downside that it would rely heavily on its own capability to distribute issues direct to investors, since there was no secondary trading market. If it was not careful, it might find itself left with sizeable portions of new issues, involving considerable exposure to risk in relation to its own financial resources. There was a danger that, as the competition from larger investment banks with better credit ratings grew, it would have to be prepared to take larger risks in order to keep pace, and in the process would overstretch its resources which were smaller than theirs.

2.52. Over time, secondary markets did begin to develop, fostered substantially by PFIL's own trading and market making activity. But they lacked real depth, and could not be relied on as a solid market place for selling bonds in the event of need. Thus, PFIL's ability to withstand unexpected events was limited and it needed to remain alert and nimble in order to react quickly before problems hit.

2.53. How did it equip itself to deal with these risks? Below I examine some of the key components which aid the measurement, management and control of risk. These are not new; they were first expounded in an authoritative report issued by the Group of Thirty (G 30) in 1993 in relation to derivatives activity. They were soon accepted as sensible in much broader circumstances. There is no magic in them; they are simply a compendium of common sense, gleaned from the bitter experience of real life examples of things which have gone wrong.

Role of Senior Management

2.54. Good risk management needs strong sponsorship and support from the top, and a clear framework of accountability reaching up to the top.

PIHL Board and EXCO

2.55. The creation of EXCO at the end of 1995 was intended to address the implications for top management of the broadening of the group's business, both into other Asian centres through the joint ventures, and into the fixed income business. The number of executive directors on the PIHL board was halved to four (Philip Tose, Francis Leung, Peter Wong and Alan Mercer). The idea was that it should monitor the performance of EXCO, which was to become the key decision making forum (Appendix 2.4).

2.56. After EXCO started, the Board of PIHL effectively ceased to operate as an instrument of control of the group's business. Although it met to conduct formal business, such as to approve its annual report and accounts and use of the company seal, EXCO took over as the senior executive management forum.

2.57. This was not as it should have been. Philip Tose told me he had modeled the reorganisation of top governance on Morgan Stanley's arrangements, and there are similarities. But there was a crucial difference in that Morgan Stanley has an active board, composed of experienced non-executive directors. It had been the intention to appoint more experienced non-executive directors to the PIHL board, but this never happened. A very important feature of the intended arrangements was lost.

2.58. EXCO was a large body, comprising 22 members in the closing months of 1997. It met quarterly, too infrequently to act as an effective control instrument. EXCO MDs was therefore created at the same time as EXCO. This was composed of the PIHL executive directors, the heads of each main business stream (Andre Lee, Andrew Jamieson, Frederick Kinmouth and Peter Fu), and John Lee as Treasurer and head of Group risk.

2.59. In principle, this new structure looked promising. As noted in Part 1 of this Report, it was a major challenge to restructure management onto a business product line basis, and to integrate the fixed income business into the rest of the group. It required shifting power away from country heads back to Hong Kong. As most of the overseas operations were joint ventures, the joint venture partners were understandably suspicious. A number of persons I interviewed thought that helping these changes along had been EXCO's main contribution. It usually met over a weekend, and was the only time when all the senior management gathered together in one place. Each member had to gain EXCO's approval for his annual business plan and budget, and, following approval, report on progress at each meeting. But decisions were more often made elsewhere.

2.60. EXCO MDs was meant to meet weekly, and, to judge from its minutes, was more executive. However, it in fact met much less frequently than weekly. In 1996, it met at approximately three-weekly intervals. It only met twice in 1997, in January and April.

2.61. In summary, by 1997 the Board had ceased to be an active overseer; EXCO was more a discussion and communication forum than an executive body; and EXCO MDs had effectively ceased to exist.

2.62. This state of affairs applied as much to risk management as any other area. Responsibility at group level must originally have lain with the PIHL Board. To judge from its minutes, after the creation of the EXCO structure, the Board took no further interest in it. Presumably, responsibility then devolved to EXCO or EXCO MDs, although according to Andre Lee, this was never made clear, and to judge from their minutes, the responsibility was recognised no more than occasionally. In December 1995, EXCO established the Commitments Committee I have described in paragraph 2.29 above, and in November 1996 EXCO MDs instructed that responsibility for Group Credit Risk Management should be transferred to John Lee. EXCO ratified this decision in March 1997. But neither body approved a crucial informal decision to disapply the group credit management policies to PFIL, and neither body regularly discussed risk management issues or internal audit reports.

2.63. From what I saw and heard, the reality was that Peregrine was directed on a highly informal basis, centred on discussions with Philip Tose. By 1997, he was regarded by all the other senior management as *the* decision maker. However, he was equally anxious to preserve the partnership character of the firm at its establishment, and he closely consulted Francis Leung on all strategic matters, including operational matters with a strategic implication. They had an informal understanding that they would rely wholly on each other in their respective areas of operational interest, the fixed income business falling under Philip Tose.

2.64. This form of governance worked superbly for the purposes of building the business and generating an order flow. It was direct, dynamic and responsive. But it was much less well suited to good risk management of a business of increasing complexity. For this, it was more important to have a formal governance structure, on which a solid system of procedures and controls could be based.

2.65. Philip Tose's dominance may not have helped the cause of good risk management. Whether true or not (and as there were over 230 support staff in Hong Kong – including those involved in risk management – it may have been untrue), he was thought to be intolerant of expenditure which did not directly contribute to revenue. Good risk management entails such expenditure. He also had a reputation for being an acute personal judge of risk. Given his personal authority, this made it more difficult for persons engaged in risk management within the group to escape his shadow. Finally, Andre Lee was personally highly influential with him, which would have given others pause for thought before taking action which Andre Lee might not like.

2.66. In terms of containing risk, until mid 1997 PIHL only applied very high level limits to PFIL, an outright position limit and a funding limit. Additional limits in terms of value at risk (VaR) were then put in place, authorised by Philip Tose, Andre Lee and John Lee. Thus Andre Lee and his fixed income team had wide discretion to incur risk as they chose, subject only to personal oversight by Philip Tose. There was good, frequent communication between Andre Lee and Philip Tose, and it seems unlikely that Andre Lee would incur a significant exposure without Philip Tose knowing about it.

2.67. Philip Tose and Andre Lee were aggressively ambitious for PFIL. In risk management terms, Peregrine was vulnerable to their power. Their power was not contained within an agreed clearly defined risk appetite, established up front. This would have made it easier to judge when the limit of Peregrine's capacity to take risks was being approached. Their power was not subject to predetermined measures to deal with excessive risks, or to robust counter measures to maintain a proper balance between risk and the capacity to absorb it. The informal style which actually operated in Peregrine meant that nothing was ruled out and, provided Andre Lee could get Philip Tose's agreement, more positions and greater risk could be incurred. Indeed, on at least one occasion, according to Andre Lee, Philip Tose instructed actions incurring significant risks to be taken against his advice, although the outcome was successful.

2.68. So far as I can see, no one was in a position to challenge Philip Tose to ensure adequate priority was given to determining what the risk appetite and risk control measures should be for the fixed income business. It seems unlikely that other EXCO members would have tackled him head-on on such an issue, even had they wished to. Alan Mercer told me that in his view the appetite of the Group for risk was dictated by Philip Tose in his drive to build the company up, but that Francis Leung was an "equal partner" in terms of the whole Peregrine enterprise. I have no reason to doubt this, but it was agreed between them that Philip Tose looked after PFIL.

2.69. This is not to argue against delegation by a board to empower the senior executives, which is essential. But it remains the board's responsibility to test that its delegation is effective and working. This does not seem to have happened in Peregrine. At the very least, the PIHL Board ought to have established objective indicators of performance against its risk appetite to alert it to the possibility of problems, particularly as the fortunes of PIHL became so inextricably tied to those of PFIL. There were none. Given this, it is my view that the PIHL Board did not delegate its authority in a safe manner.

2.70. Alan Mercer disagrees with this. He believes EXCO and EXCO MDs were themselves the forums at which the effectiveness of delegation was tested, by the regular requirement of reporting and scrutiny. This was possible because the executive directors of the PIHL Board were members and attended both committees. This argument seems to me to amount to a view that the Board abdicated its role to EXCO and EXCO MDs, which may well have been true. Whether this is correct or not, neither EXCO nor EXCO MD's established any indicators of performance against permitted risk appetite either. That would have provided a context for the members of these committees to scrutinise whether what was reported to them was acceptable or not, and would have made delegation safer.

2.71. The practical result of the lack of oversight over Philip Tose and Andre Lee was, in my view, a mindset whereby, provided they liked a transaction and it could be funded, it went ahead. Too little attention was paid to whether it was compatible with the rest of the Group's risk exposures, or whether it might prejudice the crucial assumption underlying the Group's funding that trading assets would be sold within 3 months.

2.72. Andre Lee disagrees, holding that PFIL always sought to ensure that sufficient funding existed in the event that markets changed and PFIL was forced to hold onto deals for longer periods than anticipated, and that it checked the appetite of customers carefully before committing funds to them. He knew John Lee as a matter of course sought to have a certain percentage of total funding lines kept in reserve.

2.73. I believe Peregrine's informal and personal approach to risk management did not look forward enough to anticipate possible problems. In this sense, it was reactive and backward looking. A more formal set of procedures, with parameters set at the top, while by no means foolproof, generally forces the business to adopt a more forward-looking stance, where potential problems can be spotted while there is still time to do something to ameliorate their effects.

PFIL Board

2.74. The Boards of subsidiaries within Peregrine, such as PFIL, each had legal duties which meant they had a responsibility to ensure that any central or local control system affecting their business area was effective, whether it was applied group-wide or was local to their area.

2.75. The PFIL Board rarely met formally. In general, it conducted itself informally, through bilateral discussions. There appears to have been no formal allocation of responsibilities within the Board but, by a process of elimination from the circumstances which have come to my attention, I believe the responsibility for its affairs effectively was delegated to Andre Lee, Philip Tose, Peter Wong, John Lee, and Anthony Loh. However, Anthony Loh was resident in Singapore, and so was something of a special case. Andre Lee was the Managing Director, reporting to Philip Tose who was Chairman. Anthony Loh would act as Managing Director from Singapore when Andre Lee was absent. Peter Wong and John Lee were assumed to apply their group responsibilities to the affairs of PFIL in discharging their Board responsibilities. Thus Peter Wong was assumed to be PFIL Finance Director, and John Lee PFIL Treasurer. Who was PFIL's risk manager is less clear, for, in so far as credit risk was concerned, this function was kept firmly under Andre Lee's control.

2.76. Andre Lee was a strong and forceful leader. He had a clear vision for PFIL and drew up detailed business plans to articulate his goals and how they would be achieved. He set PFIL tough profit targets, and took responsibility for meeting them. These targets were contained in his business plan submitted to EXCO, and other EXCO members had the chance to question the inherent risks and rewards. In his evidence, Andre Lee stated that Philip Tose had held up his business plan as being the example for others to follow. Against this background, it might have been difficult for others to query the wisdom of the PFIL plan.

2.77. Andre Lee had close contact with his senior staff in Hong Kong. He supplemented frequent oral and written communication with periodic meetings which pulled all his managers, wherever located, into a central place. In addition, he regularly communicated with Philip Tose on operational matters, progress on achieving financial targets, the prospects for the Asian markets and future group strategy.

2.78. Andre Lee assumed that his fellow directors of PFIL were aware of material exposures and significant events and issues, despite the absence of any formal reporting mechanisms. He communicated directly and frequently with Philip Tose, Anthony Loh, Warren Allderige in the early days (he was later posted abroad), and John Lee. His view was that the nature and frequency of bilateral and group discussions would have ensured that people were informed. He probably overestimated how much they knew. The informality of this process could quite easily have led to gaps and misunderstanding as to who knew what.

2.79. As seen from now, it would seem that Andre Lee resisted interference from Group functions, most notably Internal Audit and Group Credit Risk Management. He had concerns about an internal audit draft report on PFIL conducted in 1996, believing that many of the points had already been addressed and the report ought to be changed to reflect this. He suggested to me that John Lee also had problems with the report, and that it was left to John Lee to deal with. The report was never finalised.

2.80. With regard to resistance to Group Credit Risk Management control, Andre Lee told me that he had suggested to Philip Tose back in 1994 that the credit extension and control mechanisms were not as strong as he had been used to in Lehman Brothers. Nevertheless, PFIL was not brought under the coverage of the Group Credit Risk procedures established in 1994, although they clearly envisaged that happening. Instead, PFIL established its own internal procedures which did not require the input or sign-off from any Group function. This should not have been allowed to happen.

Valuation

General Policy

2.81. Appropriate valuation of assets and positions is at the heart of risk management, but the Group had no formally documented policy on it. The only documented policies were those appearing in the 1996 Annual Report and Accounts, which were necessarily high level and lacking in detail. However, after John Lee expressed concern about this, a table was devised by Product Control in mid 1997 to show for each type of position the source of the valuation and method of verifying it (Appendix 2.5). This went some way to describing the process, but fell a long way short of a full policy.

2.82. Peregrine was engaged in a wide range of activities and had positions which were complex and difficult to value, and which originated from many different trading desks and countries. In such circumstances, it was all the more important to establish a clear, documented policy to ensure that the process was understood and reliable.

Valuation Method

2.83. The basis of valuation for PFIL's trading portfolio was 'mark-to-market', a term used freely within Peregrine. Interviewees (except Andre Lee who in describing it as a process of deductive reasoning allowed for other factors to be included) certainly seemed to believe that they were 'marking-to-market'. However, the definition they gave was in terms of 'last traded price', even if the last traded price was away from the current market price, as was increasingly the case when the Asian crisis gathered momentum. This cannot be true marking-to-market.

2.84. Liquid, listed, simple instruments do seem to have been marked-to-market in the accepted sense of the term. For less liquid bonds, however, 'marked-to-market' had a more fluid meaning. This is not necessarily surprising; such instruments can be tricky to price, and a variety of techniques may be used to arrive at a meaningful value. But this will inevitably be a balance of judgement. The overriding principle in such circumstances, though, ought to be a prudent estimate of how much the position could be sold for by the holder today.

2.85. In PFIL, the mark-to-market value assigned to illiquid bonds was usually based on the most recently traded price, which given the nature of its portfolio was often quite old. Where a bond had not been traded by anyone in the market at all for some time, it might be compared with other similar issues which had traded, or an assessment might be made of the relative credit spread between it and higher quality bonds which had traded. PFIL's traders made the initial judgments.

2.86. The required frequency of marking-to-market was not documented, but the general assumption seems to have been that ideally it should occur daily. Instruments which were more easily valued (for example those with externally published prices) were marked-to-market daily, but it seems that the more illiquid, complex instruments in PFIL were revalued only monthly at best.

Valuation bias

2.87. Peregrine purported to be conservative in its valuation methodology - indeed many of the interviewees were at great pains to stress that Peregrine's methods were conservative, or at least were intended to be.

2.88. In fact, the general policy on valuations tended towards optimism. A conservative policy would normally include, for example, adjustment of the valuation for positions which had no ready market, and a further adjustment for positions which were larger than a typical single trade for that bond, or which were large in comparison to the overall amount of the issue. Extra caution would be applied to positions which were large in relation to the size of the holder's financial resources. Peregrine had none of these features.

2.89. The real fault here is not so much that these effects were not captured, it is rather that they were not really considered as part of the valuation procedure. As market conditions deteriorated through the second half of 1997, it is less and less likely that the values they attributed to non-liquid bonds were on market, let alone conservative. This mattered more and more through the second half of 1997 as the size of the more illiquid bond holdings increased substantially, and the effect of mis-marking, even by only a few basis points, could have been material.

2.90. Despite this, the firm did have one tool for adjusting valuations - the "aged inventory" provision, although this was only introduced in 1997. This required long held positions to be marked down in price gradually by the imposition of an aged inventory provision, the idea being (so I was told by several interviewees) that at some point the position would reach a value where it could be sold. It was thus an implicit recognition that bonds held for a long period were unlikely to be valued at their current market price. Although making a provision of this sort certainly provided a buffer to the profit and loss account, it was not conservative. The conservative approach would be to discount the price in one hit, once a threshold age had been reached. This would also have acted as a sharp discouragement to allowing a position to reach the threshold age.

2.91. This was a very important matter. At the end of 1994, the policy was adopted for the whole of the group that securities should not be held for more than 3 months (Appendix 2.6). The Group's funding would have been based on this being enforced. After a further month, the policy called for the security to be reclassified as an investment rather than a trading asset. In fact, PFIL continued to hold bonds in large quantities for far longer than that, as was clearly indicated in reports to senior management. KPMG, whom it seems Peregrine asked informally in October 1997, suggested a far harder hitting policy, as indicated in the footnote below[2]. Their advice was overruled as being too

[2] *KPMG advised:*	*after 3 months 5%*	*Peregrine used:*	*after 3 months*	*0%*
	after 6 months 10%		*after 6 months*	*0.9%*

conservative. Had it been applied before the onset of the Asian crisis, PFIL's inventory would almost certainly have been far more realistically valued, and easier to sell at or near book value. But Peregrine rejected it as too harsh, and in any case it was too late. It was a revealing episode.

Independent Oversight

2.92. Peregrine purported to have an independent check on traders' valuations, performed by Group Product Control, which was a division within Peter Wong's Finance directorate. It was established in May 1996, headed by Mark Cohen, who had been recruited from Credit Suisse First Boston. By the end of 1996, it had ten staff, apparently devoted to Fixed Income product accounting. However, Mark Cohen resigned and left in April 1997, and it remained leaderless until Catherine Sham became its interim head in October, pending the arrival of a new recruit in January 1998

2.93. Mark Cohen's departure left Product Control without the necessary leadership or skills, and its performance suffered. It did not independently verify the mark to market value of positions which had no ready market, which amounted to a substantial part of the bond portfolio. Catherine Sham discovered this when she became its interim head. She drew comfort from the fact that Group Risk Management saw the data, had the technical expertise to comment on it, and sometimes did so. She assumed silence from them meant they were content with the valuation. Group Risk Management did not know this, and assumed Product Control was doing its job. Group Risk Management did not routinely look over or comment on Product Control's data, unless something specifically came to their attention. The result was a large gap in the comprehensiveness of independent oversight of the valuation process.

2.94. It was known in the firm that the skills gap existed in Product Control, but the consequences may have been less well appreciated. It did not seem to be generally known, for example, that traders' valuations of the more complex, illiquid or esoteric instruments were not checked at all.

2.95. Independent verification of traders' valuations is a cornerstone of robust risk management; not only to ensure that the books and records are fair, but also that risk management data is accurate. Peregrine's management knew this; it was why an independent Product Control had been established in the first place.

2.96. Peregrine sought and recruited a replacement for Mark Cohen from abroad, but he could not start until the beginning of 1998 (by which time the Group had collapsed). In the meantime, Catherine Sham took on the role in October 1997, in addition to her existing

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after 9 months	*15%*	*after 9 months*	*2.7%*
after 12 months	*20%*	*after 12 months*	*4.5%*

To put this into context, under Peregrine's calculation a bond which had been on their books for 6 months would be marked down by 0.9%, for example from a price of 97 to 96.1. For a position of US$ 100 million, this would represent a P&L adjustment of US$ 900, 000. The corresponding calculation under KPMG's advice would be to mark the bond down by 10%, so 97 would reduce to 87. The P&L adjustment on a US$ 100 million would be US$ 10 million.

job as Group Financial Controller. This was inadequate for such an important issue, especially with markets becoming more difficult in the Asian crisis. Other interim steps should have been considered. Group Risk Management, where expertise existed, could have been asked to become more involved. A discount on the traders' valuation of the positions known to have no ready markets could have been applied, or a general provision against the uncertainty in valuation which the skills gap created could have been made. The most significant aspect is that no one appears to have asked the question whether anything needed to be done.

Trading book versus investment

2.97. As already noted, Peregrine had a policy of transferring securities from trading to investment portfolios if they were held for more than 4 months (Appendix 2.6). The policy was not followed, although the information was readily available in reports to senior management. Indeed, these reports indicated that the basic limits on size of position and holding period were routinely broken, over long periods of time. Catherine Sham thought the policy only covered equities, and suggested that responsibility for its operation lay with business heads (Andre Lee for PFIL). Andre Lee did not recall any policy, and so certainly was not applying it. He asserted that so long as it remained the intention to dispose of the position (or transform it into a form which was more marketable) it should continue to be classed as part of the trading portfolio. Eliza Yuen, the partner in Deloittes responsible for Peregrine's audit, supported this view, maintaining that intention was the principal determinant of the asset category. However, in saying this, she may not have been aware of the importance of the policy for Peregrine's funding arrangements, which assumed that trading assets would be turned over within three months.

2.98. Regardless of the fact that the directors have since held that this policy was only ever intended to apply to equities, the principle that long-held bonds should be recognised as such by transferring them out of the trading book is sound. It highlights that the cashflow projections and funding needs may have a different, long-term, profile, and that a different accounting treatment should be considered. However, this did not seem to concern the management in Peregrine.

Provisioning

2.99. Provisioning is a fundamental part of the risk management framework, acting as a complement to the valuation policy. The need to provide adequate amounts for anticipated losses or uncertain situations is well accepted, and guidance is provided in accounting standards. Nevertheless, despite the guidance, this is a grey area. There are no hard and fast rules, and a large amount of judgement is necessary. The amount provided will depend on a number of things; not only factors relating to the individual counterparties but also the precise nature and scale of the institution's own business.

2.100. Provisioning typically takes two different forms when applied to the activities in which PFIL was engaged (it was an investment firm rather than a credit institution): the traditional method of assigning general or specific reserves against, essentially, default events; or an adjustment to the mark-to-market valuation. The 'bottom line' ought to be the same, but they can have different effects. For example, adjusting the mark-to-market can alter the risk management data, which may or may not be desirable given the particular circumstances. Nevertheless, swaps and other derivatives are priced taking into account the quality of the counterparty (through the so-called credit spread), and a deteriorating credit rating is best accounted for in the mark-to-market procedure, at least until such time as the counterparty is likely to default on payment of interest or principal (or has done so). Then a different accounting treatment altogether is probably more appropriate.

2.101. Given these complexities the provisioning policy of any institution ought to be documented, and it ought to address, in particular, the scope and rationale for provisioning and the responsibilities for establishing the policy and for implementing it. Peregrine did not have any of this, and it was unclear who was responsible for ensuring adequate provisions were made.

2.102. In practice, it seems that Catherine Sham would initiate the exercise and Philip Tose would make the final decision, after seeking input from others, particularly John Lee, and the relevant business head – Andre Lee in the case of PFIL. The particular case of the interim results for the 10 months to 31st October 1997 illustrates that, on this occasion at least, the result was ad-hoc and confused. As such, it was unlikely to be robust or reliable.

2.103. The process was initiated by the decision in late October to make an emergency announcement designed to counter the rumours then circulating against Peregrine. Prior to making this announcement on 26th October, it was decided at a series of meetings chaired by Philip Tose that mark-downs of value or provisions of over US$ 60 mns should be made against PFIL's book. These were allocated approximately as follows:

- US$ 28 mns against identified swaps transactions
- US$ 3 mns against defaulted FX contracts
- US$ 7 mns against named receivables
- US$ 25 mns from revaluation of bond positions (including some US$ 3 mns from the aged inventory provision)

2.104. With the exception of the aged inventory, it is unclear who proposed these amounts and who agreed them; it would seem, however, that the named counterparties either had defaulted on their obligations, or were likely to do so. The amount to be provided would have required more subjective judgement, but as the interim results were ultimately reviewed by the auditor, it must be that these amounts were deemed adequate by some measure.

2.105. According to Catherine Sham, one of Andre Lee's senior managers, Lynn Chui was involved in the process to agree PFIL's provisions at the end of October 1997. Andre Lee himself was on holiday, so was not directly involved. However, John Lee phoned him, and learned that he was very strongly opposed to making any provisions, preferring to take a more measured view at the end of the financial year. Andre Lee put the same view to Philip Tose on his return to Hong Kong on 26th October, but by then he had been overruled. Instead, he was asked to distribute US$ 60 mns worth of provisions against PFIL's book. After consulting most of his front line business managers, and John Lee, he produced a list (Appendix 2.7) which was strikingly different from the final allocation (Appendix 2.8).

2.106. Andre Lee gave this list to Financial Control in mid November, and a copy was also passed to Zurich, who had asked to see it. He did not know what the final allocation was, or that it was very different from his. Catherine Sham did not recall whether she had seen Andre Lee's list, although she believed it had been passed to the auditors. If so, the auditors did not keep it in their working papers.

2.107. To say the least, it is highly unsatisfactory that the decisions about the provisions against PFIL's portfolio, which were finally confirmed in early December prior to the announcement of the results as at 31st October 1997, did not include consideration of Andre Lee's list. The process was not rigorous and the result must be regarded as unreliable. If, for example, Andre Lee's proposals were combined with the actual allocation of the provisions which were made (and excluding obvious double counting), it would suggest that an additional amount of between US$ 34 mns and US$ 55 mns might have been necessary. In saying this, I do not wish to imply that such a simplistic approach would have given the right figure.

2.108. Neither the actual provision as at 31st October 1997 nor Andre Lee's proposal contained any provision against the Steady Safe exposure. This is considered much more fully in Part 3. Given the size of Steady Safe in relation to Peregrine's capital base, the contemporary market conditions, and the fact that the ability of PFIL to reduce its exposure was critically dependent on a single event (a successful rights issue), it would seem imprudent not to have marked down its value in some way. The collateral held by Peregrine covered part of the exposure, but its value had more than halved (from US$ 166 mns at the end of September to US$ 80 mns by the end of October and then further to US$ 62 mns by the end of November). Given these facts, I suggest in Part 3 that at a minimum a provision of 20% of the exposure should have been made, amounting to some US$ 50 mns. In early January 1998 – by which time the rights issue had failed and the market had deteriorated further – Philip Tose decided to provide US$ 118 mns against Steady Safe for the annual accounts as at end November 1997.

2.109. In addition, in Part 3 I argue that Tanayong and Robinson should have been provided against.

2.110. Peregrine did begin the process of putting in place a more rigorous provisioning policy. A draft policy document was produced in October 1997 (Appendix 2.9), but it had not been finalised by the time Peregrine collapsed. As drafted, it was a far from satisfactory proposal. It did not address the question of provisions where credit quality was in doubt (other than to reinforce the existing practice which I believe was deficient). It did not address the question of who was responsible for the overall process and each stage of it.

It did not define a process which would ensure that all relevant information could be properly and independently assessed. In my view, its application at the end of October would have made little difference to the decisions about provisions against Steady Safe, Tanayong and Robinson, which I criticise in Part 3.

2.111. Peregrine's attitude to provisioning reflected its generally optimistic view of its business and the informal way in which it operated. Its experience up until August 1997 was that it could trade out of trouble, or at the very least mask it until matters improved; with this kind of culture the discipline of a formal process was unnecessary and unwanted. In common with other aspects of its control environment, it ought to have had a set of principles governing provisioning, together with clear levels of responsibility and authority. Even if a more robust provisioning policy had not produced a different outcome, it might, in conjunction with a tighter control regime, have tempered the firm's appetite for taking on more and more risk.

Measuring Market Risk

2.112. Peregrine employed a value at risk (VaR) approach to measuring market risk across the group. This was applied to each subsidiary individually, and then aggregated across all. The model employed was JP Morgan's RiskMetrics.

2.113. As a risk measurement and management tool, VaR employs various underlying assumptions. At the core is an assumption that markets are deep and liquid and that dependable mark to market prices can be established on at least a daily basis. The history of price movements is then used to estimate future price movements – and therefore potential profit or loss – according to some set of statistical bounds which may vary across institutions depending on their size and the nature of their business. PFIL generally used statistical parameters in line with those propounded by the BIS Supervisors Committee, namely it would estimate future losses which may occur over the following ten days with 99% statistical confidence.

2.114. However, PFIL had a large bond portfolio which could not easily be valued, particularly as the Asian crisis developed through 1997. This does not necessarily mean that VaR could not be useful to PFIL, but it would certainly have needed to interpret the results of VaR calculations with great care.

2.115. Despite having a VaR capability, until mid 1997 the only constraints on market risk exposures which PFIL as a single entity could incur were in terms of the overall net position plus an overall funded position. In being unrelated to risk, and being so broad that they did not act to limit risk, these limits were insufficient to control its business. The introduction of VaR limits in mid 1997 was probably too late to have made any real difference to the outcome. By then, PFIL had a large balance sheet, containing big parcels of relatively illiquid bonds and it was committed to Steady Safe. PFIL also withdrew from active marketting of new issues around August, and sharply limited its trading in bonds in September and October. The limits agreed at that time between Group Market Risk Management and PFIL fitted the exposures it then had, and although they constrained PFIL's ability to expand, they did not in themselves require any reduction.

2.116. In any case, VaR limits would have become increasingly ineffective in the stressed and highly volatile market conditions which developed in Asia in the second half of 1997. The size of individual positions held by PFIL and the Group's growing illiquidity would have further reduced their relevance. The necessary conditions for VaR to work no longer held.

Stress Simulations

2.117. To deal with conditions where markets are stressed, it is widely recognised good practice to conduct periodic "stress testing", particularly for a firm such as Peregrine whose main risk control tool is a VaR based model. VaR uses historical data to predict future market movements; thus it assumes relatively 'normal' conditions. The value of stress testing is that it provides information (although nothing concrete) on possible losses which may arise if unusual conditions prevail which have not occurred within the recent past. Of most interest is a market experiencing abnormally large market swings, or prolonged periods of inactivity.

2.118. In addition, a comprehensive programme of stress testing would include scenarios which may not be related to the market as such, but to political, company-specific or sector-specific events, or currency devaluations - events which although plausible are unlikely, but would be particularly damaging to the firm should they occur. The results of such stress testing are useful in evaluating the firm's capacity to absorb such losses and identifying how to reduce or even prevent them.

2.119. PFIL was vulnerable on a number of fronts which could have been usefully assessed by stress testing, including market illiquidity, currency devaluations and concentration of exposure to a particular country or issuer.

2.120. Andre Lee claimed that PFIL regularly performed assessments on its exposures under stress conditions on positions, credits and markets. I have no reason to doubt that before undertaking an issue PFIL would assess the effect on the issuer of significant currency devaluations or sharp spikes in interest rates, but I found no documentary evidence of it ever being done on a portfolio wide basis.

2.121. However, Group Market Risk Management did undertake what was described as stress testing, in that from time to time it computed VaR using a one month, rather than ten day, holding period. This was far too modest a change for the immature markets in which PFIL traded, and for a portfolio of bonds some of which had been held for periods far in excess of one month (at the end of October 1997 PFIL's inventory included US$ 286 mns held for more than three months).

2.122. There is some evidence that in the past PFIL had run 'devaluation' stress scenarios, in that reference is made in Group Market Risk Management reports to such tests being performed separately. Unfortunately, I could not locate any results, despite Andre Lee telling me they were made available to Group Treasury and Group Risk Management. Neither Philip Tose nor John Lee were aware what the stress scenarios might have been, and so, even if calculations were made, they would have been of no practical consequence for Group level oversight of PFIL.

2.123. However, the fact that meaningful stress testing did not take place does not mean that the possibility of adverse times was wholly disregarded. Andre Lee had a clear idea of the worst market development he could envisage occurring. This was that two, or at most three, Asian currencies might devalue by 20-30% at the same or almost the same time. Philip Tose told me he thought in terms of markets or currencies falling by 20 – 40%. PFIL managers apparently regularly discussed the impact of what they thought was the worst market development which could affect them. Andre Lee claimed PFIL knew what the profit and loss effects and impact on inventory position and hedging would be, and prepared action plans and were prepared to act on the results.

2.124. In relation to currency movements, I am sure this is correct. When Thailand devalued in July 1998, PFIL acted promptly to shut down remaining areas of open currency risk exposure, realigning its hedging strategy, and, as described in Part 3, seeking to persuade such clients as Robinson, Tanayong and SVOA to reduce their exposure to further Baht devaluation. As the crisis spread to other countries, PFIL reduced its new business generating activities. But I am not persuaded that the same vigilance was applied to stress testing of their portfolio in respect of other risks, notably credit risk.

Independent Market Risk Management

2.125. Peregrine had a well-established Group Market Risk Management (GMRM) function under John Lee, which had been built up over several years. It contained technical staff, led by Kelvin Chow, able to understand and use the widening application of modern analytics for measuring and controlling the group' s diverse range of exposures.

2.126. In general, the role of an effective independent market risk function would have been in the following areas:

i. *To ensure that the risk appetite of the firm was adhered to.* This was impossible in Peregrine as its risk appetite had not been defined or documented for either PIHL or PFIL.

ii. *Development of risk limit policies and responsibility for ensuring adherence to these policies.* GMRM did negotiate risk limits with business heads, and monitored positions against the limits. However, monitoring was largely a manual process, carried out relatively infrequently and prone to errors. Where limits were broken, GMRM seems to have preferred to refer to the fact in its reports rather than take direct action, in the hope that recipients in the business area or more senior management would act.

iii. *Design of stress scenarios.* GMRM was certainly involved in this to the limited extent it was carried out by the firm, but as I have described the stress scenarios were far too modest.

iv. *Ensure senior management received adequate and appropriate risk reports.* Numerous reports were produced and distributed, and these contained good information. However, they were probably too numerous and too detailed to be of real benefit to the senior management, particularly Philip Tose, who asked John Lee for them to be simplified. John Lee's approach, on the other hand, was to provide as much detailed information as possible to support the key messages of the report.

v. *Ensure risk model validation processes were in place.* Peregrine was involved in a number of complex businesses requiring sophisticated modeling techniques to be available to traders to enable them to value the instruments and measure the exposures they incur. It is important that an assessment independent of the trading function is made to check that these models are appropriate and properly installed; errors can lead to large miscalculations and corresponding unexpected losses (or profits). GMRM had reviewed some models used by business units, but there was no formal and documented validation process in place.

vi. *Ensure an independent price testing process was in place*. I have commented on the arrangements for independent verification of prices in the section entitled "Independent oversight" earlier in this Part of the Report.

vii. *Monitor unusual trading patterns*. This seems to have been left largely to business heads, although GMRM and Product Control did seek to monitor activity to ensure correct data for financial records. It seems clear that PFIL 'parked' positions at strategic times, for example over month ends, but it is not always obvious why. John Lee certainly sought to encourage business areas to reduce their inventories over the end of significant accounting periods, which he regarded as normal practice.

2.127. My overall impression is that GMRM seemed to have knowledgeable individuals, technically capable to withstand trader pressure and provide counterbalance. Yet there is little obvious evidence of their acting with much authority. Their role seems to have been largely passive, providing information upwards and outwards in the expectation that others would act. I cannot judge whether this was a conscious decision, but it was a missed opportunity. A risk management function has to have, and be seen to have, clout if it is to be effective.

Independent Credit Risk Management

2.128. Peregrine had an established Group Credit Risk Management (GCRM) function. It had been formed under Peter Wong, but was transferred to John Lee near the beginning of 1997.

2.129. In 1994 and early 1995, under Peter Wong's authority, a document had been put together by Solomon Yiu, the Head of GCRM who had been recruited from Citibank, which consisted of a number of separate memos describing policies in relation to credit matters. Together they constituted a set of group credit risk procedures ("Procedures") (Appendix 2.10). There has been confused and conflicting evidence on the implementation of these policies. The most likely story to my mind would seem to be as follows:

- The Procedures were intended to apply to the entirety of the Peregrine Group. Despite some interviewees suggesting that they were not meant to apply to PFIL, as they were not appropriate to the type of business it conducted, both Stan Lee (Solomon Yiu's successor as GCRM manager) and Andre Lee believed that the intention had been to include PFIL.

- The Procedures were not well received by some senior staff, including Andre and John Lee. At least part of the reason for this was that they did not have confidence in the staff of GCRM. Philip Tose was informed, following which it was felt he no longer supported the Procedures. According to Andre Lee, Philip Tose wanted Solomon Yiu fired on grounds of incompetence (if so, it was not done).

- GCRM began to implement the procedures on a piecemeal, best efforts basis, starting with business units most well-disposed to the general approach. Its hope was to instill better credit awareness and persuade colleagues over time of the merits of adopting formal procedures to govern the granting and controlling of credit exposures.

- By the beginning of 1997, when John Lee took formal responsibility for GCRM, the majority of Peregrine's business functions, but not PFIL, had implemented procedures more or less in line with the Procedures (there were minor variations to fit their differing needs). However, the precise detail of the procedures in place in different areas had not always been documented, although the intention had been to do so.

- PFIL had never been under any GCRM oversight, and continued to be thought hostile by GCRM. GCRM staff hoped John Lee, when he took command of the function, might be able to apply pressure to PFIL to come into line with the Procedures. The staff were not aware that John Lee himself, according to Andre Lee, had been instrumental in resisting their application to PFIL. The GCRM staff had no real idea what credit risk procedures PFIL was using.

- Bringing PFIL under group control was not John Lee's major priority when he assumed responsibility for GCRM. Indeed, his view was that this could and should not be done until GCRM had better staff. He proposed to Andre Lee that the credit analysts from PFIL should be transferred to GCRM. Andre Lee agreed in principle, although timing was an issue. He argued that, in order to be fair to the staff involved and not risk losing them, the transfer would need to wait until later in 1997. Paul Rusinak and Lloyd Ong did not transfer from PFIL to GCRM until December, although Andre Lee maintains they began doing work for John Lee from the summer onwards. By then, it was far too late.

2.130. Whatever the true facts surrounding the Procedures, it does seem clear that GCRM were operating under impossible conditions, particularly in relation to PFIL. In effect, the staff were not supported by senior management and had no authority; in these circumstances no one could reasonably expect them to add value. This was a matter which should have been grasped and resolved well before 1997.

Credit Risk Management in PFIL

2.131. PFIL applied its own credit procedures. At the core of this was a credit committee consisting of a variety of senior PFIL staff. All new commitments had to be approved by this committee before proceeding. Andre Lee was chairman, and likely to be highly influential.

2.132. PFIL's credit committee seems to have been reasonably structured and executed. It allowed for differing views amongst its members, who were drawn from different parts of PFIL and might well have different opinions according their area of expertise and responsibility. This diversity facilitated a rounded assessment of the business sense of an initiative for PFIL as a whole.

2.133. However, the processes within PFIL displayed a number of important weaknesses:

2.134. **Documentation of Procedures**. Although procedures were in place and often documented, this was haphazard and piecemeal, with frequent amendments. Generally instructions and amendments were sent by e-mail, with no set format, no central collation of the various (and numerous) communications, and no index.

2.135. The procedures seemed to be as much reactive as proactive. They were not regularly reviewed for relevance, nor was adherence policed. When a problem came to light, it would be addressed. A robust set of procedures would contain stringent checks and balances, which minimise the chance of problems arising in the first place. The processes covering PFIL's business had too many cracks to be considered robust. For example:

- It was discovered in 1997 that in a number of cases the documentation supporting deals was not properly in place. In particular, closeout and netting agreements for derivative transactions had not been signed and returned by PFIL's counterparties.

- PFIL had collateral from Tanayong which was not properly assigned.

- There was a lack of up-front credit risk analysis on prospective issuers of syndication deals. Although credit research was produced as a marketing aid, this would not eliminate the need for internal, documented analysis with regular up-dating. (Andre Lee disagrees with this, noting that PFIL's marketing material was the result of the internal credit due diligence which it did on deals before entering into them.)

2.136. **Limits**. Although PFIL had its own limits on syndication deals, they were routinely broken, for long periods. It is unlikely that the limits played any risk-control role. In the case of Tanayong and SVOA, the position limit and holding period had both been exceeded for many months, yet no action appears to have been taken. The Robinson Note holding had no approved trading limit at all.

2.137. Peregrine tended to engage in "bought deals", which involved buying the entire issue from the issuer, and then holding any paper it could not place. This is inherently riskier than placing on a best efforts basis, where the issuer would receive the proceeds only from the paper which could be sold. Until best efforts placing became the norm in the second half of 1997 in response to worsening conditions prompted by the Asian crisis, it would appear that the credit risk attaching to prospective primary deals was lightly regarded, on the grounds that it would not arise as these deals would be sold down to others very quickly. Peregrine was left with some substantial positions originating from primary dealing, some of them exceeding what GCRM had identified as the standard industry-acknowledged limits (25% of own capital, 10% of issuer's capital).

2.138. **Responsiveness to Group needs**. PFIL's formal processes took little account of wider group functions. For example, Andre Lee ordered his team to advise Group Treasury of all proposed new deals, but nothing documented this requirement, or evidenced that it was done. Group Treasury was unhappy with PFIL's performance in this respect, and issued several reminders of the need to be informed of deals which would require funding.

2.139. **Credit Approval and monitoring.** According to Andre Lee, PFIL had, in effect, four different approval processes (for new bond issues, derivatives, money market business and foreign exchange) reflecting the different types of risks for different businesses. It was important that these separate processes were comprehensively documented, to ensure there was no confusion between them. This was not done, and I have been unable to verify to my satisfaction what these processes were from the evidence available.

2.140. **Records**. One of the most striking effects of the informal arrangements was the poor state of Peregrine's credit files. There is no set recipe for what should be contained in a credit file, but it should include the background analysis to the relationship with each individual counterparty, information relating to the financial standing, and material facts from both public and internal sources relating to that counterparty. It should evidence periodic updating.

2.141. Andre Lee explained that PFIL maintained its credit records on an issuance rather than counterparty basis. Thus where a bond issue was accompanied by a derivatives transaction, both would be covered in the same file. But a subsequent derivatives transaction unrelated to the bond issue would be in a different file. Taking Tanayong as an example, the first swap was done at the same time as the bond issue, and therefore should have been in its deal file. The other two swaps should have been in separate files, as they were not linked. The bond deal file was the responsibility of PFIL's origination and credit staff, while the files for the separate derivative transactions were the responsibility of its derivatives staff.

2.142. These arrangements for record keeping were a very unsatisfactory basis for credit monitoring. For that, it is essential to have counterparty files including all transactions.

2.143. This may explain some startling gaps in the credit reviews of several of PFIL's more important exposures conducted by Luis Maglanoc of GCRM in September 1997 (Appendix 2.11). These represented the first evidence of any monitoring by GCRM of PFIL's credit exposures. His counterparty credit review of Tanayong was based on PFIL's public research and focused on the bond position. He did not refer in his narrative to the exposure arising from derivatives with Tanayong, although by the date of his report the exposure arising from deals done subsequent to the bond issue was already huge and still growing fast. PFIL staff had been working for several months to constrain it because they feared it would overwhelm Tanayong. Yet the total exposure, including the derivatives, was included in Luis Maglanoc's summary totals of PFIL's exposure. Robinson, which was a similar situation, was treated in the same way. I find it hard to believe that Luis Maglanoc would have ignored this in his narrative if the credit files had been organised on a counterparty, rather than deal basis. (Andre Lee maintains this was no excuse, as Luis Maglanoc should have known about Tanayong and Robinson from John Lee, who he says was fully aware of both cases.)

2.144. To judge from their present state, PFIL's credit files were very thin. For example, the Tanayong file as now held by the liquidators contained only four items: two public research documents on Tanayong produced by PFIL in November 1995 and July 1996; a print out of some information from Bloomberg; and the counterparty credit review by Luis Maglanoc done in September 1997.

2.145. However, I cannot be certain the credit files remain in the state they were before PFIL went into liquidation. Philip Tose, Peter Wong and Alan Mercer point out that Zurich, First Chicago, their advisers and the auditors all had access to credit files and did not comment on their completeness. Andre Lee is also puzzled. He notes that in November 1997, PFIL had checked all of its deal files for completeness ready for Zurich's due diligence inspection. They were left in his office for that purpose. Subsequently they were returned to filing cabinets in PFIL's credit research office and locked up, with credit research retaining the key. Whether they were tampered with subsequently remains a mystery.

2.146. The first two of the four items in the Tanayong file were produced for the purpose of promoting Tanayong to the public (PFIL was lead manager of the Tanayong bond issued in January 1996). No internal analysis or history of the bond issue is contained in the file. There is no documentation relating to the signed agreements which must have existed between the two parties. There is no mention of the underwriting limits that were put in place, or the deliberations of the credit committee. All in all, even if this file was intended to relate only to the bond issue, it was substandard even for that narrow purpose. The same applies to the credit file of Robinson. PFIL now lacks documentary evidence that it performed the necessary due diligence before entering into the underwriting commitments with these two counterparties.

2.147. **Credit risk mitigation**. Effective risk mitigation techniques are another essential constituent of a robust credit management environment. These help to contain credit exposures if they become substantial or unwanted. This is doubly important where derivatives are involved, because they bring interest and exchange rate movements into the equation, often without limit and sometimes in a way which involves losses of a multiple of the change in the underlying rate. PFIL had derivative transactions of this kind.

2.148. There are two types of risk mitigation which Andre Lee referred to as being pertinent to PFIL; netting and collateral. Netting means the ability to settle amounts on two or more derivative positions on a net basis. In practical terms this reduces the credit risk should the counterparty default; outstanding contracts can be settled by payment of the netted amount rather than having to pay amounts owed before knowing whether amounts owing will be returned.

2.149. Collateral, or margining arrangements, are often part and parcel of derivatives contracts, and may exist alongside or independently of netting arrangements. Margining arrangements will usually involve a netting agreement when applied to a number of transactions. Collateral arrangements stipulate bounds on the credit exposure which is allowed to build up, beyond which the counterparty must post collateral in whatever form and to whatever value has been agreed. The excess collateral may be returned if the credit exposure subsequently reduces.

2.150. PFIL relied on International Swap Dealers and Derivatives Association (ISDA) agreements, which are an internationally accepted standard form of netting agreements, to set out the terms of the netting and collateral arrangements with individual counterparties. However, it did not properly monitor the process of ensuring they were always finalised before taking on the business to which they related, and in the middle of 1997 it was suddenly discovered that many remained uncompleted. To be fair, unsigned ISDA agreements were not unusual in other institutions, although that is no excuse. Andre Lee assigned two of his staff to sort out the problem. Both Robinson and Tanayong had outstanding ISDA documents.

2.151. My understanding is that until this discovery, responsibility for documentation had rested with business heads. However, Andre Lee disagrees. In his view, John Lee had responsibility earlier, arising from his position as head of Group Treasury. Many of PFIL's counterparties were also Treasury's counterparties, and it was important to have only one party handle the documents to avoid confusion. Whoever is right, in August 1997, Philip Tose agreed that John Lee and Alan Mercer should establish a central documentation unit to handle ISDA agreements as well as other documentation problems which had arisen in Asia Investments International Limited, another Peregrine business.

2.152. As a result of the unsigned ISDA agreements, Peregrine had no legally robust limits to its exposure from its swaps with Robinson and Tanayong. It had no right of access to collateral from either as the exposures grew. PFIL attempted to take collateral from Tanayong as part of the restructured derivative concluded at the end of November 1997, but this was of limited value due to ineffective execution. PFIL deliberately desisted from taking collateral from Robinson when its swap was restructured, believing it was too late to do so, as it would damage Robinson's ability to survive. In short, the unsigned ISDAs impaired Peregrine's ability to deal promptly and effectively with its growing exposures to these companies.

2.153. In summary, PFIL's attention to risk mitigation was very sloppy. Its intentions were often good, but were sometimes not translated into practical benefit through inattention to essential detail. In other cases, PFIL did not consider how its risk might be mitigated if the unexpected happened, and probably missed opportunities to contain its risk. Overall, it did not behave in a credit-risk conscious manner.

Internal audit

2.154. The UK Institute of Internal Auditors defines internal audit as "an independent appraisal function within an organisation to examine and evaluate its activities as a service to that organisation." It should provide top management with analyses, appraisal, recommendations and advice on the activities reviewed. It can detect or deter fraud, identify savings and opportunities, and add value across the business.

2.155. By 1996, Peregrine's internal audit function was producing findings which in my view could have added value to the business, and certainly deserved to be noticed. But two of the more interesting reports in that year, on Group Treasury and PFIL, were never completed. I suspect that it is not coincidental that John Lee was involved on the business side with both.

2.156. Although it is fair to say that the non-completion of these two reports was the exception, it should not have been possible for two important reports to remain uncompleted. In my view, the procedures for internal audit were seriously flawed, and as there was no alternative process of overall quality control in operation, the result was that the Group had no reliable means of checking the quality of its own processes

2.157. Internal audit departments need the cooperation of the areas of the business which they are auditing. When this is achieved and they are thereby allowed to do their job well, internal audit can be highly supportive, helping business areas to achieve their objectives. At its best, internal audit is in effect a valuable free in-house consultancy.

2.158. But because internal audit represents external oversight of a business function, it is often seen as threatening. Internal audit therefore requires to be strongly supported from the very top of the organisation. Ideally, it should have a reporting line to non-executive directors of the Board, because its recommendations might touch on any part of the executive, including the executive directors.

2.159. In Peregrine, this was not practicable because the PIHL Board was inactive and the non-executive directors had no real authority. The next best thing, although much less satisfactory, would have been linkage between the Internal Audit department and EXCO.

2.160. Internal Audit in practice had no linkage into any senior management body. John Lee raised this issue at the EXCO meeting in September 1996, but there was no immediate reaction. However, EXCO MDs did become slightly more involved in 1997. Alan Mercer sent the audit programme for 1997 proposed by Internal Audit to EXCO MDs, asking for comments. As he did not receive any, it was actioned without change. There was also a proposal to establish an audit committee based on EXCO, but it did not commence before the Group collapsed.

2.161. As it was, Peter Wong, the director responsible for Internal Audit until 1997, together with the business head of the area being audited, saw the reports. It is evident that Peter Wong, despite being a director of PIHL, did not exercise his personal authority to insist that the draft reports on Group Treasury and PFIL be finalised, despite the objections of John Lee and Andre Lee to their contents. That was wrong, The format of audit reports provided for objections to be included, so that readers could judge for themselves.

2.162. I am particularly critical of the failure to complete the 1996 audit report into PFIL (Appendix 2.3). The draft report described the importance of its key findings in the following terms: "These issues are highly significant and they are of a nature which exposes Fixed Income to major risk. Immediate corrective action is required."

2.163. The key findings covered a good deal of ground, extending to areas of responsibility well beyond Andre Lee's control, but which impacted on PFIL's business. Accounting was described as "..the primary area of concern as the management information lacks timeliness and quality to enable the effective steering of fixed income activities and detecting irregular transaction patterns." Reconciliations against external statements or records were performed only sporadically, and not formally documented. The technology platform of accounting and settlement was described as "..inadequate to support the transaction volume". The draft report drew attention to the lack of authorised trading limits for all activities, or any formal endorsement of limits by the Board or EXCO. It drew attention to the lack of independence of the credit approval process from product management, and the absence of an independent credit risk control function.

2.164. The reasons for non-completion are disputed. Peter Wong, who had overall responsibility for internal audit at the time, told me that, as PFIL management believed many of the criticisms had already been identified and were being resolved, it was decided to delay completing the report until a follow up review had been conducted. He did not say anything about resistance to the report by Andre Lee or John Lee. Andre Lee agreed that he and John Lee did think the report was wrong in several respects. He told me John Lee had said he would deal with it, and as he heard nothing further, assumed it had been dealt with. After it became clear how much importance I attached to this matter, Peter Wong, Philip Tose and Alan Mercer said non completion of a critical report would be contemplated if the business head took the required remedial steps immediately. That would avoid the "sanction" which would follow from a final report reaching EXCO members, particularly the Chairman. I find this implausible, given that the standard format for audit reports included a section for line manager's comments and proposed action; and that it was the exception rather than the norm for audit reports to remain uncompleted. It would also have been unacceptable practice. I believe the report was suppressed.

2.165. Irrespective of which version of events is correct, nothing was done by way of quick follow-up review. There was another audit of fixed income business, but over a year later. Reviewing the draft findings of the previous year was an incidental rather than a central purpose. Again this never resulted in a final report. Draft findings were produced in August 1997 (Appendix 2.12), and these were translated into a draft report in October (Appendix 2.13). The language is less severe than in the 1996 report, but the findings overlap very strikingly.

2.166. I believe the findings of the internal audit into PFIL in 1996 were well founded, and indeed Philip Tose, Peter Wong, Alan Mercer and Andre Lee confirmed this in seeking to convince me they were being dealt with. They identified a number of developments supposedly in response to the report:

(i) At the end of 1996 or beginning of 1997, John Lee took over full responsibility for Group Risk Management which was consolidated and centralised under him.

(ii) In May 1996, Group Product Control was established, reporting to the finance director (which over the next year engaged approximately 10 professionals).

(iii) In February 1997, 3 major accounting firms were invited to tender to produce internal and accounting policies and procedures manuals for each business group (to include provisioning) to further strengthen the Group's control function, and in June 1997, KPMG were appointed.

(iv) In early 1997, a documentation task force was established to resolve issues concerning failures in the completion of ISDA documentation.

(v) In July 1996, a new Head of Information Technology was appointed, with priority to overhaul the Hong Kong management information system, and evaluate a consultant's report on the technology support programme for the fixed income business and the group as a whole.

(vi) Andre Lee took steps in 1997 to improve credit reporting, monitoring and approval within PFIL; and in March 1997 launched an internal exercise to produce policies and procedures manuals, which began to be promulgated in October 1997

(vii) In 1997, the internal audit team was strengthened by the recruitment of additional persons with better expertise to audit fixed income business and information technology.

2.167. The timing of these developments leave me unconvinced they occurred in response to the findings of the draft report. In most cases they were certainly not a prompt response. If the findings had been more diligently and promptly followed up, Peregrine could have found itself better placed to weather the Asian market crisis.

2.168. Philip Tose, Peter Wong and Alan Mercer also believe I should take into account that the audit took place against the background of a highly successful year for the Group, when the Asian crisis of the next year was not and could not be foreseen. This misses the point that good risk management and internal audit is intended to be preventive, avoiding undue exposure to unexpected developments.

What went wrong? – In summary

2.169. Peregrine understood the rudiments of a control structure for fixed income business, but they were not effectively applied. At Group level, reporting infrastructure struggled to keep pace with business volumes and needs. Group Product Control independently checked traders' valuations in theory, but in practice it did not have the skills necessary to check prices of complex or illiquid products. Group Market Risk Control collected and distributed data rather than performing any 'control' function. Group Credit Risk Control was not supported and had no influence over PFIL, which was the most significant creator of credit risk in the Group. Group Internal Audit drew attention to important issues, but crucial reports never saw the light of day. Within PFIL, there were glaring holes in its arrangements for credit risk management.

2.170. In summary, Peregrine did not have a control culture commensurate with the risks it was running in its fixed income business. Its procedures were informal and responsibilities were not clearly assigned. It was well intentioned, but sloppy. It was possible to live with such creaks when the weather was fair and Peregrine was content to let business generation come first. The problems were known, but not sufficiently addressed.

2.171. Meanwhile, Philip Tose and Andre Lee (and to some extent John Lee) believed they compared favourably with the competition (particularly the large American investment banks). In terms of their Asian client base and distribution capabilities this may have been true. It may even have been true in relation to the composition of their Asian securities balance sheet and capital allocation to that business. But in relation to size and financial resources it was untrue; the ability of its competitors to absorb unexpected losses far exceeded that of the Peregrine Group, which simply could not afford to take the same degree of risk.

2.172. This did not mean Peregrine should not be in the business. But it did mean that it was of the utmost importance that excellent risk management scrutiny and control informed, monitored and influenced the risk-taking activities of PFIL. That did not happen.

2.173. Peregrine's directors and managers were highly intelligent and ambitious people. They did not deliberately set out to drive the group into liquidation, from which they, particularly Philip Tose, Francis Leung and Andre Lee, stood to lose more than most. If they had been better informed about the risks they were running, they might well have behaved differently. I believe they would have wished to sell down long held bonds much more quickly, thereby reducing the size of their inventory of bonds held for trading. They would have better appreciated that this would have enabled them to take on more new business safely.

2.174. I believe they might also have been much more cautious about entering into such an open-ended very large scale commitment to Steady Safe at the end of May 1997. The Steady Safe commitment, described in Part 3 of this Report, exceeded the total capital resources of PFIL. On my reckoning, it potentially represented over 35% of the capital of the Peregrine Group. Entering into this commitment, given the size of PFIL's existing inventory of bonds and outstanding other positions, and the concentration of risk within them on certain single credit counterparties, especially APP/Sinar Mas, was hazardous and foolhardy. Taken together, the exposures to APP/Sinar Mas and Steady Safe – both Indonesian companies – alone amounted to about three quarters of the Group's capital.

2.175. Philip Tose disagrees with me about this, arguing that it insufficiently takes into account how he viewed Indonesia at the time the commitment was given, and his knowledge of the high quality of PFIL's business with APP/Sinar Mas. PFIL did indeed satisfactorily reduce its exposure to APP/Sinar Mas towards the end of 1997. Nevertheless, however attractive the business seemed at the time, it contravened the essential rule of finance not to put all your eggs in one basket.

2.176. Peregrine's ability to withstand the Asian bear markets was certainly not helped by the strong and persistent rumours about its supposed losses, in-fighting and even Philip Tose's death. Rumours can easily become life-threatening for a commercial bank, which traditionally finances unmarketable loans by short term deposit liabilities. An investment bank, with a more structured maturity structure of its liabilities, and more marketable assets, should find it easier to cope with them. And given the circumstances, Peregrine did find it easier, not least because of the skill of John Lee in broadening Peregrine's funding base, and the high regard in which he was held by the institutions which funded the group. However, ultimately too much of its inventory turned out to be unmarketable, and more like the loans of a commercial than an investment bank. That was a fatal error.

2.177. I believe Steady Safe was the straw that ultimately broke the camel's back. It is significant that the rumours did not put off Zurich or First Chicago. The latter was already a major source of funding for the group. Both companies were able to look at the underlying business, and ultimately they could not be satisfied it was strong enough in the prevailing market circumstances. It was the further downward fall in the Indonesian Rupiah at the beginning of 1998 that finally prompted their change of heart. Steady Safe dominated the group's exposure to Indonesia. In addition, PFIL's strategy for safeguarding its exposure to Steady Safe had failed with the collapse of the proposal for its rights issue at the end of December 1997. These were killer blows.

2.178. Philip Tose, Peter Wong and Alan Mercer disagree with this analysis, which they believe fails to take the severity of the Asian crisis sufficiently into account. They cite in particular the policy change in Japan, whereby the Hokkaido Bank and thereafter Yamaichi Securities were allowed to fail, causing a dramatic liquidity crisis throughout Asia at the end of November 1997. In addition there was the unforeseen and extraordinary collapse of the Indonesian currency in the first week of January 1998. I agree these were vital ingredients over which Peregrine had no control, but I believe that Peregrine was unnecessarily exposed to their influence.

2.179. Taking a broader view of what went wrong, and with the benefit of hindsight, I detect that Peregrine was working its way through a major transition, from being a medium sized to a large business. It was wrestling with problems typical of such transitions. The business base had broadened beyond the skills and experience of its founding management. It had grown too large for the initial hands-on style of management to cope with.

2.180. A good deal had been done to work through this transition. Although I have commented critically about many aspects of the group's infrastructure in this Part of the Report, the essential building blocks were there. And steps were being taken to improve their effectiveness. But they were not learning fast enough, and it was all happening too slowly in relation to PFIL's superb business generating abilities. Peregrine would probably have eventually experienced significant problems even if the Asian crisis had not stressed its financial strength to breaking point.

2.181. The transition from small to medium sized business is always a dangerous period in the life of a company, when serious imbalances in its capabilities often develop. So it proved in Peregrine.

Part 3. Specific issues covered by the terms of reference

Introduction

3.1. Your terms of reference ask me to investigate and report on a number of specific issues. In addressing these in this Part of the Report, I am conscious that several of them have already been covered in Part 2, because they are directly related to the reasons for the collapse. In these cases, I refer you back to the relevant paragraphs in Part 2. I have not made judgments about the performance of directors and senior general management officers in this Part, preferring to draw such judgements together in order to reach an overall judgement about each of them in Part 4.

3.2. The following specific issues are addressed in this Part:

I. Whether valuations were reasonable and correctly reflected in the books and accounts of the companies
II. Marking to market of positions relating to:
- PT Steady Safe (Steady Safe)
- Tanayong Public Company Limited (Tanayong)
- Robinson's Department Store (Robinson)
- Sahaviriya OA Public Company Limited (SVOA).

III. Whether full, adequate and timely provisions and disclosures were made against losses and potential losses in the announcements dated 26 October 1997 and 11 December 1997.
IV. Whether full, adequate and timely disclosures were made throughout the last 6 months of the companies' life.
V. The sale and buyback of inventories by PFIL involving Infiniti Securities and PT Infiniti Finance as counterparties
VI. The sale of inventories by PFIL to the Asian Bond and Currency Fund Limited.
VII. The management of collateral, other security and guarantees taken by the companies to secure its exposures.

3.3. Marking to market (item II above) is no more than the means of valuing the positions mentioned, and I have therefore combined this item with valuations (item I).

Marking to market and valuations of Steady Safe, Tanayong, Robinson and SVOA

3.4. I have already commented extensively in Part 2 on Peregrine's valuation practices. To recap, I believe they had a number of shortcomings:

- The policies and practices were not documented and that risked inconsistency of approach.

- Marking to market by the traders was not subject to robust, independent verification.
- Reliance was often placed on the price achieved in the most recent trade, which could be well away from the currently achievable price.
- No adjustment was made for illiquid positions.
- No adjustment was made for positions which were large in relation to the size of issue, or normal transaction size for that issue.
- No adjustment was made for positions which were large in relation to Peregrine's available financial resources.
- The adjustments to values on long held inventory (through the aged inventory provision) was inadequate.

3.5. In my view, these shortcomings meant that Peregrine's valuations were unreliable, with a strong bias towards optimism. This bias would have become stronger in its influence in more difficult bear markets, particularly if the more liquid holdings in the inventory were sold, leaving the more difficult to value items being a larger proportion of the total left on the books. This is what happened in PFIL.

3.6. Philip Tose, Peter Wong and Alan Mercer maintain that this analysis may be appropriate for government or European or US bonds, but is less relevant for Asian bonds trading in less developed markets which are prone to periods of relative illiquidity. I believe the reverse is true – that the less reliable the liquidity of the market, the more important these shortcomings will be.

3.7. The marking to market of Steady Safe, Tanayong and Robinson illustrates the problems that arose in valuations. In order to put the valuations of these exposures in context, some background history of each is necessary.

Steady Safe

Background

3.8. Steady Safe is an Indonesian bus and taxi company. Peregrine's relationship with it began early in 1996. The President of Steady Safe, Jopie Widjaja, was a close business associate of the Managing Director of Cita Marga Nusaphala Persada (CMNP), Tito Sulistio, and they both approached Peregrine with a proposal to take over the then ailing Astra Motors group. They wanted Peregrine to participate by providing some of the funding and becoming a partner in the deal. PFIL investigated and declined the offer, as it was uncomfortable about the risk dynamics and potential rewards. The proposed deal size was approximately US$ 500 mns.

3.9. Instead, in October 1996, PFIL issued approximately US$ 500,000 (Indonesian Rupiah 2 billions) of commercial paper on behalf of Steady Safe. Between this and the beginning of May 1997, PFIL issued a further 12 batches of Steady Safe paper, in the form of promissory notes or medium term notes. In all cases, PFIL sold the notes in the market within a short time of issuance. (This activity is summarised in Appendix 3.1). By the end of May 97, the total amount of Steady Safe paper in the market amounted to approximately US$ 50 mns (IDR 177 billions). It had all been placed by PFIL.

3.10. In April 1997, Jopie Widjaja and Tito Sulistio approached PFIL with the idea of helping them achieve an operational merger of Steady Safe and CMNP. Steady Safe would purchase a stake of 21% of CMNP's shares, but CMNP would take management control of the combined business. CMNP was partially owned by the government owned toll road operator, Jasa Marga, and was a listed company. It had a valuable franchise through long term government granted concessions to build and operate toll roads in and around Jakarta. It owned the only link from the city to the airport. It had just been awarded a 50 year concession to build a double decker toll road through central Jakarta for light rail and cars. The idea was to merge the transportation "software" of Steady Safe and the "hardware" of CMNP.

3.11. By now, PFIL had an established working relationship with Steady Safe. Philip Tose says he and Peregrine's Indonesian office knew CMNP and Jasa Marga well, as Peregrine had been short-listed by the Indonesian government to lead manage the privatisation of Jasa Marga. The Asian Infrastructure Fund, an associate company of Peregrine of which Philip Tose was Chairman, had invested in a CMNP toll road.

3.12. PFIL worked on structuring a substantial financing package to fund the operational merger. This package had two stages. Stage 1 involved raising US$150 mns, largely to repay a loan to a syndicate of banks, led by HSBC. The second stage was to finance the purchase of shares in CMNP.

3.13. The two stages were linked, as the covenants attaching to the HSBC loan would not allow Stage 2. Therefore, PFIL would need to provide the means to retire that loan. The structure and timing of the financing package was the subject of much negotiation through the earlier part of 1997, between Steady Safe and PFIL. The deal was considered by PFIL's credit committee, and all the necessary signatures were obtained. This culminated in a signed mandate between PFIL and Steady Safe dated 29 May 1997 (Appendix 3.2).

3.14. The mandate envisaged three tranches of debt issuance on behalf of Steady Safe through 1997, totaling in all some US$ 350 mns, with maturities of up to 5 years. Moreover, the mandate provided for short-term bridging finance to Steady Safe pending the successful launch of the longer-dated debt structures.

3.15. In entering this deal, PFIL's expectation had been that Stage 1 would have been completed by the end of July, with the debt instruments issued to PFIL and either distributed or in course of distribution into the market. It did not expect to have any sizeable residual holding, at least not for any period of time. Stage 2 would then follow, between August and December 1997. It would itself have three parts: firstly Steady Safe would build up its holding of CMNP shares, then Steady Safe would do a (5 for 1) rights issue, and the resulting improvement in Steady Safe's capital ratio would enable the final debt structure to be put in place.

3.16. PFIL assessed its risk as being in Stage 2. For this to happen successfully, PFIL would need to extend bridging finance to cover the cost of the purchase of CMNP shares. A combination of funds raised through the rights issue, and the proposed debt issue, would retire this exposure. To mitigate the risk for Peregrine, Steady Safe agreed to pledge the shares, when purchased, to PFIL.

3.17. This deal was very unusual for Peregrine, in that it became committed to supply funds over several months. The mandate itself contained no special get-out clauses, and unless Steady Safe failed to meet its obligations under the mandate, PFIL could not decide part way through that it could no longer meet its commitment.

3.18. Although Andre Lee, when describing the mandate to me, had no doubt that it bound PFIL, from both a legal and reputational standpoint, to extend up to US$ 350 mns to Steady Safe, he never thought the exposure would reach that level. He felt that at any one time it was unlikely to exceed US$ 150 mns at most, and that would be transitory. This was because the form of the loans would be transferable securities of some kind, which PFIL expected to sell in the market.

3.19. However, Andre Lee (and Alan Mercer has lent his support, although disclaiming any knowledge of the mandate at the time) has subsequently sought to convince me there were get out clauses which PFIL could have used to curtail the commitment. Certainly a standard set of events of default was built in – financial ratio covenants, negative pledge, cross default, and winding up clauses, but events of default do no more than enable investors to try to accelerate repayment of a loan which has become doubtful. In addition there is reference to force majeur, but without any specification of it. Andre Lee assured me that Steady Safe's management had agreed, outside the set of indicative terms which constitutes the mandate, to pledge its fleet of buses and taxis in support of the first transaction. However, it seems this was not documented and it is doubtful if it could have been enforced. He claimed that the third transaction could have been stopped if the rights issue failed to take place, noting that the description of the calculation of the interest rate for this transaction said that it will be determined after the rights issue has taken place. Given this context, it does not seem to me to represent a hard legal condition that the transaction could not be started until the rights issue had been completed, although I accept that was the plan. There were other protections, but in my view (which Andre Lee disputes) they lapsed either when the offer under the mandate was accepted or before the initial draw down of funds. All in all, I am not persuaded that these conditions allowed PFIL to avoid its commitment if it ceased to be viable for it, unless Steady Safe failed to meet the obligations under the mandate.

3.20. The commitment offer was subject to PFIL's internal credit committee approval, which was given on 29th May. The intention was to structure Stage 1 as an issue of US$150 mns of Floating Rate Notes. In June, PFIL sought to interest potential purchasers of the Notes and worked on documentation to meet their requirements. Pending this, on 19th June 1997 it extended US$ 100 mns. to Steady Safe in the form of bridging finance, backed by promissory notes maturing on 31st July 1997. That was the date when they expected the Floating Rate Note issue to close. Peregrine had no trouble placing the interim promissory notes; and by 26th June none remained on Peregrine's books. (Appendix 3.3 summarises the various issue streams arising from different stages of the commitment.)

3.21. However, the floating rate note issue was not ready by 31st July, and, because of nervousness amongst potential international investors about Indonesia, now looked in doubt. So Stage 1 was delayed, and decisions needed to be taken about how to proceed with Stage 2.

3.22. Andre Lee traveled to Indonesia to see the management of Steady Safe and CMNP. He came away reassured. Instead of the Floating Rate Note issue aimed at international investors, there seemed good prospects for a domestic Indonesian Transferable Loan Certificate issue, denominated in Rupiah. PFIL had successfully distributed the earlier issues of Rupiah promissory notes. The PFIL staff in Jakarta had tested the potential demand from local investors for a new issue in transferable loan certificate form, and was confident a syndicate could be formed, and that it would be oversubscribed. This would complete Stage 1, and eliminate PFIL's Stage 1 related exposure. On this basis Stage 2 could proceed.

3.23. The bridging loan maturing on 31st July 1997 was renewed until 31sy October 1997, when it was planned the issue of the Transferable Loan Certificate issue would be closed. The amount of the new loan was slightly increased to just under US$ 107 mns, representing accumulated interest and other charges. It was backed by new promissory notes, which were fully sold by PFIL by 14th August.

3.24. In addition, Peregrine advanced three new bridging loans to Steady Safe, again all backed by short term promissory notes:

- US$ 40 mns on 8th August, maturing 6th November 1997;
- US$ 50 mns on 12th August, maturing 30th September 1997;
- US$ 65 mns on 19th August, maturing 30th September 1997.

3.25. These three loans were mainly in respect of Stage 2 (there was not a clean demarcation between loans representing Stage 1 and Stage 2). All but US$ 500,000 of the promissory notes relating to the first issue were sold. All of those relating to the second issue were sold. The third had only limited sales.

3.26. So, by 19th August 1997, PFIL had issued US$ 262 mns of Steady Safe promissory notes. Although its own exposure had fallen to US$ 50.5 mns another US$ 65 mns was issued on that day. It was committed to rolling the loans which the promissory notes backed until such time as the final debt structures were put in place and sold. If the new promissory notes issued when the loans were rolled could not be sold, PFIL's exposure would rise to US$ 262 mns. The loans were not collateralised, since no shares in CMNP had yet been bought by Steady Safe. But PFIL was confident that new promissory notes could be sold, that in due course the transferable loan certificate issue would replace them and be sold, and that collateral would become available.

3.27. On 30th September, US$ 115 mns of promissory notes related to Stage 2 matured. The loans were rolled over in an amount of US$ 121 mns, and new promissory notes issued. Peregrine was not able to sell any of these, except to one counterparty related to the owner of Steady Safe, on a temporary basis over the end of September (discussed further under "The sale and buyback of inventories by PFIL involving Infiniti Securities and PT Infiniti Finance as counterparties" below). The new maturity date was 31st March 1998, when it was expected Stage 2 would be completed. This timing anticipated the rights issue by Steady Safe in December, followed by the arrangement and completion of a new debt structure by Steady Safe by the end of March.

3.28. Steady Safe seems to have begun purchasing CMNP shares in August, and by the end of September had purchased 274 mns shares, with an open market value of US$ 166 mns. These were pledged as collateral for the loans from PFIL, although the documentation perfecting the pledge was not put in place immediately. Apparently it can take up to 3 months to obtain the necessary administrative and court registrations to perfect a security pledge in Indonesia. As the Indonesian stock market weakened, so the value of this collateral fell, from US$ 166 mns at the end of September to US$ 80 mns at the end of October, and to US$ 62 mns at the end of November.

3.29. Stage 1 became further delayed. Market conditions in Indonesia had by now made it impossible to sell the anticipated Rupiah Transferable Loan Certificate issue, and this was abandoned. Work had begun to structure a similar issue denominated in US dollars. The associated "Stage 1" promissory notes which matured on 31st October had to be rolled again, this time in an amount exceeding US$ 108 mns. The new maturity was set at 1st December 1997, the date by which the US$ Transferable Loan Certificate would be finalised. Peregrine were unable to sell these new notes in the market.

3.30. So by 6th November, all the bridging finance had been rolled, some of it twice. PFIL now held it all – some US$ 269 mns.

3.31. Peregrine's view of Steady Safe had not changed despite the market disturbance. Peregrine believed that the business was fundamentally sound and the strategy to link with CMNP remained valid. Moreover, it felt that the business - public transport and toll road highways around Jakarta - was effectively recession-proof.

3.32. On 26th November, another loan was extended in an amount of US$ 3.8 mns. This arose because of unpaid cash amounts requested from Steady Safe, which Andre Lee believes was a mistake. To me, most of it looks like unpaid interest, which Steady Safe failed to pay.

3.33. In early December, a key member of the projected syndicate for the US$ 150 mns Transferable Loan Certificate issue pulled out, and by the end of the first week of December it was clear that another solution had to be found. Peregrine engaged in further intensive discussions with Steady Safe to find alternative means of reducing its exposure. Concern turned to alarm when on 29th December the rights issue failed to get the necessary regulatory approval from Bapepam. This left PFIL management with no immediate remaining options as to how to reduce its exposure of some US$ 280 mns, and, with Steady Safe in mind, Philip Tose proposed an additional general provision of US$ 140mns. Peregrine's records show that, within this total, US$ 118 mns was allocated to Steady Safe.

Valuation

3.34. The Steady Safe exposure continued to be valued on a mark to market basis until the beginning of January 1998. The method used was to categorise the loans as short term promissory notes. In general, they were marked on the basis of a yield to maturity of around 13%. Because they were so short term, the price was relatively insensitive to changes in interest rates.

3.35. While this might have been reasonable at the start, it became highly optimistic as events unfolded, and in my view untenable by the end of October 1997, at the latest. Philip Tose, Peter Wong and Alan Mercer disagree with me about this, believing that I have taken insufficient account of the fact that the Indonesian market had stabilised at the end of October, and that PFIL had started again to sell bonds. Of more relevance in my view is that PFIL failed to sell any Steady Safe paper, despite efforts to do so.

3.36. The key point is that the terms of the promissory notes rapidly ceased to reflect the nature of PFIL's commitment to Steady Safe. The notes were very short term. The commitment was open-ended, and would require the notes to be replaced by others as the underlying loans were rolled over, if necessary for several years, or until replaced with 2 to 3 year maturity debt securities.

3.37. Andre Lee disputes that PFIL would have priced the notes any differently if they had had a term of 3 years, holding that a 13% rate for 3 years would still translate into a very large floating rate spread over LIBOR, in the region of 700 basis points.

3.38. By the beginning of November, it had become clear that the promissory notes were unsaleable in their present form. There had been no sales since August, and PFIL held all the notes backing the issues which had been rolled at the end of October. Any assurance which had previously existed that they represented a very short term exposure had gone. By now, the exposure should have been attracting a provision for aged inventory, but it did not because of the technicality that the promissory notes had been rolled.

3.39. It was by now clear that the original assumption about the risks inherent in the mandate no longer held. Stage 1 had not been completed before the initiation of Stage 2, and it was becoming less certain when it would be completed. PFIL's original calculation that there would be minimal exposure from Stage 1 when Stage 2 proceeded had proved to be wrong. The Stage 1 related exposure was still US$ 100 mns, and rising as interest accrued. It was very obviously more likely that PFIL could become exposed to the full value of the mandate.

3.40. PFIL reassessed the business case before extending bridging finance for Stage 2. It apparently firmly believed Stage 1 was do-able in some form, despite the lack of any sales of Steady Safe Promissory Notes since August 1997. This optimism continued until early December, when the third refinancing proposal, for a US dollar Transferable Loan certificate, was abandoned.

3.41. The value ascribed to the Steady Safe exposure in the interim results for the ten months to 31st October 1997 would need to take account of all material facts up to the point when work on them finished. That was 11th December 1997, when the results were sent to the Stock Exchange and approved for publication.

3.42. In the published results, the Steady Safe exposure continued to be valued on the basis of the mark to market value of the promissory notes, taken at their stated maturity and using a yield of approximately 13%. No provision was applied.

3.43. The results for the 10 months to the end of October 1997 were published on 12th December 1997. Although the exposure to Steady Safe was US$ 236 mns at the end of October, Peregrine would need to have in mind that it had increased to more than US $ 270 mns by the end of November. Similarly, although comforted by a satisfactory business relationship with CMNP and its principals, Peregrine would need to take into account that the value of the CMNP collateral had fallen sharply. By the end of November, on the basis of its open value, it was worth only about US$ 60 mns. Peregrine would also need to take into account the fact that, given the size of the CMNP shareholding and the state of the Indonesian equity market, it could not expect to realise anything like its open market value.

3.44. Peregrine would also need to be conscious that by the end of the first week of December its take-out strategy had become dependent on a single event – the rights issue by Steady Safe.

3.45. Management should also have been highly sensitive to how important the decision about provisioning against Steady Safe was for shareholders, given that by the end of November Steady Safe accounted for 30% of the Group's total capital.

3.46. By early December, following the collapse of Yamaichi in Japan and events in Korea, Peregrine's management was acutely aware how difficult it was likely to be to sell debt in any Asian market. PFIL revised its estimate for completing the Steady Safe financing package to the end of the first quarter of 1998, rather than the end of December 1997. Not only was the exposure much higher than originally anticipated, it was now longer term, and the markets were becoming increasingly problematic.

3.47. Andre Lee told me that he felt then and said to Philip Tose that it would be better to wait until the rights issue towards the end of December 1997 before seriously reviewing whether the valuation for the Steady Safe exposure remained appropriate. This would be done in the context of the work on the results for 11 months to end November 1997, which would be fully audited. In the meantime, he took comfort from the fact that Zurich Centre Investments (Zurich), who had examined Steady Safe very carefully, and whose advisers, Donaldson, Luftkin, Jenrette, knew it well from their own business, had not suggested that it was over-valued. The auditors and SFC examiners had reviewed it and, so he was informed, been satisfied.

3.48. Valuation and provisioning in such complex circumstances is bound to involve a large area of justifiable discretion. But I cannot accept that the valuation attributed to the exposure as at the end of October 1997, as seen in early December, falls within acceptable bounds. The uncertainties were just too great. The loans were in effect non-performing. The value of the collateral provided too little comfort. In my judgement, and at an absolute minimum, a provision of 20% of the amount outstanding should have been made - at least US$ 50 mns.

3.49. My instinct is that it should have been much larger, but I am very conscious of the dangers of applying hindsight. In mid December, very shortly after the publication of the interim results, Zurich did informally suggest a provision, which Andre Lee recalled as between US$ 50 and 75 mns. At the time, this was thought to be a negotiating ploy by Zurich to reduce the price of their participation. Nevertheless, after the failure of the rights issue by Steady Safe at the end of December, Philip Tose decided to provide US$ 118 mns, and so informed Zurich. But by then the circumstances had definitely and considerably worsened.

Tanayong

Background

3.50. Tanayong was a middle sized Thai property company focusing on the Bangkok market. It won the concession to build an elevated railway system in Bangkok.

3.51. In order to raise funds to support this venture, Tanayong issued Thai Baht 3.2 billions (approximately US$ 126 mns) in the form of fixed rate Asia Bond Notes in January 1996. This was a three year Note, with 12.75% coupon, maturing on 10th January 1999. The issue had two tranches; one domestic and the other international. PFIL was the lead manager of the Baht 1.55 billion international tranche.

3.52. The Notes were secured by a mortgage over property of the Tanayong Group. The trustee of this security was Thai Farmers Bank Public Company Limited. The terms and conditions of the issue required the value of this security to be at least 200% of the principal amount of the Notes. If the security fell below this value Tanayong would provide additional mortgages to bring the value back up to 200%. Conversely, if the value of the security rose, Tanayong could request that some mortgages be relinquished. In addition, there were various other covenants attached to the issue.

3.53. Peregrine sold some of the Tanayong Notes over the next year, and also entered into a number of what appear to be sales with associated agreements to repurchase (repos). The last recorded sale was in February 1997, after which it made four purchases. The last deal was in May 1997, leaving Peregrine with a residual position of Baht 698 mns (about US$ 17 mns). This corresponded to 21.8% of the total issue (and 45% of the international tranche which PFIL lead-managed).

3.54. At the same time as issuing the Notes, PFIL entered into a matching cross currency fixed-for-fixed interest rate swap with Tanayong. The swap had the same payment dates and maturity as the Notes, and effectively converted the loan which Tanayong had raised into US dollars rather than Baht. Thus Tanayong would be liable for interest payments and principal repayment in US dollars, whereas most of its assets were in Baht. Presumably, Tanayong incurred the cross-currency risk in order to benefit from a lower cost of funding in US dollars.

3.55. In March 1996, PFIL entered into a second swap with Tanayong, under which Baht interest streams were exchanged for interest based on a basket of currencies consisting of US dollars, Deutschemarks and Japanese Yen. The notional principal amount of this swap was Baht 2 billions, maturing in March 1998.

3.56. In March 1997 the original swap was closed out and replaced with another basket currency fixed rate swap, also based on US dollars, Deutschemarks and Yen. This time, the notional principal amount was Baht 3.2 billions and the maturity January 1999.

3.57. I found no initial credit analysis relating to the derivatives exposures to Tanayong; nor do any limits seem to have been placed upon Tanayong as a derivatives counterparty. However, Andre Lee recalled that the credit analysis was done as part of the Asia Bond Note issuance.

3.58. Over the next few months, these swaps became increasingly profitable to PFIL as the Baht weakened. PFIL became concerned about Tanayong's ability to absorb its loss when the swap matured in January 1999. It believed that the Baht would continue to weaken, and its analysis of Tanayong's projected cashflow suggested it would be insufficient. PFIL had extensive discussions with Tanayong through the summer of 1997, culminating in agreement between the two parties in October that the swaps would be closed out and replaced by a deal whereby Tanayong could pay off its losses (now amounting to US$ 89 mns) on the swaps over several years.

3.59. The new agreement was designed to cater for Tanayong's high debt servicing liabilities over the next three years, the covenants and financial ratios which it was committed to maintain, and PFIL's funding costs of, in effect, financing Tanayong to pay off its losses over several years.

3.60. The result was a 25 year "amortising swap", in which the US$ 89 mns would be effectively repaid in equal instalments, starting after the third year. It was really no more than a loan, as the only payment flow would be from Tanayong to PFIL. According to Andre Lee, a high "interest rate" had been incorporated as a built-in inducement to Tanayong to repay much earlier than 25 years, if it could.

3.61. In addition, PFIL attempted to take collateral from Tanayong in respect of this exposure. It analysed the company's assets and took what it could, believing that it had covered some 70% of the swap exposure. However, it turned out to be of limited value; in one case PFIL took a promise of a pledge over land which was found to be already pledged, in another case the documentation supporting the pledge was not effective.

Valuation of Tanayong Notes as at 31st October 1997

3.62. At 31st October 1997, Tanayong Notes held by PFIL were marked at 100. This was the traders' valuation. Product Control nominally had responsibility for verifying this mark-to-market but had not done so for some time. The auditors sampled 15 bond positions in order to review their valuations for the interim results of 31 October 1997. Tanayong was on the list, but in the event the auditors did not perform any independent check on it, taking it on trust that the valuation was reasonable. Thus no independent scrutiny was applied to the valuation.

3.63. As a separate exercise, the auditors did review the credit risk arising from the Notes. Deloittes' records shown to me do not contain any mention of the derivatives exposure, or the plans to restructure the outstanding swaps, or the wider concerns which PFIL had about the financial standing of Tanayong. This is odd, as Catherine Sham recalls drawing their attention to the derivatives exposure, and answering questions and handing over documents about it, Whether or not they took account of the derivatives exposure, the auditors concluded that no provision was necessary for the Tanayong Notes position.

3.64. According to an internal PFIL document of 27th November 1997, the rationale given for the pricing of the Notes at 100 was that collateral supporting the issue was valued at 140% of the issue (on an open market basis) (Appendix 3.4). The collateral referred to here was the security held in trust by Thai Farmers Bank on behalf of all the bondholders. It was not private collateral granted to PFIL. As such, the existence of the security was public knowledge and its worth would be subsumed within the market price.

3.65. The terms and conditions of the Note issue required Tanayong to maintain the security at 200% of the issue size; if the value fell below this level, a top up would be required. It is normal practice to provide a cushion of this sort against sudden variations of price or uncertainties of valuation. The fact that the collateral was only 140% was, therefore, more a source of concern than of comfort.

3.66. An e-mail from John Lee to Andre Lee dated 25th August 1997 shows that John Lee had insisted on the 200% coverage when the terms of the Note issue had been originally agreed with Tanayong. This e-mail also shows that John Lee had requested a revaluation of the security given the falling property values, higher interest rates and tighter liquidity in Thailand at that time. The revaluation, done on 13th August 1997, indicated collateral coverage of 146% on an open market sale basis, falling to 52% on a forced sale basis. By the end of November, even the forced sale value must have been doubtful, given developments in the Thai property market since August.

3.67. Thus, PFIL knew there was a shortfall in the value of the security. On this basis, together with the general condition of the Thai economy and property market, it would seem reasonable to discount the value of the Notes. To continue to mark the position at 100 was too optimistic.

3.68. Furthermore, the internal limits in respect of this position had been broken. The position exceeded US$ 17 mns (and had done for over 5 months) against a limit of US$ 10 mns, and it had been held for 274 days (as at 31st October 1997) against a limit of 30 days. Particular caution was needed given that PFIL held over one fifth of the total issue.

3.69. As at 31st October 1997, the ageing provision on the Tanayong Notes position amounted to US$ 370,000. This equated to a mark down to 97.84 (or 2.16%). Given the circumstances, I do not believe this was sufficient. A minimum provision of 10% ought to have been applied. That equates to some US$ 1.4 mns in addition to the ageing provision already made.

Valuation of the swap position as at 31st October 1997

3.70. The accounts for the 31st October 1997 did not include the new "amortising swap", but continued to reflect the original swap which it replaced. This was because the paperwork to close out the original swap and replace it with the new one was not completed until the end of November 1997. So the mark-to-market profit on the original swap, amounting to some US$ 89 mns, was included in profits at that date. The balancing item was a trading account asset (described in the books as 'cross currency interest rate swap – revaluation').

3.71. The new structure was included in the November accounts, although it did not affect the financial position, and had only a minimal (and cosmetic) effect on the balance sheet. The profit now realised from the original swap would have become a cash receivable, offset by a notional outgoing cash payment representing the new loan (repayable over 25 years). The incoming interest and repayment of principal streams continued to be shown as a trading account asset (although now described as a 'debt swap').

3.72. The only real difference would have shown up over time. Whereas the original swap, being of short maturity, was marked-to-market and the resulting profit or loss posted to the profit and loss account, the new structure would only be revalued to show losses. Profits would be allowed to accrue only when payments of interest and principal became due.

3.73. This accounting treatment was based upon Catherine Sham's advice. She stated to me in interview that she had been unaware at the time that PFIL's reason for restructuring the swap was that it had concerns about Tanayong's creditworthiness. She had, however, been aware of a similar situation involving Robinson. In that case, she had queried with

John Lee whether it was appropriate to allow the unrealised profit on the original swap to continue to be shown as a profit. She had wanted to reverse it out, but had not done so, she claimed, because John Lee's advice, as the expert in these matters, was that it should remain. She implied that she would have had equal concerns about Tanayong. Presumably, however, she would again have deferred to John Lee.

3.74. It was clear that Peregrine had concerns at this time about the company's ability to service its obligation, particularly in the short term to medium term. Indeed the 25 year amortising swap had been structured to avoid heavy payments by Tanayong falling due in the following three years. Given this situation it would be unreasonable not to provide against the swap.

3.75. Andre Lee, when asked to allocate general provisions of US$ 60 mns (which at the time he did not believe were needed), suggested a provision against this exposure of 15%, amounting to US$ 13.4 mns (see Appendix 2.7). He assumed there was sufficient collateral to cover 70% of the swap exposure. In reality, the security for the Notes was not available to PFIL; in any case, it was already well below the minimum required under the terms of the Note issue.

3.76. According to Peregrine internal schedules prepared by Luis Maglanoc of Group Credit Risk Management in September 1997, the total exposure (Notes plus swap) to Tanayong constituted 9.7% of PIHL's equity and 49% of Tanayong's (see Appendix 2.11). He suggested that this implied an exposure of US$ 38 mns in excess of prudent limits, based on BIS regulatory guidelines. It appears that his work was based only on PFIL's published research, and that he was unaware of PFIL's concern about the swap.

3.77. A prudent amount to provide, given all the circumstances, would be no less than 25% (US$ 22.25 mns) and perhaps as much as 50% (US$ 44.5 mns).

Robinson

Background

3.75 Robinson was a large Thai retailer. In 1995, it merged with Central Department Stores, another retail outfit, to create the largest retail group in Thailand, with over 40% of the local retail market.

3.76 During 1996, Robinson wanted to undertake a programme of expansion into local provincial markets, through a series of joint ventures. It needed finance, and became a client of PFIL. PFIL arranged a financing programme, which encompassed debt issues and swaps.

Debt issues

3.77 Robinson established a Baht 3.75 billions (about US$ 148.5 mns) Asian Currency Note Programme to fund its corporate activities. Under this programme, Robinson would from time to time issue Asian Currency Notes denominated in Baht or US dollars or such other currencies as may be agreed between any dealers and the company. In February 1996, Robinson raised US$ 100 mns as part of this programme. The issue was structured as a US$ Floating Rate Note, paying interest semi-annually at a rate of 6 month US$ LIBOR plus 1.1%. The maturity date of the Notes was 15th February 2001, but they could be put back to the issuer in February 1999. PFIL was a lead-manager for this issue.

3.78 From the date of issue, the Notes sold well; by the end of February 1996, US$ 93 mns had been placed, leaving PFIL with a holding of US$ 7 mns. Over the next months the main activity in the Notes was repo transactions, although there were a few pure buys and sells. By the end of September 1996, PFIL had acquired US$ 9.5 mns Notes which were not subsequently sold. By the end of November 1996 this had risen to US$ 20.5 mns. A further US$ 6.5 mns were purchased in July 1997. Altogether, PFIL then held US$ 27 mns (which was 27% of the total issue). There were no further trades.

Swap transactions

3.79 In May 1996, PFIL entered into a swap with Robinson, described as a "digital spread interest rate swap". It was due to mature in May 1999, but was closed out in June 1996 with Robinson making a small profit.

3.80 In December 1996, the parties entered into another swap, maturing in February 1999 (the date on which the Notes described above could be put back to the issuer). The effect of this swap was to hedge the principal repayment of the Notes at their put date in February 1999; Robinson would still be exposed to the US dollar interest payments, but had no Baht currency risk for the repayment of US$ 100 mns principal.

3.81 Embedded in this swap was a put option which allowed PFIL to buy US dollars and sell Baht at a fixed exchange rate of 26.75 Baht per US dollar, but with a payout which was leveraged three times. The effect of this was to increase the notional principal amount underlying the swap to US$ 300 mns (rather than US$ 100 mns). The structure would become profitable to PFIL if the Baht traded above 26.75 per US dollar, and that profit would be magnified by a factor of three. This would have constituted quite a substantial risk to Robinson; such leverage can cause losses to rack up alarmingly fast.

3.82 PFIL valued the Notes and swap on its normal mark to market basis. However, as 1997 proceeded, the Baht's devaluation made the swap very costly to Robinson on a mark to market basis. Research by PFIL concluded that Robinson's losses on the swap if the Baht continued to devalue would cause it to break financial covenants it had entered into under the Asian Currency Note Programme, which would be an event of default. PFIL also concluded that if the Baht rate hit 40 to the US dollar, Robinson would become insolvent, even if there were no calls for repayment of the Asian Currency Notes. PFIL's internal memo which set out this analysis also suggested a provision of 20-25% on all outstanding exposures to Robinson (Appendix 3.5). This memo is undated and unsigned, but given the information it contains would seem to have been written in July or August 1997.

3.83 PFIL concluded that its best course of action was to encourage Robinson to avoid risking a breach of its covenants by helping it to close out the swap. In July 1997, PFIL started discussions with Robinson, suggesting that the loss accumulated so far on the swap should be transformed into a long term debt. This would reduce Robinson's immediate financial burden. Robinson finally agreed to do this in September 1997, although the paperwork to conclude the new arrangement was not completed until late November.

3.84 Under the new agreement (elaborately described as a Thai Baht Annual Hedging Premium Option) PFIL's profit (and Robinson's loss) on the swap, which now amounted to US$ 68 mns, was to be repaid over a maximum of 25 years. In addition, Robinson undertook to improve its financial structure, including obtaining from Asian Currency Note holders waivers from certain of its financial covenants under the Programme.

3.85 According to Andre Lee, PFIL explored the possibility of taking collateral from Robinson for the outstanding exposure, and identified a pool of unpledged assets. However, it decided this would have reduced Robinson's ability to negotiate working credit lines, and so PFIL settled for what amounted to a negative pledge, whereby Robinson guaranteed to obtain permission from Peregrine before pledging any of its assets in favour of another party.

Valuation/Provisioning

The Notes

3.86 According to PFIL's schedules, at 31st 0ctober 1997 the Notes were priced in PFIL's books at 90, which equated to a US dollar yield of LIBOR plus 930 basis points. The traders decided this. Product Control, which nominally had responsibility for independent verification, did not review this position. The result was a loss on the position over the 10 months to end October 1997 of US$ 2.3 mns.

3.87 The auditors received the breakdown of the Robinson Notes position as part of their review of the results to end October 1997. However, it was not one of three bond positions which their specialist reviewed, and they did not discuss the valuation with any Peregrine staff, nor did they perform any independent check. Moreover, there are no records which I have seen which indicate that the auditors took note of the derivatives exposure or of Peregrine's concern about the financial standing of Robinson. I therefore take no comfort that, on the basis of their analysis, the auditors concluded that no credit provision was necessary for Robinson.

3.88 In arriving at the mark-to-market valuation, PFIL's traders had sought to benchmark the position against a more active bond. This was necessary because there had been no trades in the Robinson Notes for some time. According to a PFIL schedule dated 27th November 1997 (appendix 3.4), there was a "comparable Yen deal done in June at LIBOR + 177 basis points." I have not been able to find further details, and so cannot judge how comparable the deal was. Nor have I been able to identify definitely more comparable deals at the time.

3.89 No provision was made against the holding of Robinson Notes other than an ageing provision of US$ 945,100. Andre Lee took the view that a provision of 10% (US$ 2.7 mns.) should be made against the Note position, when he was asked to distribute the additional provision of US$ 60 mns included in the interim statement (which he did not believe was needed) (Appendix 2.7). However, this was not reflected in the final allocation of provisions as at 31 October 1997.

3.90 In summary, the position at 31 October was that PFIL held US$ 27 mns principal amount of Robinson Notes. This was over 25% of the total in issue, but only 2.5% of Peregrine's total bond inventory. The most recent trade in the Notes had been a purchase by PFIL four months previously, and before that, a purchase also by PFIL a year previously. No other comparable bonds were traded in the market to provide an objective price benchmark. At 31st October 1997, 6 month US$ LIBOR was around 5.78%. LIBOR + 930 basis points would have equated to a yield of 15.08%. PFIL had concerns arising out of the swap transaction about the ability of Robinson to service its debt obligations, although it was working with Robinson to reduce the latter's immediate financial burdens. Finally, when pressed, Andre Lee, PFIL's managing director, considered a provision of 10% was warranted.

3.91 In these circumstances, I believe that a provision against the Notes position should have been made at 31st October 1997 over and above the amount of the ageing provision. A total provision of 20% (US$ 5.4 mns) would not have been unreasonable given the uncertainty in valuation plus the heightened likelihood of default by Robinson. This is some US$ 4.4 mns greater than the amount provided by Peregrine at 31st October 1997.

The Swap

3.92 Valuation of the swap is complicated by its conversion into a long term debt obligation. Catherine Sham recalled that she discussed the appropriate accounting treatment for the restructuring of a short term swap into a much longer term item with PFIL staff when the proposal was first canvassed. Her advice to them was that the profit on the original swap could continue to be recognised (although now it would be categorised as a realised, rather than unrealised, profit).

3.93 When Catherine Sham gave this advice she was unaware that the reason for closing the swap and converting the profit into a long term loan was concern about Robinson's ability to continue to meet its obligation under the swap. She subsequently learned of this, and reverted to PFIL (she cannot recall to whom she spoke) to warn that her previous advice had been given on the assumption that the restructuring was for sound commercial purposes and on the basis that there was no doubt about Robinson's credit quality.

3.94 Given what she now knew, Catherine Sham spoke to John Lee. She is not sure when this conversation took place but it is likely to have been before October 1997. She recalled that in this conversation she expressed concern about allowing the large unrealised profit on the existing swap to remain in the P&L account, and wanted to reverse it out. John Lee reportedly argued that the profit should remain in the P&L account, this being (according to him) the normal practice in banks. Despite her reservations, Catherine Sham went along with this on the basis that John Lee was considered the expert on these matters and she should defer to his judgement. She did not raise the matter with any other people, either then or subsequently.

3.95 The paperwork for the new structure was not in place until the end of November. The accounts for the 31st October 1997 therefore continued to include the original swap (as a trading account asset) and its associated mark-to-market profit of some US$ 68 mns. There was no provision against the swap exposure to Robinson as at 31st October 1997.

3.96 The new structure was included in the November management accounts, but did not affect the financial position, and had minimal (and cosmetic) effect on the balance sheet. The profit from the original swap had become a cash receivable, offset by a notional outgoing payment representing the nominal upfront loan on the new 25 year structure. The incoming interest and repayment of principal streams showed up as a trading account asset. The only real difference would have shown up over time. The original swap, being of short maturity, was marked-to-market and the profit or loss posted to the profit and loss account. The new structure would be marked-to-market only for the purposes of ascertaining whether any loss needed to be recognised; profits would only be allowed to accrue as payments of interest and principle became due.

3.97 It is clear from correspondence that Peregrine had concerns at this time about Robinson's ability to service its obligation. Given the financial difficulties which faced Robinson, PFIL was right to seek to restructure Robinson's obligation in order to maximise its recovery in the longer term. However, in doing so, PFIL should have reflected the realities of its exposure to Robinson in a fair manner in its books and records.

3.98 Although the immediate financial burden on Robinson was lifted, improving its immediate creditworthiness, the new loan was for up to 25 years. This was a very long period during which Robinson's financial health could either improve or deteriorate. Given the Thai economic crisis, the chance of default remained high. PFIL had rejected the option of collateralising its holding of Robinson Notes, for fear of prejudicing its ability to generate working capital.

3.99 The allocation of provisions adopted in the end October 1997 results did not contain any provision against the Robinson swap related long term loan. To judge from their working papers, it appears that the auditors may have been unaware of the proposal to convert the profit on the swap into a long term loan, although by the end of November, when the auditors completed their review, it was a fact. Catherine Sham recalls that she did not specifically draw their attention to the proposal, or raise her concerns about the proper accounting treatment with them. That was a pity, as I believe her earlier instincts were right. As it was, it would appear from their working papers that, in so far as the auditors examined PFIL's exposure to Robinson, they focussed only on the Robinson Notes.

3.100 Andre Lee took the view that the new loan replacing the profit on the swap should be treated like the Notes for provisions purposes. He recommended allocating a 10% provision, amounting to US$ 6.8 mns. I believe a higher provision should have applied to the new loan than the Notes, reflecting its much longer term, and the fact that no interest was payable for several years. I therefore consider a minimum provision of 25%, equivalent to US$ 17 mns, should have been made. It would be easy to argue for much more.

SVOA

Background

3.101 In October 1995, SVOA issued Debentures totaling Baht 750 mns. Peregrine's joint venture in Thailand, Peregrine Nithi Securities & Finance (Nithi), was the lead manager for the issue. Unlike PFIL, it had a license to underwrite local Thai bond issues. However, in practice PFIL worked closely with Nithi on structuring the deal and undertaking the necessary due diligence. The Debentures had a fixed coupon of 12.75% with interest paid semi-annually. The maturity date was 13th October 1998.

3.102 At the same time, SVOA and PFIL entered into a cross currency fixed-for-floating swap. Under this, PFIL paid interest in Baht at a fixed rate of 12.75% on a notional amount of Baht 750 mns, and received interest in US dollars at a floating rate of US$ LIBOR + 3.5% pa on a notional amount of US$ 30.2 mns. This swap effectively changed SVOA's liability from one in Baht at a fixed rate of interest to one in US dollars at a floating rate.

3.103 Over the following year, there were sales, some purchases and some repo. activity in the Debentures. By October 1996 a nominee account at Peregrine Trading Singapore Pte Ltd had a position of Baht 250 mns, which I believe represented PFIL's interest. I have been unable to ascertain why PFIL did not hold the debentures directly. In addition, the Peregrine Asian Bond Fund, an independent investment fund within the Peregrine stable, held a parcel of Baht 20 mns.

3.104 By the end of 1996, PFIL was aware that SVOA was in breach of certain financial covenants attaching to its Debenture issue. Pressure to act was coming from Bank of America, which was in negotiation with SVOA on a further financial package, and required the Debenture holders to grant the necessary waivers before it was willing to proceed. Internal PFIL emails from November and December 1996 suggest that PFIL favoured granting a waiver from some of these covenants, and re-defining certain financial terms in order to reverse the breach of others.

3.105 Although PFIL had concerns about the financial standing of SVOA, it was reassured when its staff visited the company and apparently came away confident that its management was fully aware of its problems and actively managing them. In particular, SVOA had already significantly decreased the size of its Accounts Receivable and its inventory.

3.106 Nithi, as manager of the issue, had no power to grant the necessary waivers. This would require the consent of the bondholders in a specially convened meeting. Other courses of action were also considered, such as restructuring the debt to a shorter maturity, higher yield instrument. PFIL was clearly worried that bringing the matter of the breach of covenants to the attention of the Debenture holders could have an adverse effect. The holders might decide to declare an event of default, and seek immediate repayment of the Debentures by SVOA, which SVOA would not be able to meet.

3.107 PFIL transferred its bond position to another Peregrine group company, Brisk Win Investments Limited (Brisk Win). This was a special purpose subsidiary of PFIL, whose only assets were the SVOA Debentures. This happened in February 1997, at a price of 99.02. Transferring the holding made it less likely that PFIL would be accused of protecting its own interests in providing financial advice to SVOA. The effect was purely cosmetic – to the outside world PFIL may not have seemed to be a Debenture holder, but the books and records of Brisk Win were consolidated within those of PFIL and the group. The SVOA Debenture position was treated as part of PFIL's bond inventory for internal management purposes.

3.108 Andre Lee told me that the transfer was done to help Peregrine deal with its dual interest in the issue. It was (through Nithi) the manager of the issue, with duties to all the investors in it; and it was also itself a substantial investor. As manager, its reputation was at stake if SVOA could not repay; as investor, it would lose money directly.

3.109 It may not have been so innocent as that. An internal PFIL document relates that, in a meeting between SVOA and PFIL on 19th February 1997, PFIL warned SVOA that 'international investors' were putting considerable pressure on Peregrine to negotiate with the company to redeem the Debentures, or they would declare an event of default (Appendix 3.6). It had not disclosed the breach of covenant to 'domestic investors', because of the adverse effect it would have on SVOA's reputation. The suggestion was made that it would be in SVOA's interests to repay the international investors, and to contract to do so before the end of February when the results of the company would be published. This internal PFIL document is unsigned and undated. It does, however, refer to the presence of three PFIL staff.

3.110 The 'international investors' to which the document was referring were Peregrine Trading Singapore Pte. Ltd. (which was only acting as nominee for PFIL) and Peregrine Asia Bond Fund. It does not appear PFIL disclosed this to SVOA. PFIL did seem to be using the information it had available to put its own interests ahead of other Debenture holders. Andre Lee denies this, on the grounds that the lead manager and underwriter was Nithi, and not PFIL or its affiliates, and so no conflict of interest arose. However, this overlooks that the Peregrine Group interests would benefit relative to other holders.

3.111 Work proceeded in PFIL on redemption by SVOA of the Brisk Win Debenture position in the following months. On 2nd April 1997 an agreement for repurchases by SVOA in May, June and July 1997 was sent for signature by SVOA, but was never signed (Appendix 3.7). SVOA claimed it needed the required resources to carry on its normal business, and the economic crisis in Thailand had caused its customers to delay payments. Instead, SVOA proposed a new schedule of payments in three quarterly tranches, starting in the autumn of 1997.

3.112 Meanwhile the performance of the swaps between SVOA and PFIL in response to the devaluation of the Baht meant that PFIL's exposure to SVOA was increasing. Another solution was sought, and in October 1997 PFIL offered to buy a building owned by SVOA in settlement of its bond holding and the mark-to-market profits on the swap (which by then amounted to Baht 450 mns.). SVOA rejected the offer.

3.113 Peregrine's response was a notice of default by PFIL on behalf of Brisk Win, and a demand for immediate repayment of the outstanding amount on its bond position due to the breaking of the bond covenants.

3.114 SVOA appointed AFC Merchant Bank as financial advisor to restructure its debts. In November 1997, SVOA presented a restructuring plan, which would turn all outstanding term debt into a 3 year syndicated loan. PFIL again attempted to negotiate a package which would reduce its net exposure to SVOA in return for the building. Discussions were never concluded on this.

Valuation of the bond position

3.115 The balance sheet of Brisk Win as at 31st October 1997 shows that the SVOA bond position was being marked-to-market at a price of 75 (versus the value of 99.02 at which it had been transferred to Brisk Win in February 1997). In addition, the position attracted an ageing provision in excess of US$ 500,000. Taken together, the total year-to-date loss in respect of the SVOA bond position amounted to over US$ 2 mns. Looking at this another way, the SVOA position had been marked down by 33%. This does not seem unreasonable.

Valuation of the swap

3.116 At the end of October, a PFIL schedule shows that the mark to market profit on this swap amounted to US$ 12.7 mns., against which PFIL had provided US$ 5.1 mns. (40%). Given the circumstances, this does not seem unreasonable.

Provisions and disclosure

Adequacy of provision at the end of October 1997

3.117 My conclusions about marking to market and valuations in relation to Steady Safe, Tanayong, and Robinson imply that full, adequate and timely provisions were not made in the announcements of 26th October and 12th December 1997. However, Philip Tose advanced an argument that the directors, in judging the uncertainties attaching to the valuations of exposures to Peregrine's Asian counterparties, took comfort from the existence of unrecorded unrealised profits on a number of open foreign exchange positions. Peregrine consciously took these on in the hope that they would provide some profits which would offset losses from any further deterioration of Asian markets.

3.118 According to Philip Tose, it was decided at the time of the announcement on 26th October 1997 that the gains on these positions should no longer be booked, but held as an unrecorded hidden buffer to offset sudden shocks to the business. Philip Tose recalled these unrecorded gains as being around US$ 30 mns by the end of November, US$ 80 mns by 12th December, and US$ 140 mns by early January 1998. He subsequently produced a PFIL profit and loss account summary which indicates that at 30th November 1997 there was indeed a positive difference of US$ 31.5 mns between the profit measured at "normal" rates and that measured at "market" rates. Catherine Sham's recollection was that these foreign exchange positions were marked-to-market, but that the resulting profit was deferred. That seems consistent with the schedule shown me by Philip Tose.

3.119 In effect, these unrecorded gains constituted a hidden reserve, whose value could be expected to fluctuate in parallel with, but in the opposite direction to, the fortunes of Peregrine's Asian counterparties.

3.120 The normal rules of disclosure require such gains, although unrealised, to be included in the profit and loss account. Not to do so distorts the company's measured performance and could mislead investors. Although in practice property and other fixed assets can often be worth more than their balance sheet values, this is not used as a substitute for the proper valuation of current assets, taking into account all known facts at the time of valuation. In any case, as at 31 October, there were no or negligeable unrecorded gains available to absorb any of these additional provisions, since the gains made up till then had been included in the results.

3.121 I conclude that, while the subsequent unrecorded gains might have given the directors some comfort about their ability to withstand further deterioration in Asian markets, they should not have influenced the valuations finally confirmed in early December of PFIL's exposures as at 31st October. Taking the combined shortfall of provisions I identify against the major exposures discussed above, at 31st October 1997, PFIL's assets were overvalued by an absolute minimum of US$ 95 mns at 31st October[3]. Had provisions of this size been made, PIHL's declared pre-tax profit would have all disappeared.

3.122 Even if the directors had been entitled to take full comfort from the unrecorded gains on the "hedge" transactions, by early December they would not have absorbed the absolute minimum additional provisions against major exposures I identify as being needed.

3.123 Philip Tose, Peter Wong, Alan Mercer and Catherine Sham argue that I have not given adequate weight to the fact that "vigorous" audits and due diligence were conducted on Peregrine's business, notably PFIL, in the last quarter of 1997 by Deloittes and by Zurich and other potential investors and their advisers. They say all gave a clean bill of health to the Group's business and financial position, and that quite reasonably they took great comfort and placed significant reliance on the outcome of their work. They believe I have ignored these crucial facts.

3.124 They are correct that in assessing whether the provisions were adequate I have taken no material account of the views of these outside agents. It is the responsibility of the directors to make adequate provisions, and no one else's. Zurich was interested in the overall value of the business to itself, rather than provisions. Deloittes' responsibility was to report to the directors whether the results had been prepared using accounting policies consistent with those employed by Peregrine in its last annual accounts, and whether, based on analytical procedures and discussions with management, they were aware of material modifications that should be made to the interim results as presented. I discuss their performance in Part 4 of this Report, and at this point will do no more than say that I do not believe the letter they sent to the directors following their review justified the level of provisions then held.

3.125 The same directors (but not Catherine Sham) make a similar argument in relation to the SFC inspection in November 1997. They drew great comfort from what they perceived to be acquiescence by the SFC in the valuations put on the larger exposures of PFIL. This was in fact a complete misunderstanding of the views of the SFC's inspectors, who believed much larger provisions than I have suggested should have been made.

Disclosure

3.126 You have also asked me to assess whether full, adequate and timely disclosures were made throughout the last six months of the companies' life. This question has two parts:

- Did the directors properly disclose all material facts in their public statements during the period? And
- Did the directors make public statements whenever there was information that should have been disclosed?

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[3] Steady Safe $50mns; Tanayong Notes $1.4 mns: Tanayong swap $22.25 mns; Robinson Notes $4.4 mns; Robinson swaps $17.0 mns = $95.05 mns

3.127 The Hong Kong Stock Exchange's listing agreement requires disclosure for general matters to be made "...as soon as practicable of any information relating to the group (including information on any major new developments in the group's sphere of activity which is not public knowledge) which:

- is necessary to enable holders and members of the public to appraise the position of the group;
- is necessary to avoid the establishment of a false market in its securities; and
- might be reasonably expected materially to affect market activity in and the price of its securities; ..."

3.128 This leaves a good deal of discretion to the directors.

Did the public statements disclose all material facts?

3.129 It follows from my conclusions that provisions were inadequate, that disclosure of the provisions was also inadequate. However, in judging the responsibility of the directors for this, it is necessary to separate what they thought was the financial position of the companies from what I believe was a more realistic judgement of their positions. My investigations have not unearthed evidence that the directors knowingly failed to disclose facts to shareholders they knew to be true.

3.130 In challenging my view that provisions were inadequate, Philip Tose, Peter Wong and Alan Mercer put the view of the directors well. They stated to me that as at 26th October 1997 it was genuinely believed that the proposed provisions were conservative. As at 12th December 1997 this view still seemed justified and was supported by the following:-

(a) the fact that Fixed Income had liquidated a number of bonds through November and the Indonesian market seemed to have stabilised;

(b) Zurich and the First Chicago had given clean bills of health on their due diligence and had not challenged the provisions;

(c) SFC had conducted a vigorous inspection and had not communicated any concerns or problems;

(d) the unrecorded FX positions gave a buffer of approximately US$80 mns up to that time;

(e) the Zurich transaction was to complete in approximately 20 days providing US$ 200 mns to the Group; and

(f) the external auditors had conducted what they considered to be a vigorous audit and had confirmed in writing they had no concerns.

3.131 I judge the directors to have been conscientious in preparing the public statements made in the last six months of Peregrine's life. The fault lay in their judgments about valuations and provisions, not how they reported what they believed to be the facts.

Were there sufficient public statements?

3.132 PIHL made seven major public statements in the last six months of its life. On 3rd September, it made its first interim announcement of results for the first six months of the year to end June 1997. On 26th October, it addressed the rumours then circulating, gave the directors' opinion of trading performance, and announced an accelerated and enhanced timetable for further disclosure of the group's financial results and trading performance in 1997. On 17th November, it announced the participation of Zurich Centre Investments and its terms. On 12th December, it made its second interim announcement of results, for the 10 months to end October 1997. On 16th December it announced that Frist Chicago International Finance Corporation, a subsidiary of First Chicago NBD Corporation, would also participate and revised terms for Zurich's participation. On 7th January, it announced that discussions were being held with Zurich to revise the terms of its participation, in the light of the further deterioration in Asian markets. On 8th January 1998, it announced the calling off of the plans for participation by Zurich and First Chicago. In addition, there were numerous smaller announcements relating to purchases of its own shares and other more technical matters.

3.133 By any normal standards, all this amounted to frequent disclosure. But these were extraordinary times.

3.134 I have sought to identify events or developments, known to PIHL's directors, which might have been the trigger for further disclosure. The deterioration of the health of the Peregrine group was for the most part due to the accumulating effect of the Asian crisis on its ability to continue to generate cash, and on the value of its remaining assets and positions. The two announcements made, on 26th October and 12th December, responded to the need to disclose the directors' best estimate of the performance of the group. It seems to me they were adequate for the purpose.

3.135 Events began to move more quickly after 12th December. Within a few days, Zurich suggested that US$ 50-75 mns provisions against Steady Safe should be considered. On 29th December, the Steady Safe rights issue was rejected by its shareholders, puncturing PFIL's strategy for reducing its exposure to the company. In the first week of January 1998, Philip Tose decided extra provisions of some US$ 200 mns were necessary. It could be argued that one or more of these events were sufficiently serious to be considered as a prompt for further disclosure.

3.136 However, by then the group's fortunes rested on the participation of Zurich and First Chicago. The directors believed, rightly or wrongly, that Zurich's suggestion of substantial provisions against Steady Safe was at least partly a negotiating tactic, and decided to await the outcome of its rights issue before deciding whether to provide and if so how much. Given that it was expected to be no more than two weeks away, I think that was a reasonable decision.

3.137 When the rights issue was decided and it became inevitable that significant provisions would be needed against Steady Safe, the directors faced the prospect of the close-out negotiations Zurich within a few days. To have disclosed massive provisions just before those negotiations would have had unpredictable consequences. If those consequences had caused Zurich to withdraw, the consequences for shareholders would have been disastrous. I think it was a reasonable decision to continue with the negotiations with Zurich rather than disclose the new provisions immediately. The directors were prompt to announce on 7th January 1998 that the terms of Zurich's participation would be amended, and on 8th January that the deal was off.

3.138 In summary, I believe the directors were conscientious in their disclosures to shareholders.

The sale and buyback of inventories by PFIL involving Infiniti Securities and PT Infiniti Finance as counterparties

3.139 On 29th September 1997, PFIL sold US$ 100mns of Steady Safe promissory notes to an Indonesian company called Infiniti Securities. On 6th October, the whole amount was repurchased by PFIL, at the same price. On 30th September 1997 there was another US$ 20 mns sale, this time to a company called Infiniti Finance, which was also repurchased at the same price on 6th October.

3.140 As these transactions had the same settlement date and price, no cash flowed and no profit or loss was reported. There was no obvious economic justification for PFIL or the Infiniti companies to undertake the deals.

3.141 I have not been able to establish why these transactions took place. There are a number of reason why they might have been initiated by Peregrine. The deals might have been undertaken for window dressing purposes. PFIL traders might have wished to shrink the size of their inventory at the end of the month, in order to improve the appearance of the end September management accounts. They might have wished to establish a new market price for valuation purposes. They might have wished to establish a new "age" for the Steady Safe notes which PFIL held, in order to create the appearance of fresh turnover of the inventory in reports going to senior management, or to avoid an aged inventory provision being applied against the holding.

3.142 None of these reasons seems likely. The end of September was not a significant date so far as public disclosure was concerned. In any case, Catherine Sham told me the standard practice was to net matching sales and purchases of this kind against each other for reporting and accounting purposes, even if they were not formally identified as repos. Group Product Control was under instructions to seek to identify them. There does not seem to have been any attempt to hide any of the facts that tied the deals together. The Steady Safe notes were priced by reference to their implied yield, rather than the price they had most recently been traded.

3.143 Both these companies were part of the business empire of Jophie Widjaja, who owned 51% of Steady Safe and was its president. It is possible the transactions were undertaken at his initiative.

3.144 I do not think this odd episode is important in relation to the matters you asked me to examine.

The sale of inventories by PFIL to the Asian Bond and Currency Fund Limited (ABC)

3.145 Towards the end of November 1997, a similar set of transactions took place between PFIL and ABC. On 19th November, ABC bought US$ 6 mns promissory notes for PFIL. They were repurchased by PFIL on 1st December.

3.146 ABC was a closed end investment fund managed by Peregrine Asset Management, itself a 75% subsidiary of PIHL. It was listed on the Osaka Stock Exchange. Nikko Securities Investment Trust and Management was the investment adviser, and Nikko Bank Luxembourg was the Fund administrator. The former provided two members of its Board of Directors, Peregrine the other (in the form of John Lee). Rosa Wang, from Peregrine Asset Management, acted as the day to day fund manager.

3.147 Rosa Wang explained to me that she bought the notes in good faith from PFIL, having received credit research material from PFIL, analysed it, and checked with other brokers. However, shortly after the purchase another investment manager in Peregrine Asset Management mentioned to her he had heard rumours that Steady Safe might be in financial difficulties. Rosa Wang asked PFIL about this, and received the reply that it knew of no difficulties, but that if she was unhappy with the investment PFIL would take it back. After considering it further Rosa Wang took up the offer and the transaction was unwound.

3.148 I have no reason to doubt this explanation. Rosa Wang impressed me as a credible witness. All transactions by the Fund were reported to Nikko, and her superior in Peregrine Asset Management, Gary Greenberg. Gary Greenberg did notice the sale of Steady Safe Notes and asked about it. He was satisfied by her explanation.

3.149 There were a number of other purchases of bonds by ABC from PFIL during the autumn of 1997. In some cases, the bonds were subsequently sold at sizeable losses. I was satisfied by Rosa Wang's explanation that the purchases were made at arm's length, and that no preference was given to PFIL.

The management of collateral, other security and guarantees taken by the companies to secure its exposures

3.150 PFIL had a flexible approach towards taking security in order to improve its protection against default by its counterparties. That is evident from the descriptions of the key exposures given earlier in this Part of the Report. Andre Lee told me that, in relation to derivative transactions, the presence or absence of collateral arrangements would be determined during the credit approval process. Each counterparty and each transaction was judged on a case by case basis, with the exception of those counterparties with whom PFIL entered into multiple transactions, or had existing exposure. In these cases, the overall credit and risk exposure would be examined in conjunction with the proposed derivatives transaction.

3.151 There can be no objection to taking a flexible approach, making a business judgment in each case. Although it is routine to require collateral in the form of margin to be provided against exchange traded derivative open positions, PFIL's key derivative exposures with its customers were bilateral "over the counter" agreements, where a more flexible approach is possible.

3.152 What is important is that the exposure is adequately monitored, and remedial action taken promptly to limit any deteriorating situation. Where the exposure is dependent on a volatile and unpredictable market price, a rapid response mechanism is required. Collateral arrangements have significant benefits in controlling fast moving exposures, such as arise with derivative transactions. They are particularly attractive for geared derivative transactions like the put option with Robinson described earlier in this Part of the Report, where the exposure can increase very quickly for reasons unrelated to the financial soundness of the counterparty. Where the transaction is long term, extending the period in which losses can rack up, it is still more important to have a reliable means of control. In such cases, it is normal market practice to require collateral under a formula agreed at the outset of the transaction, failing which the transaction is automatically terminated. This offers an attractively simple and predictable formula for controlling exposure promptly, without further argument or negotiation.

3.153 Typically, collateral arrangements for derivatives are set in documentation between the counterparties which covers all derivative transactions between them, and is usually contained in a credit annex to a standard derivative agreement developed by the International Swap Dealers Association (ISDA). This document will stipulate a threshold above which collateral in an agreed form will be posted by one party to the other in order to constrain the uncovered credit exposure to the threshold amount (which may well be zero). The collateral is periodically adjusted to keep the exposure within the agreed bounds.

3.154 Peregrine used ISDA documentation for swaps, including with Tanayong, Robinson, and SVOA, but in these cases there was no provision for collateral. That put PFIL in a weak position to negotiate and, as will be evident from earlier paragraphs in this Part of the Report, the results were very unsatisfactory. It may be that provision for collateral could not have been negotiated before these transactions were undertaken, although I have seen no evidence it was seriously considered. With the benefit of hindsight, it was clearly unfortunate some arrangement enabling the exposures to be controlled was not built in at the start. The responsibility for that lay with PFIL, and within PFIL ultimately with Andre Lee, since PFIL was subject to no group oversight at the time these transactions were initiated.

3.155 Where there were arrangements for collateral in place, they were not always properly observed. In 1997, serious documentation problems were identified in Asia International Investments (a special purpose derivatives trading vehicle company managed within Peregrine), Peregrine Nithi in Thailand, and Peregrine Sewu Securities in Indonesia. Resolving these problems required a major firefighting effort by John Lee and his group risk management team, which continued for at least six months. In the end, in August 1997 John Lee secured agreement from Philip Tose to establish a central documentation unit within Group Risk Management, in order to ensure that documentation was better managed. This had been a feature of the Group credit risk procedures introduced early in 1995, but had never been applied to the business areas. When I suggested to John Lee that sloppy documentation had been a self-inflicted wound by Peregrine, which impaired its ability to deal with several difficult cases, he agreed that was a fair statement. He told me he had discussed with Andre Lee the idea of establishing a general provision against the possible consequences of inadequate documentation at the time of the first interim statement for the half year to the end of June 1997, but nothing came of it.

3.156 In sum, PFIL operated in a tricky business environment, where a number of its counterparties were immature businesses and most were below investment grade. Some of the Asian markets were subject to political influence, and featured peculiarities of law. All this points to the need for robust protection mechanisms. Collateral arrangements were potentially valuable, but in several important cases did not feature up front or at all. Where used, poor execution and control within the Peregrine meant they did not always provide the protection planned.

3.157 Some further observations on this topic appear in Part 2 of this Report, under "Credit risk mitigation".

Part 4. Conclusions on the performance of senior management and their advisers

Introduction

4.1 This part comments on the performance of directors and senior management officers. My terms of reference also ask for my conclusions on the performance of advisers and providers of professional services to the companies, and this part concludes with comments on the performance of the external auditors.

Who was in charge?

4.2 Peregrine's arrangements for senior management were reformed at the end of 1995. The reforms were described in an internal memorandum dated 19th December 1995. (see Appendix 2.4). It described the main board (i.e. PIHL) structure as no longer adequately representing the overseas offices or the product lines offered by the group. A broadening of the Group's management body was required. The main board would therefore cease actively to manage the group. It would instead fulfil a role similar to that of a board of governors. The number of executive directors would be reduced to four, and it was planned to increase the number of non-executive directors (although this never took place).

4.3 The plan was that active management of the group would pass to an Executive Committee (EXCO), responsible "..for driving the Peregrine Group's business forward in our next era of development." Within EXCO, an individual was made responsible for managing each product line of the group – Andre Lee for the fixed income business. These would be designated managing directors. Peter Wong, Alan Mercer and John Lee were also managing directors, representing operational areas.

4.4 In fact, as I have described in Part 2, EXCO operated more as a discussion and communications forum than as a decision making body. The Managing Directors in EXCO formed an inner cabinet which was more executive, but it ceased to meet regularly in early January 1997, and altogether in April 1997. That left no formal body effectively in charge at group level.

4.5 At the product line level, the PFIL Board was responsible for fixed income business. However, the PFIL Board also rarely met formally, and when it did, it was to do business which could be done in no other way, such as approving accounts or matters which required the use of the company seal. Nevertheless, although PFIL operated as a business division of the Group rather than as a separate entity, it was legally distinct and independent, and its Board was responsible for ensuring its separate legal obligations were met.

4.6 In these circumstances, responsibility for the Group's affairs is best described as having been distributed between a number of individuals. The key players in so far as the fixed income business was concerned were Andre Lee, PFIL's managing director, and Philip Tose, his line manager and PIHL and PFIL Chairman. The key players in so far as infrastructure is concerned were Peter Wong, and John Lee. Alan Mercer, became important when he took charge of internal audit early in 1997. Until then, he had little involvement with the fixed income business, because it was not a regulated business. Catherine Sham, although not a director of PIHL or PFIL, was important; as Group Financial Controller and temporary head of Product Control she held pivotal positions in relation to decisions about valuation and provisions in the autumn of 1997.

4.7 I have focussed my attention on these persons in seeking to consider whether any director or senior management officer was in breach of any fiduciary duties, negligent in performing his (or her) function or otherwise in breach of his duties of skill, care and diligence.

4.8 In addition, as all the directors of PIHL and PFIL had common law and statutory duties to the companies of which they were directors, I have considered the positions of Francis Leung, who was a director of both companies, and Anthony Loh and Warren Allderige, who were directors of PFIL. These all held executive positions within the Group. I have not, however, considered the positions of the non-executive directors of PIHL (Professor Gao and Canning Fok), who had no part in the events leading to the Group's collapse.

The context for assessing performance.

4.9 My conclusions on the matters which I have investigated do not include any findings of fraud or dishonesty by any of Peregrine's directors, managers or advisers. I interpret the evidence I gathered as indicating that all concerned consistently sought to further the interests of the Group and its shareholders. The failures I detected were all failures of performance rather than intention.

4.10 I have made my judgments about these failures on the basis of what I would have reasonably expected of persons in the position of the individuals under consideration, making decisions at the time and with no benefit of hindsight. In the case of directors and senior management, I have sought to take into account their different levels of knowledge and experience and the reliance which they might reasonably have placed on others and which others might reasonably have placed on them in the conduct of the affairs of the companies.

4.11 I emphasise that my findings in respect of the performance by persons of their duties reflect my personal opinion, based on what I have seen and heard. My findings have no force in law. Any legal issues arising out of the same subject matter can be determined only by courts of competent jurisdiction on evidence adduced in legal proceedings. Such determinations may or may not accord with my findings.

4.12 I have described in Part 2 of the Report why the Group collapsed. Many Asian institutions which had financed PIHL were themselves subject to strong financial pressures and having sharply to reduce the scale of their operations. Peregrine's credibility was increasingly undermined by its association with Asian markets and damaging rumours about its affairs. But Peregrine was inadequately prepared for what happened, and unnecessarily vulnerable to it.

4.13 The crisis in Asian markets was without question much more severe than had been anticipated by the consensus of informed financial practitioners and commentators. It would be unreasonable to expect a degree of foresight by Peregrine's senior management which was not present in the rest of the financial community. I have sought to take care to avoid doing so in making my judgments of the performance of the directors and senior managers. I have focussed particularly strongly on whether the two companies were reasonably placed to survive what might have been expected, and whether management reactions to the more severe deterioration in market conditions which actually ensued were reasonable in the circumstances.

Catherine Sham

4.14 Catherine Sham was the group's Financial Controller, and, briefly, caretaker interim head of the Group's Product Control. She became a member of EXCO only in September 1997, but was not a director of any Peregrine company. EXCO only met once after September 1997, in November, and for the purposes of this review I have regarded her responsibilities as having been exclusively defined by her managers within Peregrine. It is clear she was held in high regard by Peter Wong, her immediate manager, and by Philip Tose, Peter Wong's manager.

4.15 Catherine Sham's responsibilities were for the most part clear and give rise to no comment from me, with the exception of her temporary responsibilities for Product Control, and responsibility for provisioning.

Product Control

4.16 The Product Control function was to be an independent check on traders' valuations. Catherine Sham was instructed to manage Product Control in a care taking capacity between October 1997 and January 1998, when a newly recruited manager was due to take over. It was made clear to her that her role was a temporary one, until the newly recruited manager was able to start. But Peter Wong, in giving her the responsibility, did not make clear whether she should act merely as a caretaker or be more active. She regarded it as a caretaker role, and although she became aware while doing the job that

Product Control was not in all circumstances acting as an independent check on trader's valuations, she did not seek to bring about improvements in the processes. This issue long predated her assumption of responsibility, and there were no obvious instant remedies.

4.17 However, she told both Peter Wong and John Lee about the areas of weakness and performance deficiencies she detected, and that she considered more senior staff were needed. Both men told her they considered these issues should be resolved once the new manager of Product Control arrived in January 1998. In my view, she did all that was necessary in the circumstances.

Provisioning

4.18 The role of financial controller would typically include a responsibility for ensuring that valuation and provisioning procedures had been properly followed. I concluded in Part 2 that these procedures were unsound, as were the valuations and provisions on which the statements of 26th October and 12th December 1997 were based.

4.19 Catherine Sham was well placed to identify the key procedural weakness. She worked closely with Product Control, and became its head in October 1997. She knew that the less marketable positions were the least subjected to independent verification of their value by Product Control. She also knew that some of the exposures had been held for a long time, and she knew the size of Steady Safe. She was very well placed to doubt the validity of valuations and provisions. Furthermore, according to a statement by Fred Kinmonth, who participated in the meetings over the weekend of 25/26th October 1997, Philip Tose had delegated to her and John Lee the task of preparing the financial information which was included in the announcement of 26th October.

4.20 On the other hand, Catherine Sham was not an expert in risk assessment, and it is clear that valuations and provisioning were carefully considered at the most senior level before the public statements in October and December, and also later during December and in early January 1998. Philip Tose took the lead; he received regular reports on the age and pricing of the positions. Catherine Sham knew that in the meetings on 25/26th October, Philip Tose asked John Lee to be responsible for ensuring the PFIL's provisions were adequate. John Lee was held in high regard for his expertise and awareness of risk. Peter Wong, who as Finance Director had an obvious interest in the procedures, was also involved. In these circumstances, although a more skilled or assertive financial controller could have done more, I do not criticise Catherine Sham for not doing so.

Warren Allderige

4.21 Warren Allderige was on the Board of PFIL; having been appointed a managing director in 1994 with broad operational functions, including early steps in establishing PFIL's credit risk systems. But he ceased to be executive in 1996, when he became business head of Peregrine's New York operations. Although he remained on the PFIL Board, other people assumed his operational functions, whom he reasonably thought to be well able to perform them. In January 1997, he transferred his residence to Korea, on becoming Chief Executive of Peregrine's joint venture operation there. Under the terms of that employment, he was precluded from any active role elsewhere in the group. It does not appear that anything came to Warren Allderidge's attention which would have required him to intervene in the conduct of the affairs of PFIL.

Anthony Loh

4.22 Anthony Loh was a full executive director of PFIL, but was resident in Singapore and responsible for the development of sales activities in South East Asia. Although the reason for his appointment as a director was not explained to Anthony Loh, there were no circumstances to suggest that he had any responsibility for risk management, syndication or structured finance activities, which were all based in Hong Kong. He did not routinely take part in meetings in Hong Kong relating to PFIL business. He not unreasonably assumed he was appointed a director purely because of his experience and market knowledge in Asia, having previously been in charge of fixed income activities of Lehman Brothers in Singapore.

4.23 However, Andre Lee looked to Anthony Loh to deputise for him when he was away. This did not necessarily mean he had to come to Hong Kong. Andre Lee was away on honeymoon in late October, and missed important meetings about provisioning. However, Anthony Loh did not attend these, and I have no grounds for questioning his performance. It does not appear that anything came to his attention, at any time, which would have required him to intervene in the conduct of those affairs of PFIL which were outside of the scope of his functional responsibilities.

Francis Leung

4.24 Francis Leung was Deputy Chairman of PIHL. He was effectively co-chief executive with Philip Tose, focussing on the corporate finance and equities business of the Group. This was the core business, in that it was the original activity, well understood and controlled, more established in its market place than the group's newer businesses, and reliably revenue generating. It caused no problems.

4.25 Francis Leung had co-founded Peregrine with Philip Tose. In fact, it had been his idea originally, and he had invited Philip Tose to join him. He and Philip Tose remained the key strategists and directors. They had worked together for many years very successfully. They both described their relationship as very close and mutually reliant. They broadly divided the business of the Group between fixed income on the one hand and corporate finance and equities on the other, and trusted each other to manage their own areas with complete discretion.

4.26 They both agreed that establishing a fixed income business was the right strategy for Peregrine. But they recognised that it would be a challenge. It was a very different business from Peregrine's traditional business, requiring different skills, styles, financing, systems and controls. The skills would need to be bought in, and they expected a culture clash with Peregrine's more home–grown existing staff.

4.27 Their expectations were born out and gave rise to rumours of strife and turmoil within the group. I attach no credence to the claims that the stresses created by the establishment of the fixed income business were damaging to the cohesiveness or effectiveness of management at the most senior levels in Peregrine. Francis Leung denied that there was any schism between him and Philip Tose, and no serious evidence of one came to my attention.

4.28 Francis Leung did initially strongly disagree with Philip Tose about the participation of Zurich as a substantial shareholder. This partly reflected his disappointment that Peregrine's favoured strategy of becoming a Chinese investment bank through a major Chinese participation failed to materialise in the summer of 1997. He believed the Chinese authorities studying the idea were put off by the devaluation of the Thai Baht and emerging difficulties elsewhere in South East Asia. His disagreement also partly reflected his nervousness about Zurich's motives, and the possibility that Zurich were more interested in participation as a short-term investment than as a strategic business alliance. He was won round by the lack of credible alternatives and increasing need for Peregrine to find a financially strong partner. But his fears were probably sound.

4.29 I have no criticisms of Francis Leung's performance as a director (and Deputy Chairman) of PIHL.

4.30 Francis Leung was also a director of PFIL, although he was effectively non-executive in that he was not actively involved with fixed income business. As a non-executive director, he took no part in day to day management functions which had in effect been delegated to the executive directors. However, his director's duties required him to act in the event of anything adverse coming to his attention.

4.31 Francis Leung knew that an internal audit was being done on PFIL in mid 1996. But he did not see the draft report and so had no idea of the seriousness of its findings. As it was not the practice to circulate completed internal reports to senior management who did not have direct responsibility for the business being audited, he would not have been alerted to the fact it was not completed.

4.32 I have no criticisms of Francis Leung as a director of PFIL.

Alan Mercer

4.33 Alan Mercer was an executive director of PIHL, Group Legal Counsel and Group Compliance Officer. He also took over responsibility for internal audit from Peter Wong early in 1997. He was the only member of the PIHL Board who was not also a director of PFIL, although he was its Company Secretary.

4.34 Alan Mercer and Philip Tose were clear that the role of group compliance was limited to compliance with the statutory, listing and other regulatory requirements which applied to the Group in different countries. It had no responsibility for compliance within Peregrine with its own rules and controls. As Legal Counsel, Alan Mercer was responsible for group level legal documentation. Client related transactions and their documentation were the responsibility of the execution managers within the individual businesses, supported by outside lawyers where necessary. Thus Alan Mercer had no direct responsibility in relation to the fixed income business, which was not regulated, or PFIL, which was not listed and of which he was not a director.

Internal audit

4.35 Alan Mercer described his ambition on taking over responsibility for internal audit as being to make it more effective and more of a value added tool for the management of the Group. It was his expectation that internal audit reports would be discussed by at least EXCO MDs and possibly EXCO itself. To that end, he circulated the proposed 1997 audit programme to EXCO MDs in late January 1997. Plans were initiated in Internal Audit to propose that the function should have a formal relationship with EXCO, but these had not come to fruition when the Group collapsed.

4.36 Alan Mercer did not question Peter Wong, whom he succeeded, about outstanding issues when he took over. But he did discuss the main problem areas which Internal Audit had observed in Fixed Income in 1996 with Adam Robinson, the Internal Auditor. He read the draft report, and knew it cited five key issues which were described as highly significant, exposing PFIL to major risk. He was aware how important the fixed income business was to the Group. He knew that Adam Robinson thought the report had not been completed because PFIL disagreed with it. Despite all that, another audit into PFIL did not start until June 1997, and Mary Ballard, who led the team undertaking the new audit, received no special instructions to review the findings of the uncompleted audit the year before.

4.37 Alan Mercer explained to me why there was a delay in initiation of a new audit following his assumption of responsibility. He wished to allow time for John Lee to take the necessary steps to consolidate his control of Group Credit Risk Management, which he had only recently taken on. He suspected that one reason for the lack of finalisation of the 1996 draft report had been successful objection by PFIL that the auditors did not understand its business. He wished to strengthen the credentials of the audit team before launching another audit, and recruited Mary Ballard from NationsBank in USA promptly after he took charge of the function. She arrived at Peregrine in March. She had the required experience, and in his view the strength of purpose and personality to counter the self-confidence and aggression of the fixed income team. But she needed time to settle into Peregrine. In these circumstances, I think it was reasonable to delay starting the new audit until June.

4.38 Preliminary findings were compiled in August. These were in the form of a factual list, but were potentially critical, with definite similarities to some of the more serious findings of the year before. In again raising concerns about credit risk management, the draft findings should have alerted Alan Mercer to the possibility that his earlier confidence that John Lee was now grasping this issue was misplaced. However, Alan Mercer told me he did not ask to see the preliminary findings, and so did not see them.

4.39 The preliminary findings were not translated into a draft report until October 1997. This was more diplomatically phrased than the report in 1996, and concluded that, given the growth of PFIL, its operations were relatively well organised. Nevertheless, it referred to a need to improve in ten areas, which exposed PFIL to significant risk, including credit reporting, monitoring and control, lack of documentation for transactions, lack of policies and procedures, accounting policies and independent and consistent position revaluations. It appears no further work was done and the draft report was never finalised.

4.40 I am very surprised that work on completing the audit did not proceed much more quickly. Having planned so carefully to ensure he could confront PFIL, and John Lee, if the potential findings were critical, and delayed the start of the audit in order to do this, I am perplexed why Alan Mercer was not anxious to see the preliminary findings, which surely should have prompted acceleration of work to verify them, complete the report, and action remedial work. If resources were inadequate internally, outside consultants could have been bought in to help. They might in any case have provided a valuable second opinion, given the likelihood of disagreement between internal audit, PFIL management and John Lee.

4.41 Alan Mercer told me he discussed progress on the audit with Adam Robinson (the Internal Auditor) in September, when he was told that Andre Lee and his team had received but not commented on the provisional findings. He had intended to discuss the findings with Andre Lee when the draft report was completed in October, but by then circumstances had changed. PFIL was no longer looking for new business, and its teams were actively involved in restructuring some of the illiquid and difficult positions they already had. He told me he also took comfort from his knowledge that Peter Wong and John Lee had signed off the description of Group Credit Risk Management's oversight in the 1996 Annual Report. This description stated that a system of centralised credit risk management applied to the whole group (although the draft internal audit findings might have caused him to doubt that). He was also comforted by the fact that Philip Tose had authorised his legal team to undertake a legal processes and procedures audit of PFIL (although it never took place because of other priorities arising in the last quarter of 1997).

4.42 Andre Lee recalls that Alan Mercer did discuss the findings in the draft report with him in October. He claims Alan Mercer agreed that he could delay his formal response until there was a break in the Asian crisis. Alan Mercer denies any such conversation.

4.43 Alan Mercer was responsible for ensuring compliance with Stock Exchange listing requirements and would or should have been sensitive to the need for proper valuations and adequate provisions. By the end of October, when critical decisions on provisions began to be taken, he had seen both the 1996 and 1997 draft internal audit reports. They should have alerted him to the potential weakness of the Group's valuation and hence provisioning procedures and policies. He took no special steps to ensure they were taken into account before allowing the 2nd interim results statement for the 10 months to end October 1997 to be released. At the very least, he could have alerted the external auditors to the two internal audit reports. He could also have checked that the SFC inspectors, who he knew had questioned the valuations and provisions of PFIL's book because he was in charge of relations with them, really were satisfied with the explanations they had been given.

4.44 Alan Mercer considers he was entitled to rely on the greater expertise of Andre Lee and John Lee in relation to valuation and provisioning. Andre Lee had insisted at EXCO briefings in February 1997 that his teams had conducted and were conducting extensive reviews of their credit exposures, both in Indonesia and more particularly at that time, in Thailand. Andre Lee thought they were way ahead of their competitors in this. Alan Mercer believed John Lee was exercising oversight over PFIL's credit procedures, noting that John Lee had traveled to Thailand and Indonesia during 1997 and in both cases had worked on reducing PFIL's credit exposures to existing clients. John Lee had insisted that collateral be taken against Steady Safe.

4.45 The problem for me with this explanation is that it takes no account of the information which Alan Mercer now held. Two internal audits, led by different persons, the second of whom (Mary Ballard) he had recruited having regard to her experience and personality specifically with the PFIL audit in mind, had raised serious questions about the robustness of the procedures on which valuations and provisions relied.

4.46 Alan Mercer also notes that he had many competing priorities. He notes, in particular, that during September and October he spent a large proportion of his time in Korea dealing with litigation arising from the sale of the shares of another shareholder in Peregrine's Korean joint venture company, Dongbang Peregrine Securities, contrary to the terms of the shareholder agreement. I accept this had serious implications for Peregrine and its shareholders, and deserved high priority. Nevertheless, I do not accept it condones the lack of action in relation to the 1997 internal audit draft findings before September, or during November; and I believe it is no more than partial mitigation during September and October.

4.47 Alan Mercer also notes that he took steps to satisfy himself that the external auditors would carefully review the valuations of PFIL's inventory of bonds and derivative positions. He received assurances from Peter Wong and Catherine Sham on this point, and was comforted that the auditors proposed to apply full audit standards in undertaking their review of the interim results. However, what he did not do was to alert the auditors to the draft findings or the draft report of the 1997 internal audit.

4.48 Alan Mercer should have done more to ensure the criticisms made in the preliminary findings and draft report of the 1997 internal audit were promptly followed up. He should have asked to see the preliminary findings as soon as they were available. He should have sought to ensure the draft report was finalised as soon as possible. He should have sought to ensure that the 2nd interim results were not released until he was sure they were not affected by the weaknesses identified in the reports. In failing to do so, he fell below the standard of competence which should have been shown. In this instance, he was negligent and in breach of his duties of skill, care and diligence to PIHL.

John Lee

4.49 John Lee was a director of PFIL. However, his main executive responsibilities were at group level, although he was not a director of PIHL. He was recruited in 1994 as a key element of the adaptation of Peregrine's business to accommodate a fixed income component. Philip Tose placed increasing reliance on him to ensure the fixed income business was properly controlled and prudently financed, and by 1997 probably regarded him as the second most important person on this side of the business. Initially, he worked closely with the fixed income managers, although by 1997 there are differing views about how intimately involved he remained on a day to day basis. He was never formally appointed to PFIL's Credit Committee, but attended it from time to time by invitation as an adviser, and this led some, notably Philip Tose, to believe he was a fully-fledged member. He had group wide responsibility for treasury and market risk throughout 1997. He also assumed responsibility for group credit risk in February 1997. I think he performed very well in relation to treasury management, except in one important respect. While I have no significant concern about his performance in relation to market risk I am very critical of his performance in relation to group credit risk and associated functions.

4.50 John Lee did not regard his duties towards PFIL as separate from his executive responsibilities within the wider Peregrine Group. He acknowledged that in principle he had duties of skill, care and diligence towards PFIL arising from his directorship of it, but argued that in a group context it had no practical meaning. He claimed that when he joined Peregrine he asked Peter Wong, the Legal and Compliance Department and Alan Mercer what his duties as a director of PFIL would be. The advice he recalls being given was consistent with that given by Lehman Brothers, his previous employer, that, in the context of a group structure with function based management, his duties as a director were limited to that of signing legal documents on behalf of the company. John Lee's written terms of engagement do not indicate any such limitation, and Alan Mercer denies having given any advice to John Lee. The law is quite clear that the duties of directors of subsidiaries must be seen as separate even in a group context.

Treasury management

4.51 John Lee introduced modern treasury management techniques into Peregrine, starting in 1994. This was a vital component of the transformation of the Group from an equities brokerage and corporate finance house into a broader ranging investment bank. He did an excellent job, and Peregrine survived the collapse of its market place for much longer because of his skills as a treasurer and the respect accorded him by the banks and institutions which funded the Group.

4.52 However, there was a potential flaw in the arrangements, in that the Group's funding strategy was to match fund its trading assets to their assumed holding period. In itself, there is nothing wrong with that, provided the assumption holds. It did not do so, and large quantities of PFIL's trading assets could not be sold in the late autumn of 1997 despite great efforts to do so.

4.53 Philip Tose, Andre Lee, Peter Wong and Alan Mercer blame this on the drying up of liquidity in the markets, rather than the quality of the assets the Group was trying to sell, citing the considerable volume of trading assets which Peregrine was able to sell in November 1997. That evidence seems to me more credibly interpreted as indicating that the remaining assets they would have liked to sell were unattractive in their own right. They would counter that my view takes no account of the fact that the markets in Japan and Korea deteriorated further and dramatically in early December, leaving Peregrine unable to sell the trading assets still on its books then. That raises the issue whether the Group began to liquify its position early enough.

4.54 Two points arise from this discussion for John Lee in relation to his performance as group Treasurer. Was he alert to the need to start to liquify the Group's portfolio of trading assets in order to safeguard its position should the markets deteriorate? And was he sufficiently alert to the potential flaw in the Group's funding policy of relying on the assumed holding period of trading assets?

4.55 I am satisfied that John Lee was alert to and sought to act on the need to liquify the Group's balance sheet from the middle of 1997. He urged a reduction in the Group's total assets, after unexpected growth in the first half of the year, and sought to persuade PFIL, through Philip Tose, Andre Lee and others, and at an EXCO meeting on 6th September, to reduce assets. This was well before PFIL moved in November decisively to do so. It was not John Lee's fault that there was so great a delay.

4.56 I have a very different view about John Lee's alertness to the danger of relying on the assumption that trading assets could be sold quickly. Group policy required trading assets to be held for not more than three months, but, as John Lee well knew because it was crystal clear in internal management reports, this was frequently breached, and, it would seem, not policed. (Appendix 2.6). Long held assets continued to be regarded as trading assets, even when there was no visible external market trading in them. Even when intensive work was going on to restructure exposures (such as Steady Safe, Tanayong, Robinson and SVOA) to contain their riskiness, the mindset remained that while the restructuring was going on they remained marketable, and after it had been completed the restructured exposure would remain as liquid as before.

4.57 I could understand a treasurer who was dependent on outside expertise for risk management falling into this trap, but John Lee was the Group risk manager and had, or should have had, the expertise and knowledge of the exposures to avoid doing so. In my view, there were ample warning signs, which should have been detected by John Lee, that PFIL's trading assets were less liquid than they were assumed to be.

4.58 John Lee believes that in saying this I have taken insufficient account of the efforts he made to persuade other directors of the need to reduce the Group's balance sheet and of the bad state of the Group Credit Risk Management function when he took it over early in 1997. In addition, he had an impossible work load throughout 1997, as he had to tackle a series of credit management related crises in a number of overseas joint ventures. I would have sympathised with him about the last point if he had warned Philip Tose that too many demands were being placed on him. According to Philip Tose, he never did.

4.59 I conclude that John Lee failed to take proper account of the warning signs that PFIL's trading assets were less liquid than they were assumed to be. PFIL was wholly dependent on funding from PIHL, and was therefore vulnerable to this serious flaw in the arrangements for Group funding. He fell below the standard of competence which should have been shown, and he was in breach of his duties of skill, care and diligence as a director of PFIL.

Group and PFIL credit risk management

4.60 John Lee became involved in Group Credit Risk Management in December 1995. In response to his suggestion to EXCO that the group establish a Group commitments committee, EXCO mandated him to do it. The EXCO minutes do not contain its terms of reference, but describe it as being "..largely a data consolidation exercise" (Appendix 2.1). Given that he did not have general responsibility for Group Credit Risk Management, was not a member of any group wide credit committee, and had no group wide authority to approve credit limits outside his Treasury function, John Lee did not regard himself as having any general authority for the management of credit at group level. I think this was entirely reasonable on his part.

4.61 In November 1996, EXCO MDs approved the transfer of responsibility for Group Credit Risk Management from Peter Wong to John Lee, although this was not formally announced until the end of January 1997, when it was stated the transfer took effect from 1st January. John Lee says he discussed the timing of the actual transfer with Peter Wong, and they agreed the transfer would happen in late February, after Chinese New Year. This was a natural break point, which coincided with the transfer of internal audit from Peter Wong to Alan Mercer.

4.62 John Lee found on his arrival what he believed to be an inadequately staffed and poorly experienced credit risk management function. It had five staff, although its head, Solomon Yiu, promptly resigned. In his view, they had limited or no capital markets and derivatives credit experience. He believed the Group credit processes were ineffective, to a large extent decentralised, dependent on front office data and analysis, and unsupported by proper credit systems. This was a very poor basis for extending his remit into PFIL quickly, and he decided his first step must be to recruit more experienced staff. Shortly before he took on the new responsibility he discussed this with Philip Tose in January 1997 and was instructed "to get on with it". He was also faced with demands to firefight credit risk management problems which had been identified in the joint ventures in Thailand, Indonesia and India. The Thai business at that time (early 1997) was a particularly important contributor to Peregrine, and when he visited it in February he found a mess. It demanded very high priority, as Philip Tose made clear to John Lee.

4.63 The result was that he did not attempt to extend his remit into PFIL until about August 1997. He then reached agreement with Andre Lee for the transfer of PFIL's credit research team to Group Credit Risk Management, although the transfer did not physically occur until December 1997. Andre Lee maintains they were, however, working for John Lee for most of the second half of 1997.

4.64 In the meantime, Philip Tose assumed John Lee was fully operational in relation to Group Credit Risk Management, and drew considerable comfort from it. Peter Wong also claims he assumed John Lee was in full and effective charge, although it is doubtful if he should have, given that, according to an internal email, he did not suggest John Lee take his place on two Group wide credit management related committees until July. John Lee did not alert either that he was leaving PFIL completely alone. However, at the beginning of September he did ask Philip Tose to insist in EXCO (in his absence) that all new commitments must be cleared with Group Treasury before proceeding.

4.65 The question arising from this is whether John Lee did enough in response to the situation he inherited when he took over. Although he had alerted Philip Tose to his strategy for improving Group Credit Risk Management in January, he did not seek greater access to PFIL's new business flow, despite being well placed to do so. Nor did he inform Philip Tose that he was not involved with PFIL's credit approval processes. Philip Tose was his manager, and also Chairman of PFIL and Andre Lee's manager. He had a right to expect to be informed in each capacity.

4.66 John Lee knew this was a serious matter. He knew PFIL was a major generator of credit risk within the Group. He was aware that a recent credit rating of the Peregrine Group by the Japan Bond Research Institute (JBRI) had identified Peregrine's vulnerability to weaknesses in credit risk management. He knew how important the JBRI credit rating was for Peregrine's funding. In my view, in not making sure that Philip Tose knew that he was taking no part in PFIL's credit approval processes, despite being responsible for Group Credit Risk Management, John Lee fell below the standard of competence which should have been shown in relation to his responsibilities for Group Credit Risk

Management and as a director of PFIL. He was in breach of his duties of skill, care and diligence in dealing with the company's credit risk appraisal processes during 1997.

Provisions against bad or doubtful exposures

4.67 John Lee's responsibilities for credit risk meant he was well placed to advise on provisions against bad or doubtful exposures in PFIL. He was closely involved in decisions about valuations and provisions preparatory to the two public announcements on 26th October and 12th December 1997. Given his role, the other "non executive" directors of PFIL substantially relied on him for this. Philip Tose told me he relied primarily on John Lee's expertise in the decisions about provisions in late 1997. In a statement, Fred Kinmonth, another Managing Director who was present at crucial meetings discussing provisions on 25th and 26th October 1997, confirmed that Philip Tose had charged John Lee with establishing a level of provisions for PFIL which was appropriate for the purpose of the announcement to be made on 26th October.

4.68 Nevertheless, at group level, John Lee was only one of several persons responsible for this. Catherine Sham, the Group Financial and (temporarily) Product Controller, was also closely involved, although she was junior to John Lee. Andre Lee would have had greater knowledge than John Lee as regards the facts and background relating to the positions being valued. He was abroad at the time of the meetings on 25th and 26th October, but Philip Tose instructed John Lee to liaise with him, which he did. Andre Lee did not believe any extra provisions should be made at that time.

4.69 I would expect the contribution of a competent credit risk manager to be to see through the complexities of a situation and the frightening jargon used by specialists in order to ensure that precautionary common sense is applied. I would expect him to be very conscious that provisions are required not only against bad but also doubtful exposures. I would also expect him to be acutely sensitive to the difficulties of marking to market large positions in illiquid assets. John Lee was also Group Treasurer, and a good treasurer is always sensitive to the need to discount the value of assets to reflect the possible need to sell them quickly.

4.70 John Lee had ample warnings of exposures which were causing significant concern within the Group. In July 1997, Robert Jolly, who worked in Product Control, questioned the level of provisions then suggested against Robinson in an email to John Lee (Appendix 4.2). John Lee also saw the credit reviews prepared in mid September and October 1997 by Luis Maglanoc, who worked for him in Group Credit Risk Management (see Appendix 2.11). The reviews for Steady Safe, Robinson, Tanayong and some others concluded with a warning about the size of these exposures for Peregrine. Some were described as "..far exceeding the company's present underlying creditworthiness." In the case of Steady Safe, the credit review also said "Steady Safe's planned 1998 rights issue should add some comfort, although PIV (i.e. the Peregrine group) exposure would still remain high."

4.71 Given these warnings, I do not believe John Lee's judgments on provisions made at the meetings just before the announcement on 26th October can be justified. Provisions were reviewed again by the PIHL Board just before the announcement of the interim results to end October 1997 on 12th December. By now, events were moving rapidly and unpredictably, and Peregrine's position was clearly deteriorating. Its ability to continue to fund its operations was causing real concern, despite the comforting presence of Zurich. In my view, a person in John Lee's position would be profoundly cautious in approaching decisions about provisions for the purpose of publicly disclosed interim results, and he should have urged great caution on the Board. He did not do so and no additional provisions were made at that stage.

4.72 John Lee believes I take insufficient account of relevant background in coming to this conclusion. He suggested provisions were necessary, but because neither he nor Credit Risk Management had been actively involved in monitoring PFIL's exposures or the work to restructure some of them, he was not the most informed individual to make the quantitative judgments just before the announcement on 26th October. He had no formal training in credit training, and did not consider himself to be a credit expert. He would have to rely on experts, and given the shortage of time he relied on Group Financial Control to do the work, with him being available if needed. In the circumstances, he believes he was cautious in even advising that additional provisions were required, given that this was against the advice of Andre Lee and PFIL staff. When it came to confirming the level of provisions in early December, he took comfort from the fact that nothing had been reported to Peregrine from the due diligence done by Zurich and its advisers.

4.73 I do not find this convincing. If John Lee considered at the time he was the wrong man for the job he should have said so, or taken more active steps to ensure he was properly advised. I conclude that John Lee fell below the standard of competence which should have been shown in his assessments of the need for provisions in late October 1997, and subsequently in the preparation of the 2nd interim results published on 12th December. He was in breach of his duty of skill, care and diligence as a director of PFIL.

1996 Annual Report

4.74 PIHL's annual report and accounts for 1996 contained a description of Group credit risk management procedures, which was given considerable prominence. This reported that the Group Credit Risk Department "..evaluates the creditworthiness of each client with which the Group may do business ...". The Group Credit Risk Committee was said to be "..responsible for the ongoing approval of credit limits granted to clients and monitoring thereof."

4.75 Alan Mercer, who was editor of the 1996 Annual Report, looked to Peter Wong and John Lee to ensure this part of the Report was accurate. They approved the description of Group credit risk in March 1997. Although Peter Wong was still in charge of Group Credit Risk Management until the end of February 1997, John Lee had known since November 1996 that he would take over soon.

4.76 John Lee told me he relied on Peter Wong and Alan Mercer to make appropriate disclosures of control weaknesses in this area. I do not accept this was adequate. John Lee had discussed the inadequacies of Group Credit Risk Management with Philip Tose in January 1997, and knew well then that the Department did not evaluate the creditworthiness of each client. I conclude that John Lee fell below the standard of competence which should have been shown in his handling of his responsibilities for the 1996 PIHL Annual Report.

Peter Wong

4.77 Peter Wong was a director of PIHL and PFIL. Prior to the fixed income business being commenced in 1994, he was broadly responsible for ensuring that the Group ran effectively, with proper systems and controls. He was effectively (although not formally) the Group's chief operating officer. As the business grew and diversified, and in preparation for his eventual retirement and emigration to Australia, there was a phased transfer of his responsibilities to Alan Mercer and John Lee. Alan Mercer acquired Group Compliance in 1993 and Internal Audit in February 1997. John Lee acquired Group Treasury in 1995, Group Market Risk Management in 1996, and Group Credit Risk Management in February 1997. That left Peter Wong with finance, IT, personnel, and back office settlement functions.

Financial and accounting systems

4.78 These remaining responsibilities were challenged by the very rapid growth of Peregrine's business and its diversification. By all accounts, equity brokerage and corporate finance, which was the heart of the Group's business, was well serviced operationally. Other systems and controls did not fare so well. At Group level, financial and accounting systems were by 1997 becoming too slow and cumbersome to be acceptable to top management. The systems had not yet broken down but, without improvement, it would not be long before their effectiveness would be compromised. In particular, management accounts took too long to produce, inter company reconciliations became harder (and none were successfully completed during 1997) and Product Control was not providing a truly independent oversight over marking to market by the trading teams.

4.79 However, there was an increasing level of activity to overhaul the worst areas, notably financial reporting and control. And Peregrine was not alone in being challenged by the pace of changing needs and demands for modern operational systems. I think improvements could have been achieved much faster under more dynamic leadership but, while critical of Peter Wong's performance, I think it would go too far to conclude that he fell below the minimum standard of competence which should have been shown.

Group credit risk management

4.80 Peter Wong had no previous experience of fixed income business. The PIHL Board recognised more skill and experience was needed to ensure the implications for funding and risk control of establishing the fixed income business were properly covered. This was the reason John Lee was recruited in 1994. Peter Wong's responsibilities for risk management were seen as temporary from early in the life of the fixed income business.

4.81 However, Peter Wong clearly understood from Philip Tose that he believed John Lee's responsibilities should be gradually increased as John Lee proved himself, and that credit risk management would not pass over quickly. Peter Wong therefore recruited Solomon Yiu from Citibank to establish the Group credit risk control capability. The Group credit policy was clearly set out in a series of memoranda at the end of 1994 and early 1995 (the Procedures) (see Appendix 2.10). These were personally signed off by Peter Wong and circulated widely. However unconfident Peter Wong may have been about his technical knowledge of fixed income business, these Procedures constituted a set of requirements and instructions which he could ensure were policed.

4.82 In fact, the Procedures were never followed in PFIL. Andre Lee and John Lee thought they were unsuitable for a fixed income business, and so resisted them. There was no oversight at group level of the internal procedures adopted within Fixed Income under the control of Andre Lee, and the idea of group wide credit risk management fell into abeyance. Andre Lee continued to use and further develop PFIL's own system of credit risk control.

4.83 Peter Wong maintained that the Procedures had been prepared largely with the equity business in mind, although he agreed he had asked Solomon Yiu to add some requirements generally applicable to a fixed income business. Andre Lee acknowledged the intention had been to apply the Procedures to his business. Stan Lee, who was the successor to Solomon Yiu in charge of the Group Credit Risk Management team, confirmed that the team was still seeking to gain PFIL acceptance of the Procedures throughout 1997. The position appears to have been that Peter Wong, with limited knowledge of fixed income business, could not prevail on the issue of whether controls at group level should apply to PFIL, and just dropped the whole issue.

4.84 Although his knowledge and experience may not have equipped him to devise fixed income credit procedures, Peter Wong was well placed to ensure PFIL was subjected to Group Credit Risk Management oversight. He failed to deliver either the Procedures or a replacement. The consequences of this failure were in my view at the heart of the unpreparedness of Peregrine for the Asian crisis.

4.85 Peter Wong maintains that the Procedures contained in the memoranda at the end of 1994 and start of 1995 were a framework, to be used as a starting point by the individual business units to develop detailed credit procedures suitable for their business. The Group Credit Risk Management staff were actively involved in working with each business unit to develop credit procedures. It had never been intended to apply the Procedures as they were to any part of Peregrine's business. They were abandoned in respect of PFIL after consideration by senior management. Group oversight of PFIL's credit risk was to come not from applying the Procedures, but by individuals with group level authority. He also maintains that responsibility for new credit commitments passed from him to John Lee in December 1995, when EXCO mandated John Lee to establish a Group Commitments Committee.

4.86 I agree that during the period of Peter Wong's oversight, group oversight of PFIL's credit risk was provided by little if anything more than Philip Tose's supervision of Andre Lee. That does not seem to me to have been credible implementation of a group credit risk management policy. Given that the relevant EXCO minutes described the Group Commitments Committee as "largely a data consolidation exercise", and in the absence of any other terms of reference for it, I do not accept that Peter Wong's responsibility for credit risk oversight of new business passed to John Lee at the end of 1995.

4.87 I conclude that Peter Wong fell below the standard of competence which should have been shown in his management of Group Credit Risk Management, and breached his duties of skill, care and diligence as a director of the two companies.

1996 PFIL internal audit.

4.88 Peter Wong was responsible for internal audit until March 1997. The internal audit of Fixed Income between February and May 1996 culminated in a draft audit report which identified five key issues which it described as "..highly significant and they are of a nature which exposes Fixed Income to major risk. Immediate corrective action is required." (Appendix 2.3.)

4.89 Peter Wong saw this report, but did not bring it to the attention of the PFIL or PIHL Boards. In particular, Philip Tose was unaware of it. (Andre Lee and John Lee, of course, knew about it because it was critical about matters which came within their responsibilities.) Peter Wong took no action to ensure the report was finalised, or that an action plan was put in place to rectify inadequacies within defined periods.

4.90 Peter Wong explained to me that the report did not need to be finalised because another internal audit would be made which would verify whether the required improvements were being put in place. I find this difficult to accept, and have been unable to corroborate it. But if it was true, he should have known it was the wrong procedure to adopt. It created a precedent for not completing an audit. Moreover, there was no follow up until well after he handed over responsibility for internal audit in March 1997 to Alan Mercer. He should have given a very clear message to Alan Mercer that this was urgent and important unfinished business, when handing over responsibility over to him. He did not brief Alan Mercer at all.

4.91 Peter Wong disagrees that it was the wrong procedure to adopt. The key findings took no account of remedial work already initiated, and more remedial work was undertaken subsequently. He did not need to brief Alan Mercer because he could rely on Adam Robinson, Head of Internal Audit, to do so. Adam Robinson was well aware of the status of the 1996 draft report and closer to the detail.

4.92 The five key issues identified in the report included the observation that the credit approval process and structure regarding fixed income underwriting risk, issuer credit risk and counterparty risk were under the control of the product managers and not independently controlled. It was observed that this risked a conflict of interest between the role of credit control and revenue generation. As this was Peter Wong's home territory, he could and should have undertaken remedial action immediately. He did not do so. Peter Wong disagrees, holding that the transfer of responsibility for Group Credit Risk Management to John Lee in February 1997 was a reasonable response. It may have been reasonable, but it certainly was not timely.

4.93 Another observation in the report was that no formal endorsement of authority by the PFIL Board (or by any entity at group level) existed for delegating and controlling trading risk limits. Peter Wong was unfair to his Board colleagues (other than Andre Lee and John Lee, both of whom saw the draft report) in not bringing this matter to their attention. They were thereby not alerted to the assertion (which as a director of PFIL he must have known was true) that they were not exercising proper control.

4.94 I conclude that Peter Wong fell below the standard of competence which should have been shown in his handling of his responsibilities for the 1996 PFIL audit, and breached his duties of skill, care and diligence as a director of both companies.

1996 Annual Report

4.95 PIHL's Annual Report for 1996 contained a description of Group credit risk management procedures, which was given considerable prominence (Appendix 4.3). This reported that the Group Credit Risk Department "..evaluates the creditworthiness of each client with which the Group may do business ..". The Group Credit Risk Committee was said to be "..responsible for the ongoing approval of credit limits granted to clients and monitoring thereof."

4.96 Peter Wong must have known that, in relation to fixed income business, this description was either untrue or likely to be untrue. Even if it had escaped his direct notice, he would have been alerted to it by the draft audit report on PFIL. By 1996, the fixed income business was the greatest generator of credit risk in the group, and this part of the Annual Report was given considerable prominence alongside the credit rating report from the Japanese Bond Research Institute. It was therefore an important mis-description. Alan Mercer, who was editor in chief of the 1996 Annual Report, looked to Peter Wong and John Lee to ensure this part of the report was accurate.

4.97 Peter Wong was either still in charge of Group Credit Risk Management when this statement was given, or within a few days of passing the responsibility to John Lee. He must take the main responsibility for it. I conclude that Peter Wong failed to exercise due care as a director of both companies in permitting the description to be included in the report without correction and that this matter further demonstrates shortcomings in Peter Wong's oversight of Group Credit Risk Management.

Valuations and provisions

4.98 As Group Finance Director, Peter Wong should have had prime responsibility for ensuring that companies in the Group, including PFIL, accurately valued their assets and exposures and provided against possible shortfalls. But his lack of experience of fixed income products meant that he was at a severe disadvantage in meeting this responsibility skillfully. It was with this in mind that John Lee was recruited. In meeting his responsibilities in this matter Peter Wong therefore relied on John Lee to provide and apply the required expertise. He also relied on others, Andre Lee, the Product Control team, and Catherine Sham. Peter Wong would have also drawn comfort from his knowledge of the close personal interest which Philip Tose took in the fixed income business, and his involvement in the decisions about provisions in the second half of 1997.

4.99 In my view, provided he was watchful for evidence that valuations were not being done properly, this was reasonable. Product Control provided (supposedly) an independent check on the process. He had a high regard for Catherine Sham as being tough and suffering no nonsense. He rated John Lee's technical expertise highly. Philip Tose agreed with these assessments. In so far as he knew of independent evidence, it appeared to corroborate rather than throw doubt on the validity of valuations and provisions in the autumn of 1997. Neither the due diligence by Zurich and First Chicago nor the audit work by Deloittes threw up any obvious warning signs. Peter Wong thought that Deloittes were applying full audit procedures to the interim results of the 10 months' trading to end October 1997 in preparation for the full audit on the 11 months' results to end November 1997. Peter Wong was not aware that the SFC remained dissatisfied with the valuations of a number of exposures.

4.100 However, Peter Wong also knew of the critical findings of the draft 1996 internal audit report. This would have alerted him to the possibility of weaknesses in PFIL's valuation procedures. On the other hand, these findings related to 18 months previously. Many other changes, notably John Lee's assumption of responsibility for Group Credit Risk Management and the creation of Group Product Control, had taken place in the interim to strengthen the procedures. In addition, the Group had been subjected to a formal full audit of its 1996 results, with no apparent problems being thrown up. Peter Wong did not know of the findings of the 1997 internal audit (although he did not ask for them, despite knowing that one was scheduled to take place in mid 1997).

4.101 In the circumstances, I think it would be unsafe to conclude that Peter Wong failed to meet his responsibilities as a director to ensure the assets and liabilities of the two companies were reasonably valued. Even though he was Group Finance Director, and despite my judgment that the valuations were too high, I think that he had reasonable grounds to rely on others.

Andre Lee

4.102 Andre Lee was not a director of PIHL, but was the Managing Director of PFIL. As its Managing Director, he had responsibility for all aspects of its operations. Until May 1997, the fixed income business had been highly successful, and I have no reason to suspect the genuineness of that success. I am sure the main reason for this was Andre Lee. He gathered around him a group of capable people, many of whom have subsequently progressed in the industry, despite the stigma of association with a failed company.

4.103 Contemporary emails and my interviews serve to confirm that Andre Lee was a demanding and abrasive manager, combining an acute ability to observe developments and identify strategies to exploit business opportunities with the ability to communicate them fluently, and a considerable capacity to handle detail. This combination of abilities is obviously highly valuable, but it is also dangerous. Such people are hugely credible, and easily become arrogant and contemptuous of less articulate, quick thinking or self-confident colleagues. If not adequately complemented by restraining systems, there is a danger of them becoming too dominant and powerful for the good of the business. Andre Lee was certainly very much in charge of PFIL's management and business. If the business had flaws, I have no doubt he should share responsibility for them.

4.104 Andre Lee learnt his trade in Lehman Brothers, a large and well-founded investment bank. In my view, he had a blind spot in not sufficiently appreciating the greater vulnerability of Peregrine, a much smaller and less diversified business, to unexpected setbacks. Not surprisingly, he disagrees. I suspect John Lee suffered from the same defect, but to a lesser degree.

4.105 The consequence was that PFIL, and PIHL on whom it depended absolutely for its funding, were less well prepared for the successive crises in Asian markets than it was reasonable to expect from an experienced management team in an international investment bank. It was not that the risks of individual transactions were necessarily higher than other major institutions were undertaking. I have seen nothing to suggest PFIL was not competent in this respect. The problem was a failure sufficiently to appreciate that Peregrine's position in the market demanded greater safety margins than its larger competitors. This could be delivered by lower risk appetite than these competitors or by superior risk assessment and management.

4.106 Peregrine were certainly not shy of taking on business which was large in relation to its own resources. Investment banks will rarely take positions in excess of 25% of their capital without being as certain as possible that the exposure will fall within a few days. Peregrine undertook a number of transactions which resulted in exposures larger than 25% for several months. At the end of May 1997, when the commitment to Steady Safe (itself potentially equivalent to over 35% of group capital) was entered into, PFIL had an exposure to another Indonesian industrial group, APP/Sinar Mas, of over 40% of group capital. This was successfully reduced, but not until October 1997.

Steady Safe

4.107 It is easy to see why Steady Safe seemed to Andre Lee to be an attractive business proposition in May 1997. PFIL had got to know the company, with some small successful deals already transacted. The purpose of the new transaction was to enable the businesses of Steady Safe and CMNP to be merged. Steady Safe was the largest bus and taxi operator around Jakarta, and CMNP was the operator of toll roads and motorways in the same area. Both were established businesses with reliable cash flows. President Suharto's daughter was associated with CMNP, a relationship which at that time was generally thought to be a decided asset. This was exactly the sort of business which PFIL was targetting – below the size to which the US investment banks were attracted, but with the potential to grow into that territory, having become loyal to Peregrine because of its support and good service. Finally, not unreasonably at the time, Andre Lee saw Indonesia as the most stable economy in Southeast Asia, after Singapore.

4.108 However, in my view the Steady Safe commitment was a fundamental mistake, going far beyond a simple error of business judgment. It should not have been undertaken in anything like its size alongside the existing exposure to APP/Sinar Mas. The potential exposure to these two industrial groups could rise to three quarters of the capital of the Peregrine Group. The mandate committed PFIL to a series of transactions continuing over several months, with no effective get out clauses if Peregrine had second thoughts about continuing, so long as Steady Safe continued to meet its basic covenants.

4.109 Andre Lee, with some support from Alan Mercer, disputes that the safeguards for PFIL were inadequate, pointing out that the documentation was handled by reputable external lawyers. If so, it is a mystery to me why the safeguards were not deployed. PFIL continued to lend large sums in relation to the size of Peregrine's resources when most informed observers, including Andre Lee himself, were having increasing worries about region, even if Indonesia seemed a better prospect than some of its neighbours. Either way, I have been unable to convince myself that PFIL's risk management of the exposure to Steady Safe arising from the commitment was anything other than awful.

4.110 It is also a mystery to me why Andre Lee did not consult John Lee, as Head of Group Credit Risk Management about such a large and unusual commitment before it was made, or ensure that he had been consulted and had approved. He seems to have assumed he knew about it, but did not take steps to make sure he knew. John Lee denies knowing about the commitment until August, over 2 months later, and I found no documentary evidence to suggest he knew.

4.111 Andre Lee holds that Steady Safe was a good risk at the time of initiation of the commitment, and PIFL had proved it could distribute its paper. He does not believe that securities regulators in Asia have applied what I suggest is a prudent limit on single exposures of 25% of capital resources, or that it has gained widespread acceptance in the securities industry. Due to the staggered structure of the Steady Safe deal, he estimated that the maximum exposure would not, in any case, exceed US$150 mns. Under his calculation, even at its actual maximum of US$275mns, it did not exceed 25% of Group capital. (He uses the published consolidated figure for capital in the PIHL's 1996 Annual Report; I use the figure used by Group Credit Management for its series of credit reviews in September 1997). He notes there were a number of bonds and loans transacted during 1997 in Indonesia which were far larger. He believes that PFIL, as an Asian based investment bank, should be compared with the Asian business of US and other international investment banks who were its competitors, without taking account of their parents and affiliates, which would be unfair. He notes that at the time the transaction with Steady Safe was initiated, Asian markets were historically less volatile than the markets of the major industrialised nations. Finally, he holds that the transaction was not exceptional for Peregrine in terms of the duration of PFIL's exposure

4.112 I do not agree with these points, believing some to be inaccurate, and others irrelevant. For me, the key point is the scale of the potential exposure, alongside another significant exposure to an Indonesian counterparty (Sinar Mas/APP), in relation to Peregrine's capacity to absorb losses if it went wrong. Even if it was unlikely that something would go wrong, the consequences if it did were unacceptable. Too many of Peregrine's eggs were in one basket. The Group would not have survived as a business if these two exposures went seriously wrong, even if there had been no Asian market crisis. I do not believe the shareholders and creditors of the Group had any reason from Peregrine's Annual Reports or other public statements to expect that Peregrine's management would expose the Group to that possibility even if it was unlikely, nor do I think they would have found it acceptable.

4.113 Within PFIL, I attribute responsibility for Steady Safe to Andre Lee. Although PFIL's credit committee approved the commitment, the other members of the committee were all his subordinates, and by all accounts his judgment was dominant. Philip Tose relied substantially on Andre Lee's judgment, and he was seriously let down by Andre Lee on this matter. It had grave consequences for Peregrine.

4.114 Having made the commitment and taken it as binding, Andre Lee managed the subsequent efforts to meet its terms and to diminish Peregrine's exposure to risk from it. Although they did not succeed, it was not for want of trying. Given the nature of the commitment, and the market environment, it was a hopeless task.

4.115 Although reasonable technical credit risk assessments were applied by PFIL to Steady Safe – and in that respect the decision to have dealings with the company was not made carelessly or incorrectly –the magnitude of the commitment made it disastrous. Notwithstanding Philip Tose's approval, it was hazardous and foolhardy to agree to it. In committing PFIL to the Steady Safe deal, Andre Lee fell below the standard of competence which should have been shown and was in breach of his duty of skill, care and diligence in allowing it.

Group oversight and responsibility for PFIL operational infrastructure

4.116 Although Andre Lee disagrees, I am left with the impression that PFIL resisted Group oversight which was not convenient to it. By one means or another, Group credit risk management was not extended to cover it until it was too late to matter. The two internal audits of PFIL in 1996 and 1997 were never completed.

4.117 Andre Lee's close relationship with Philip Tose provided him with all powerful patronage, which made him a daunting prospect to challenge (particularly given the substantial profits which PFIL was contributing). I believe this was instrumental in the failure to apply Group procedures and controls to PFIL. However, it was unfortunate. Proper group risk management oversight might well have caused sufficient pause for thought for the business with Steady Safe to have taken a different and less risky form, or not to have happened at all. A more powerful internal audit regime might well have led to more rapid and effective reaction to the critical findings of the 1996 internal audit into PFIL.

4.118 Although Andre Lee was by nature a business generator, it was clear from my interviews of him, and the contemporary evidence he produced, that he was concerned to have good administrative procedures and controls, and that he pressed his staff to establish and adhere to them. However, his efforts were unsystematic, and not followed through. He did not sufficiently understand that operational controls needed to be systematically documented, and constantly checked to ensure they were being complied with. Had PFIL been more open to group oversight, it would have been easier to remedy these weaknesses.

4.119 Very few directors are gifted with complete all round qualities. A competent director makes up for this by understanding his weak points, and ensuring they are compensated by alternative arrangements.

4.120 In taking such an independent line towards Group oversight of PFIL, Andre Lee did not help the cause of integrating the new fixed income business into the rest of the Group. As Managing Director of PFIL, his attitude was bound to be influential with his staff, whether or not he intended that.

4.121 He also did not help himself or the Group in permitting resistance in PFIL to group wide risk management oversight, but I do not think he breached any duties as a director of PFIL in doing so. He thought the Group policies established in 1994 and 1995 were inappropriate for PFIL, and he instituted alternative arrangements within the company on his own responsibility. In my view, they did not work well in relation to Steady Safe, but I have already dealt with that matter earlier in this Part of the Report.

4.122 Andre Lee saw the draft 1996 internal audit report on PFIL (see Appendix 2.3). As its Managing Director, he should have been alarmed by the identification of five key issues which it described as "..highly significant and they are of a nature which exposes Fixed Income to major risk. Immediate corrective action is required." In his own account to me, Andre Lee said he had discussed them with John Lee, and left him to take care of the draft findings. Subsequently, Andre Lee told me he continued to liaise with John Lee about the progress of the draft report, and heard in late 1996 that Adam Robinson, the Internal Auditor, had assured John Lee that internal audit recognised that PFIL was making progress in implementing some of the recommendations, and that the report would be amended to reflect this, as well as to include responses from Andre Lee and John Lee. He assumed this had been done and the audit report reported up to senior management. He was not concerned that he heard nothing more.

4.123 This was not good enough. PFIL was his responsibility, not that of John Lee. He did not check with John Lee or with Internal Audit what had eventually happened to the report. I find it inconceivable that a responsible head of a major business division trained in a major US investment bank would not take a very strong interest in an internal audit of his division. If it contained findings and recommendations as potentially significant as those in the 1996 draft report, he would personally monitor its progress to finalisation and consideration by higher management.

4.124 Andre Lee disagrees. He notes that the majority of the key issues identified in the draft report were not under his direct management control, and in particular, he was not in charge of accounting, described in the report as the primary area of concern. He was therefore not authorised to deal with most of the principal recommendations. However, he says he did take steps to implement recommendations in those areas for which he was responsible. I would have thought the fact that he was not directly responsible for several of the areas criticised would have made him still more anxious to see the report finalised and remedial action properly monitored.

4.125 The 1997 draft internal audit findings and report, although noting a number of improvements, remained critical, and its findings contained a number of similarities with the year before (see Appendices 2.13 and 2.14). Andre Lee remained uncharacteristically undynamic. According to Mary Ballard, who led the audit, he participated in a meeting between his officials and the internal audit team, but remained in listening mode, and did not engage subsequently with the internal audit team to explore how best to complete the report. He took comfort from the work underway within PFIL to overhaul its operating manual.

4.126 I can just about justify Andre Lee's lack of responsiveness to the 1997 report. By October 1997, when it appeared, it must have seemed to him a pretty low priority compared with the firefighting then underway in PFIL. Alan Mercer, for whom finishing the report should have been a very high priority, was not pressing. But I judge that in failing to respond adequately to the 1996 internal audit draft report, Andre Lee fell below the standard of competence which he should have shown. As such, he breached his duties as a PFIL director of skill, care and diligence.

Philip Tose

4.127 Philip Tose was Chairman of the Group, and effectively co-chief executive with Francis Leung, focussing on the fixed income and general management of the group. He was also the Chairman of PFIL, and thereby the manager of Andre Lee, its Managing Director.

4.128 The fact that the problems which did so much to reduce Peregrine's resistance to the Asian crisis related to PFIL, of which Philip Tose was Chairman, does not necessarily imply that he was at fault. Until the Asian economic crisis, the fixed income business was regarded as highly successful by many observers and was taken seriously by much larger competitors. Its establishment was a major management challenge, and it came a long way in a short time. Many of the problems which were so damaging were in the process of being identified. There were few completely blind spots in Peregrine; the issue was usually more whether those who knew of the problems were being listened to and the problems dealt with fast enough. Philip Tose's job was to support the positive effects PFIL was bringing to the group, while ensuring that the accompanying risks and vulnerabilities were properly controlled.

4.129 By virtue of his close relationship and strong support for Andre Lee, in my view, Philip Tose was more executive than non-executive Chairman of PFIL. He was not remote from PFIL, and frequently dropped in on its trading teams, although reportedly he spent much less time with support staff such as credit analysts. Philip Tose disagrees with this characterisation of his role, pointing out that PFIL was but one of many business streams for which he had overall responsibility, including the overseas businesses; that he did not actively conduct or execute the business of PFIL; and that my view gives insufficient weight to the role EXCO played in the management of the Group. He characterises his role as non-executive Chairman. This does not fit the impression I received from others, who in general terms seemed to see PFIL as Philip Tose's baby.

4.130 However the role is described, in my view Philip Tose was the PIHL director who was by far the most closely involved with and supportive of PFIL. This was entirely justified. Andre Lee was very ambitious and capable – a charismatic figure. He needed close supervision to ensure the business developed in a balanced way. Andre Lee and his team, being the new boys on the block, also needed protection to give them the space to prove their worth. Older hands in the group did not always welcome their innovativeness and quick success. The new boys needed strong support from the top.

4.131 Nevertheless, the fact that PFIL's business was so instrumental in the collapse of the group prompts the question whether Philip Tose over relied on Andre Lee, thereby tilting the balance too far in favour of business generation for the good of the Group.

Over reliance on Andre Lee

4.132 Philip Tose much admired Andre Lee's business acumen. In his evidence he spoke of Andre Lee as "..very knowledgeable of his whole product area, instilled an enormous amount of loyalty within his people who worked for him; the best in the business in Asia, without doubt."

4.133 I can understand this high opinion of Andre Lee. Andre Lee was largely responsible for the exceptional success of the fixed income business up to mid 1997. I am also satisfied that he was broadly conscious of the risks being undertaken to generate business. However, Philip Tose needed to ensure his high opinion did not result in his uncritically over-relying on Andre Lee, to the detriment of good management. Two aspects have caused me concern: that over-reliance may have unduly exposed Peregrine to Andre Lee's blind spots; and that Andre Lee's influence with Philip Tose may have weakened the ability of others to extend better risk management into PFIL.

i. Exposure to Andre Lee's blind spots

4.134 Andre Lee's experience was with a much larger and more diversified investment bank than Peregrine. The scale and nature of a number of transactions undertaken by PFIL were more suited to a large diversified international banking group than to a middle sized regional specialist like Peregrine. Steady Safe is an example. Andre Lee believes I am unfair to contrast the financial resources available to PFIL with that of the international banking groups with Asian business in this way; in his view the proper comparison is with their Asian businesses, excluding the resources of their parents and affiliates. However, the fact is that size and diversity of business help when times are tough. Although larger investment banks sustained damage equal or greater than Peregrine in relation to their Asian business, they were able to survive on the back of their businesses elsewhere and the financial resources of their parents. In sum, I have no evidence that Andre Lee addressed the necessity to adjust the risk appetite of the large and diversified investment bank of his prior experience to the difficult, smaller scale circumstances of Peregrine. This was a blind spot, which as Andre Lee's line manager and main sponsor, it fell primarily to Philip Tose to identify and compensate for. The effect of this blind spot, if unchecked, would have been to disturb the proper balance between risk taking and risk control. A key role of any chief executive is to ensure this is achieved.

4.135 With the benefit of hindsight, it is clear that the balance was wrong. The control structure was broadly in place, but it was not being given sufficient priority or sponsorship from the top. This is always very much a matter of interplay of personalities; and the interplay between Peregrine's top managers was not conducive to proper Group oversight of PFIL. By the first half of 1997, it does seem that Andre Lee was beholden to no one other than Philip Tose. Andre Lee outclassed Peter Wong, who as a director of PIHL was nominally his senior but had no experience of fixed income business. John Lee, nominally having equal authority, spoke the same language as Andre Lee, but was much less incisive and more oriented to detail in his presentation. He seems to have felt the need to tread very carefully in trying to extend his authority for group credit to align it with his responsibility. Alan Mercer, to judge from his very careful preparation for the 1997 audit of PFIL, also found Andre Lee's influence over Philip Tose very challenging. Francis Leung was another potential counterweight, but trusted absolutely on Philip Tose's judgment on fixed income matters.

4.136 Philip Tose disagrees that the balance was wrong. In recruiting John Lee and appointing him as head of Group Treasury, then Group Market Risk Management and then Group Credit Risk Management, he demonstrated his insistence on having a suitably qualified and experienced person in these positions. John Lee was suitably qualified and experienced, and someone who Philip Tose could reasonably rely on to execute these functions. At all times, John Lee had open access to Philip Tose as Chairman, and he believes he was always responsive to John Lee's point of view and supported him fully in his dealing with business managers, including Andre Lee, in respect of risk management and treasury operations. In addition, Andre Lee was subject to EXCO's scrutiny.

4.137 My problem with this explanation is that it takes no account of the interplay of personalities. Philip Tose was king in Peregrine, and his every word and gesture mattered. If he appeared to support one side rather than the other in a discussion, this would be likely to have a disproportionate effect on his colleagues' perception of the balance of argument. This is the environment in which those responsible for group risk management infrastructure worked.

ii. Support for strong group risk management infrastructure

4.138 When Andre Lee suggested that the Group's treasury and risk management needed strengthening, Philip Tose was receptive. John Lee was recruited, and group risk management functions were established. Internal audit was strengthened. However, Philip Tose was inconsistent in his support for some of these functions, especially Group Credit Risk Management. He fatally damaged the prospects of extending its oversight into PFIL, and thereby its authority, by agreeing in informal discussions with senior colleagues sometime in 1995 that the group credit risk management Procedures were unsuitable for fixed interest business, without following up to ensure that something more suitable was put in place.

4.139 Philip Tose holds that I have taken the application of the Procedures out of context, as it was widely agreed (notably by Andre Lee and John Lee) that they were not appropriate for fixed income business. They were replaced by a procedure which required personal approval from himself, or Francis Leung or Peter Wong (although this seems to have happened by default rather than by a conscious new policy decision). He also drew comfort from his belief that John Lee was closely involved in vetting PFIL's new business as a member of PFIL's credit committee.

4.140 I am not convinced. The decision to replace the Procedures was taken informally and not recorded or communicated to the staff in that function. The intention of the Procedures had been to establish pre-agreed parameters for credit risk, independently monitored, with resort to higher authority where the process threw up questions or exceptions. The effect of the decision was to draw Philip Tose himself into much closer involvement with day to day credit decisions in PFIL, and remove Group Credit Risk Management from any role. John Lee, of course, did not become head of Group Credit Risk Management until the beginning of 1997, two years after the decision to abandon the group credit

Procedures in relation to PFIL had been taken. John Lee's status in relation to PFIL's Credit Committee seems to have been very unclear. He was never formally appointed to it, but occasionally attended by invitation as an advisor.

4.141 Philip Tose's actions in relation to the Steady Safe transaction in May 1997 suggest that it never occurred to him that John Lee or others in Group Credit Risk Management should be consulted. He told me he finds it inconceivable that John Lee did not know about the Steady Safe commitment at the very outset, but he did not check to ensure this was the case. John Lee denies knowing about it until August, over 2 months later, and I found no documentary evidence to suggest this is untrue. Philip Tose also told me that he took comfort from the fact that group procedures obliged PFIL to alert Group Treasury, of which John Lee was head, to the funding required and cash flow implications of all new commitments. But that was very different from consulting Group Credit Risk Management about the specifics of a commitment on which the funding needs were going to be phased over several months, and hopefully would hardly arise at all if the bonds were sold to investors.

4.142 Philip Tose's failure to ensure John Lee had been consulted about such a large commitment lasting several months was unsupportive of strong group credit risk management. It diminished the stature of John Lee personally and made it more difficult for him to act as counterweight to Andre Lee. This was precisely what Philip Tose had appointed him to do as Head of Group Risk Management.

4.143 I do not maintain Philip Tose sought deliberately to cut John Lee and Group Risk Management down to size, but good evidence that risk management and infrastructure had fallen behind the needs of PFIL's business existed if he had wished to see it. I find it very surprising that as Chairman of PFIL, which had grown very quickly from nothing, he did not press for an independent view of its operations to be undertaken periodically by Internal Audit. He appears not to have known about the 1996 internal audit, and did not see the draft report. He would have known that internal audit regarded PFIL as a priority in 1997 from material circulated to EXCO MDs in January 1997. But he took no interest.

4.144 Philip Tose holds that it did not require an internal audit report to come to his attention to address any concerns. Had any executive expressed concern to him – and "his door was always open" – it would have received his earnest attention. He reasonably relied on Andre Lee and John Lee to monitor and manage the fixed income business from both an operations and risk perspective and report directly to him. He holds neither ever reported any such concerns to him.

4.145 This seems to me to miss the point that he took no steps himself periodically to check that all was well, and that he was safe to rely on his managers, notably Andre Lee to the extent that he did.

4.146 The result of Philip Tose's stance was that Andre Lee was too powerful for the group's good. Andre Lee's blind spot of having insufficient regard to the fact that Peregrine was less strong than the major US investment banks which he regarded as the competition was not effectively countered. John Lee was much more aware of Peregrine's funding vulnerability. He was also aware of the international banking norms for exposure to single counterparties, and would have recognised that Steady Safe exceeded them. Had a more realistic view been held about Peregrine's position in the market, a different judgment might have been made about the wisdom of committing as much to Steady Safe.

4.147 Philip Tose was at fault in not recognising that Andre Lee's mission to generate new business and revenue was not sufficiently counterbalanced by a good risk control environment covering PFIL. This fault was compounded into a serious error of judgment by his failure to provide those responsible for achieving this, especially John Lee, the same consistent backing for their activities as he provided to Andre Lee. I conclude that in this matter Philip Tose's conduct fell below the standard of competence which should have been shown, and breached his duty of skill, care and diligence.

Steady Safe

4.148 Philip Tose was aware of and approved the Steady Safe commitment, relying largely on his confidence in PFIL's Credit Committee and Andre Lee's judgment. He had by then seen Andre Lee at work for over two years, and his confidence had not so far been called into question. He did not consult or inform his fellow directors of PFIL about it, which given its size and open ended nature, and the presence at the time of another single large Indonesian exposure, constituted a major risk exposure for the group. Philip Tose assumed that John Lee knew, but he did not. (This illustrates the dangers of such informal arrangements). By failing to ensure his fellow directors were informed, Philip Tose in effect assumed their responsibility as directors for it.

4.149 Philip Tose believes that, having the benefit of hindsight, I have exaggerated the risk exposure which Steady Safe then appeared to involve. In response to that, I note that Luis Maglanoc of Group Credit Risk Management was very critical of the size of the Steady Safe exposure in relation to Peregrine in September 1997; and by November the SFC was concerned that it might destabilise the regulated businesses within the Peregrine Group. In addition, Philip Tose would have been aware from the reports to him on PFIL's bond inventory that PFIL was already very heavily exposed to another Indonesian group, the APP/Sinar Mas group of companies. Taken together, the sums potentially at risk from these two exposures represented some three quarters of Peregrine Group capital. Philip Tose counters that APP/Sinar Mas, was a highly rated blue chip Asian company and one of Asia's largest producers of wood pulp and paper, and that PFIL had a long-standing relationship with it. I note, however, that Luis Maglanoc described the exposure in his credit review in September 1997 as "…"quite significant and far exceeds the APP group's underlying creditworthiness" (see Appendix 2.11).

4.150 I think it was grave error not to have consulted others, especially John Lee, or at least made sure he knew of the proposal. He had a right to expect consultation given his responsibility for Group Market and Credit Risk Management.

4.151 As I have said in dealing with Andre Lee, in my view, the decision to enter into the commitment was a fundamental mistake, going far beyond a simple error of business judgment. It was hazardous and foolhardy of Philip Tose to join in that decision, without engaging in prior consultation with his fellow directors, particularly John Lee. In doing so, Philip Tose fell below the standard of competence which should have been shown, and breached his duty of care, skill and diligence.

4.152 Philip Tose believes this judgment fails to take account of the generally good view held about the Indonesian economy at the time the commitment was entered into. The decision was made on legitimate business criteria, without the benefit of knowledge of the financial meltdown which subsequently ensued. He points out that the initial Steady Safe issue was successfully sold down within one month of issue. In my view, this takes no account of the open-ended nature of the commitment, which meant that Peregrine was locked into a commitment which ultimately was instrumental in its collapse.

Provisioning for 2nd interim statement of results, for the 10 months to end October 1997

4.153 Philip Tose told me he instructed John Lee to ensure PFIL's exposures were properly valued for the purposes of the public statement made on 26th October 1997. He was anxious to avoid successive increases in published provisions within a relatively short time, which could further undermine confidence in the group. That he did so was corroborated by Fred Kinmonth, a participant in the meeting. Having issued this request, he looked principally to John Lee for comfort that provisions were adequate.

4.154 The decisions made at the end of October had to be reviewed immediately before the announcement of the second interim results for the 10 months to the end of October. By then, the Group's position benefited from the participation agreement with Zurich, but the general market prospects looked much worse. It was decided no further provisions were needed.

4.155 The fact that I conclude that the valuations were too generous and provisions correspondingly inadequate does not in my view cast doubt on Philip Tose's performance. His instructions were reasonable and appropriate. John Lee was the best placed person in the Peregrine Group to rely on, and there were no indications from Zurich or the auditors at the time that his confidence in John Lee was misplaced. He overrode Andre Lee's opposition to the extent of the provisions being made.

4.156 In mid December, Zurich for the first time suggested to Philip Tose and Andre Lee that in view of the further deterioration in Indonesia during December Peregrine should consider providing against Steady Safe. This became inevitable following the unexpected refusal of the Indonesian regulator to endorse Steady Safe's rights issue and the withdrawal of the proposal on 29th December, which was central to Peregrine's plans to reduce its exposure. Philip Tose alerted Catherine Sham following Zurich's suggestion and consideration was given to how much should be provided. The Indonesian markets worsened significantly in early January 1998, and this prompted a series of revisions to the draft end November management accounts. The provision finally proposed on 5th

January 1998 was US$118mns. Philip Tose intended to discuss this with Zurich and First Chicago as part of preparing the announcement of completion of their investment in PIHL

4.157 I believe that in the circumstances this was a reasonable course of action. The situation was deteriorating steadily during this period; Philip Tose believed Zurich's suggestion was a negotiating tactic aimed at reducing the price of its participation; and it would not have been in the interest of shareholders to announce new provisions until it was clear that Zurich and First Chicago were either proceeding with their investment or withdrawing. In any case, Zurich's opinion would be valuable in confirming whether $118mns was reasonable.

Advisers and suppliers of professional services

4.158 The only adviser and supplier of professional services which has featured in any significant way in my investigation has been the Group's external auditor. The 1996 Annual Report and Accounts of PIHL and PFIL were audited by Kwan Wong Tan & Fong, which subsequently became Deloitte Touche Tohmatsu (Deloittes). Eliza Yuen was the audit partner in charge of the Peregrine account throughout 1997, and had been in charge of the 1996 audit.

4.159 In the public announcement of 26th October 1997 Peregrine stated it would produce a 2nd interim results statement, covering the 10 months to the end of October 1997. It would also bring forward their year end by 1 month, so that the Annual report and Accounts would cover a year of 11 months ending end November 1997. It promised to publish the Report during January 1998.

4.160 In a letter dated 18th November 1997 Deloittes set out their terms of engagement (Appendix 4.4). In addition to the annual full audit on the accounts to end November 1997 they contracted to review the 2nd interim results for 10 months to the end of October 1997. The review would be less than an audit, consisting "..principally of applying analytical procedures to the underlying financial data, assessing whether accounting policies have been consistently applied and making enquiries of management responsible for financial and accounting matters." That is indeed what they did.

4.161 The letter continues to describe their duties as auditors, in relation to the review. This was "..to report to the board of directors of the Group whether in our [Deloittes'] opinion the interim results have been prepared using accounting policies consistent with those adopted by the [Peregrine] Group in its financial statements for the year ended 31 December 1996, and we are not aware of any material modifications that should be made to the interim results as presented." Following their work, on 28th November Deloittes claim they sent the PIHL Board a letter dated 24th November 1997 saying they were satisfied on both counts (Appendix 4.5). This letter was resent on 11 December in substantially the same form but it did not contain an earlier restriction on circulation beyond the Board (Appendix 4.6).

4.162 From what I could gather so long after the event, I was unimpressed by the review by Deloittes of fixed income related exposures as at the end of October 1997. Although I have no reason to doubt that the accounting policies were consistent with those adopted for the 1996 annual accounts, there was no questioning whether those policies remained appropriate given the developments affecting Peregrine since then. The Asian financial markets had changed very considerably, and there were many rumours about Peregrine having financial difficulties. Deloittes knew that PFIL had a large concentration of exposure to Steady Safe, and that some assets held for short term trading had been held for a very long time.

4.163 Eliza Yuen agreed with me that the words “not aware of any material modifications that should be made to the interim results as presented” could apply to a situation where, because of substantial changes in a company's circumstances, different accounting policies might be required. The extreme case would be where the auditors think it is no longer safe to assume a company remains a going concern. To continue to observe the company’s existing accounting policies would then clearly be misleading and inappropriate.

4.164 Although Peregrine collapsed little more than a month after Deloittes sent their letters of 24 November and 12 December, I do not believe it would have been right to question the group’s ability as at those dates to continue as a going concern. The participation of Zurich then looked to be a firm proposition, and the group’s ability to continue to find funds, although deteriorating rapidly in early December, did not yet look disastrous. However, sufficient had changed to require much closer scrutiny than normal in reviewing the interim results. The level of scrutiny applied fell short of what I would expect in these circumstances, seemingly relying very heavily on assurances from Peregrine’s management, notably Catherine Sham, that there was no cause for concern. In these circumstances, in my view, Deloittes should have at minimum sought to discuss prospects with the Board, or representatives of the Board.

4.165 I was given the impression by those in Peregrine whom I interviewed that Peregrine wanted and instructed Deloittes to do a thorough job. Unusually, Peregrine suggested that as Deloittes and the SFC inspectors had shared interests in relation to the valuation of PFIL’s bond inventory, they should work together. They did meet together once, but Deloittes seem to have been unenthusiastic, and nothing further came of it, for reasons that remain unclear. The SFC and Peregrine both regretted nothing more came of this, and I believe it was an opportunity missed. They could each have had the benefit of an independent view from experienced persons.

4.166 Deloittes were unable to demonstrate clearly from their records what they had done in their review. A number of substantive items remained outstanding at 28th November, which was the date Deloittes claim that the first letter was signed and sent to Peregrine (notwithstanding that it was dated the 24th). Eliza Yuen assured us that she would not have signed the letter unless she was satisfied that all necessary work had been completed, but documentary evidence to corroborate her assurances would have improved their credibility. To make such claims alongside a half-completed checklist can be less credible than having no checklist at all. I am surprised by this example of an incomplete audit trail in an auditing firm of Deloittes' international standing.

4.167 However, for the first time in dealing with Peregrine, Deloittes added a fixed income expert into the audit team, Juliana Wang. She was not briefed about any special circumstances in relation to the work she did on Peregrine (for example, the rumours in the market about Peregrine's losses), although she had only arrived in Hong Kong from Canada in mid October. She reviewed three fixed income bond positions from the list of 15 which were sampled by Deloittes. She considered these three positions had been conservatively valued. But she did not look at Steady Safe, Tanayong, SVOA or Robinson. I am surprised she was not asked to look at Steady Safe, given its size, or Tanayong, SVOA or Robinson, given their longevity. The audit seniors knew she had looked at only three of the 15 bond positions. She explained that if she been asked to review the other 12 positions being sampled by Deloittes (which did include Steady Safe, Tanayong, SVOA and Robinson), she would need to speak to Peregrine's traders or risk management staff. But she was not asked to do so. There is also no evidence that Deloittes reviewed the derivative exposures of PFIL, particularly the restructuring of Tanayong and Robinson which were being finalised at that time. It seems to me Juliana Wang's skills and experience were underused.

4.168 I regard these concerns about the work done by Deloittes for the review of the interim results as serious. I am not convinced sufficient skill and experience was deployed to review the fixed income business adequately, and it was a pity Juliana Wang was not asked to do more. But for Eliza Yuen's assurance that the review tasks were completed, I would conclude Deloittes had taken insufficient care in their work. Unfortunately her evidence is not supported by the documents.

4.169 I conclude that there is insufficient evidence to conclude that Deloittes were in breach of or had otherwise failed to properly discharge their duties.

Part 5. Disqualification as directors.

5.1 I am required by my terms of reference to report on whether it is appropriate for the Financial Secretary or the Official Receiver to consider, on the grounds of public interest, making an application for a disqualification order against specified persons pursuant to section 168 I of the Companies Ordinance.

5.2 The Companies Ordinance confers jurisdiction on the court to make disqualification orders against persons whose conduct in relation to a company or companies makes them unfit to be concerned with the management of a company. The court may set a term of up to 15 years for a disqualification order made on the ground of unfitness. During the term of disqualification the disqualified person is prohibited, without leave of the court, from being a director of a company or being concerned or taking part in the promotion, formation or management of a company.

5.3 Under section 168 J of the Companies Ordinance, if it appears to the Financial Secretary from a report made by an inspector (such as this report) that it is expedient in the public interest that a disqualification order should be made against a former director, he may apply to the court for such an order. In cases involving companies which are being wound up by the court, as is the case with PIHL and PFIL, the companies' liquidators are required to report to the Official Receiver conduct which appears to indicate grounds for disqualification. If it appears to the Financial Secretary or the Official Receiver to be in the public interest that a disqualification order should be made, either of them may apply to the court for the making of it. In relation to PIHL and PFIL reports, if any, made by their liquidators to the Official Receiver will be relevant to consideration by both the Official Receiver and Financial Secretary of whether to apply to the court for disqualification orders. As at the date of this report, I am not aware of any reports made by the liquidators of PIHL and PFIL to the Official Receiver.

5.4 The directors disqualification provisions of the Companies Ordinance were derived from and generally follow the UK Company Directors Disqualification Act 1986. The jurisdiction to make disqualification orders on the ground of unfitness has rarely, if ever, been exercised in Hong Kong. However, in UK, the disqualification jurisdiction is quite active and has produced a considerable body of jurisprudence which, it seems reasonable to expect, is likely to be largely adopted by the Hong Kong court.

5.5 In determining whether a person's conduct makes him unfit to be concerned in the management of a company the court is required by section 168 K of the Companies Ordinance to have regard to certain statutory criteria, including additional criteria in cases involving insolvent companies. Of the statutory criteria which bear on a determination of unfitness, those which appear to be of relevance to the Peregrine directors are:

(a) "Any misfeasance or breach of any fiduciary duty or other duty by the director in relation to the company"; and

(b) "The extent of the director's responsibility for the causes of the company becoming insolvent".

5.6 Concerning the first of the above criteria, I have made no finding of misfeasance or breach of fiduciary duty against any director of PIHL or PFIL. I have made findings of incompetence including breaches of common law duties of skill, care and diligence against Philip Tose, Peter Wong, John Lee, Andre Lee and Alan Mercer. I regard some of these breaches as more serious than others.

5.7 In the case of Philip Tose, I have concluded that he failed to attain the standard of competence required of him. His failure to ensure that risk management controls over fixed income business were in place and operating properly was at the heart of the most serious aspect of mismanagement within Peregrine. That manifested itself disastrously in the case of Steady Safe when, without Philip Tose personally exercising any restraint on the commitment, there was no system of control in place at group level to apply any restraint.

5.8 In the case of Peter Wong, I have concluded that he failed to attain the standard of competence required of him. His failings included his inability to establish centralised, independent risk management covering the fixed income business. He thereby also played an important part in that crucial aspect of mismanagement. In addition, Peter Wong's mishandling of the fixed income internal audit report (in particular, his serious failure to ensure that the 1996 draft audit report was brought to the attention of the PFIL Board, to ensure that it was finalised and that immediate remedial action was taken to rectify the weaknesses identified), and the misdescription of the scope of credit control in the 1996 Annual Report, which would have misled shareholders and other readers of that report, contributed to the delay in improving fixed income credit procedures.

5.9 In the case of John Lee, he failed to attain the standard of competence required of him and was also instrumental in the failure to establish and apply proper credit risk controls to the fixed income business. He had principal responsibility for the credit risk function prior to the Steady Safe commitment but failed to put anything in place in time or alert Philip Tose that he was not discharging that responsibility. As separate matters, John Lee mishandled the requirement to make provisions against bad and doubtful exposures, the important treasury requirement of caution with regard to long-held trading assets, and the misdescription of the scope of credit control in the 1996 Annual Report.

5.10 In the case of Andre Lee, I have concluded that he failed to attain the standard of competence required of him. In committing PFIL to the Steady Safe transaction, Andre Lee made a fundamental error of judgment. Because of the size, nature and circumstances of the transaction, his decision (even without the benefit of hindsight) can only be characterised as hazardous and foolhardy. He rejected the application of Group credit risk management over fixed income business, yet failed to take any adequate steps to establish a strong independent alternative. He failed to react to the significant findings of the draft internal audit report on the serious weaknesses in credit controls or to take steps to ensure that those weaknesses were immediately remedied or addressed. These failures enabled his serious misjudgment on the Steady Safe transaction to take place and directly led to the enormous loss on the Steady Safe transaction.

5.11 In the case of Alan Mercer, I have concluded that he failed to attain the standard of competence required of him. I have identified only one matter in which I consider him to have been in breach of his duty and that was that he failed sufficiently to pursue the 1997 internal audit of PFIL.

5.12 In the absence of any allegation of dishonesty of any kind against the directors, the burden would be on the Financial Secretary or Official Receiver, if applying for disqualification orders, to satisfy the court that the directors' conduct demonstrates incompetence of a high degree and the burden would be heavy. In my opinion, the conduct of Philip Tose, Peter Wong, John Lee and Andre Lee exhibited incompetence of a very high degree. They were remunerated very handsomely, in terms of millions of US dollars per year. They held themselves out as being the leaders in their field in the region. As the most senior executive directors of PFIL and, in the case of Philip Tose and Peter Wong of PIHL, the management of risk in relation to fixed income business was in their hands. Their mismanagement in that respect was very serious.

5.13 Concerning the second of the statutory criteria – "The extent of the director's responsibility for the causes of the company becoming insolvent" – I take that to have a broad scope and not be constrained by narrow legal principles of causation.

5.14 The event which triggered the insolvency of Peregrine was the unprecedented economic downturn in Asia in 1997 and early 1998. However, I have taken the view that Peregrine was unable to survive, or at least survive for longer than it did, in that adverse environment because of corporate structural weaknesses in relation to the fixed income business. The persons with principal responsibility for strengthening those areas, by installation and monitoring of adequate risk control systems, and who failed to discharge that responsibility, were Philip Tose, Peter Wong, John Lee and Andre Lee.

5.15 In the circumstances, in my opinion the question contained in paragraph 1 above should be answered in the affirmative, in relation to Philip Tose, Peter Wong, John Lee and Andre Lee.

Part 6. General lessons and public policy recommendations

Introduction

6.1. This part considers more general lessons and policy recommendations arising from the collapse of Peregrine.

6.2. These are considered under the following headings:

- Lessons and recommendations for financial institutions and their advisers
- Lessons and recommendations for Hong Kong regulatory and supervisory arrangements and the regulatory system generally

Lessons and recommendations for financial institutions and their advisers

6.3. Although Peregrine was a public company, listed on the Hong Kong Stock Exchange, with a broad range of shareholders and high visibility in Asia, the reality was that it was still a young business, growing and diversifying rapidly. PFIL operated in an immature market place. Businesses addressing change on this scale are almost bound to be vulnerable. Peregrine displayed some typical shortcomings of businesses at its stage of development. Its governance structure was not fully formed, in that the role of the Board of PIHL had not developed as intended in the reform introduced at the end of 1995. PFIL's administrative and back office functions fell well behind the pace of business generation. The Group's management was heavily reliant on bought-in experience, and from learning from its mistakes. It was open to increasing competition from far larger and more established potential business rivals.

6.4. These are normal strains of growth and development. It takes time to adapt to meet new needs and learn from mistakes. Had Peregrine had the luxury of more time, it might have successfully made the transition to a more broadly based investment banking business. But time was not on its side. Stronger competitive pressures were beginning to be felt even before the onset of the Asian markets crisis, and that crisis itself cruelly exposed the Group's vulnerability.

6.5. The severity of the Asian markets crisis was unprecedented in recent memory. As I have sought to convey in Parts 2 and 3, Peregrine was in my view needlessly vulnerable to the crisis because of a number of administrative and managerial shortcomings, which could and should have been identified and rectified more promptly and properly.

6.6. The great danger in making recommendations following investigation of a business failure is that they are seen as an attempt to discourage risk taking. That is the wrong message. Businesses must take risks not only to prosper, but also to survive. Every business makes mistakes, sometimes serious ones, which result in some of these risks materialising into losses. It is thoroughly desirable that they should be free to do so, for experimentation is necessary in order to find the best way to create and supply a needed service. In hindsight, every unsuccessful experiment looks like a mistake. Good management learns from the experience. Trying to avoid mistakes will almost certainly be a mistake in itself, damaging capability to generate business.

6.7. This is particularly important for a business at Peregrine's stage of development. Its key competitive advantage was its ability to innovate, react rapidly, act decisively, and adapt quickly to new market needs. It makes no sense to advocate anything which inhibits this. I do not believe that the dynamism required to prosper in today's financial industry is compatible with a mindset of trying to avoid all, including some serious, mistakes.

6.8. Instead, the emphasis should be on promoting the ability to spot and learn from mistakes as rapidly as possible. I did not see much evidence that Peregrine was good at this in respect of its fixed income business. In my view it is likely to be the best route to informed and rational risk taking, and a sense of proportion so that serious mistakes do not become life threatening.

6.9. Promoting the ability to spot and learn from mistakes cannot be reduced to a set of prescriptions. It is much more about management culture and personal relationships; these are soft attributes which cannot be purchased, or ordered into existence. What is required is an atmosphere which encourages the challenging of policies and processes, promotes a willingness to air rather than hide embarrassing information, and encourages learning from mistakes rather than simply blaming their perpetrators. Mechanisms for independent oversight, such as non-executive directors on the board or internal audit, are unlikely to work well if this atmosphere does not exist. Somehow it must be made to coexist with the strong directional management often needed to achieve the change required to compete in today's rapidly changing marketplace. In the process, the boss can easily become elevated to an almost god-like status. It does not help that employees in the financial industry move between employers quite rapidly, making it difficult for a business to maintain a distinct culture and ethos. Employees are often highly incentivised by bonus schemes to generate instant income. It is not easy to pause and reflect on criticism from others during the thrill of the chase for a fast buck.

6.10. Subject to this caveat about the importance of culture, I identify the following areas which, had they worked better in Peregrine, would have improved its ability to identify and respond to deficiencies in its policies and practices:

- Governance
- Risk management
- The role of internal audit
- The role of external audit
- Incentivising employees

I note that the Hong Kong Monetary Authority has recently published for comment draft guidance on corporate governance which covers a good deal of the ground I cover in this Part of the Report.

Governance

6.11. I noted in Part 2 that the reform of Peregrine's governance at the end of 1995 was meant to include recruitment of more non-executive directors experienced in the industry, but this never occurred. Instead, the Board of PIHL effectively ceased to operate as an instrument of control of the group's business. In PFIL too, the Board did not function in any practical sense as an instrument of governance, as PFIL was regarded as a division of the Group rather than the separate legal entity that it actually was.

6.12. In both cases, I believe that something was lost as a result of the emasculation of the normal role of the Boards. This was the potential for input from independent persons who, not being intimately involved in the day to day affairs of the business, or part of the executive hierarchy, could have brought additional experience, freshness of perspective, objectivity, and willingness to challenge. An important check and balance was lost.

6.13. Of course, boards are no more than a collection of individuals, and the success of their efforts depends crucially on their ability to interact and cooperate. Fruitful interaction and cooperation between individuals can never be guaranteed, and it comes in many different forms. Some boards thrive on conflict, others on less overtly competitive interaction. But whatever the culture and process operating within a board, its working is likely to be fostered by consciousness of the fact that each board director, whatever his role in the day to day operation of the company, has the same duties of skill, care and diligence to it.

6.14. The directors of the PIHL and PFIL Boards from whom I collected evidence did not have a shared consciousness of the duties of the directors or the practical consequences of those duties for each of them, given their different roles in the Group. This is not to suggest they were wholly unaware that the duties existed, but it was not a matter which had been discussed collectively by the directors. Quite apart from the practical benefit which might have resulted from a discussion of each director's role in improving the Board's performance, I think periodic discussion would have been helpful in fostering a sense of identity and responsibility in each of the Boards. It would certainly be far more likely to be helpful than unhelpful.

6.15. The desired outcome of these discussions would be an improved shared understanding of the role of the board and of each member of it. Ideally, each director would be clearer as to how his performance should be measured in meeting his allotted role, although performance measurement is always easier to accomplish in theory than in practice. This should help each director to judge whether he and his peers are adding value to the board's work, and whether the board as a whole is adding value to the business.

6.16. The other essential ingredient for success is information. Non-executive directors cannot contribute at all without that, other than haphazardly. Frequently, as in Peregrine, even executive directors gain little overall perspective of the business from their day-to-day executive responsibilities. Another outcome of discussions should be specification of the information required by board members to enable them all to monitor progress in achieving the objectives set for the business.

6.17. I do not advocate periodic discussion on these lines within a board as a requirement, to be imposed on all companies or all financial institutions. That would make it less likely that a genuine discussion would take place, or have any useful result. It will be more useful for some than for others, and the danger of imposing a requirement is that the process becomes a formal matter. But it could be recommended as good practice, and it would be a productive avenue for the SFC's inspectors to explore when seeking to understand the governance and high level risk management practices in a regulated firm. In Peregrine, given the quality of the directors on the Boards of PIHL and PFIL, I believe more collective discussion on these lines could have been very useful.

Risk management

6.18. Good risk management practice in respect of PFIL's mainstream business has already been excellently catalogued in the Group of Thirty report on derivatives referred to in Part 2. Although this was intended for derivatives, it is equally applicable to investment banking more broadly. Peregrine's experience confirms the continuing validity of the G30's recommendations.

6.19. I have commented extensively in Part 2 on Peregrine's risk management and its deficiencies. In my view, the most serious weaknesses were not highly technical or specialist. They were a failure to keep infrastructural development in balance with business generation and to recognise that good risk management is a *prerequisite* to doing the type of business done by PFIL; and the incomplete application of good intentions.

6.20. With the benefit of hindsight, I believe it was a serious mistake to have left Peter Wong in charge of so much of the operational infrastructure supporting PFIL for so long. He did not understand what was needed for a fixed income business, and the delay before responsibility was placed in more qualified hands allowed PFIL's business generation to run well ahead of the capability of the infrastructure to support it safely. Quite apart from the unintended exposure to risks which ensued, it would almost certainly have been easier and cheaper to have invested more fully in proper monitoring and control systems at the start, rather than trying to catch up later as actually happened.

6.21. The problem is that it is so much easier to identify quickly the benefit of the front line business generator than the back room monitor and controller. In reality, they are equally important, in that a business of assured quality requires both.

6.22. The incomplete application of good intentions is particularly dangerous because it creates the illusion that progress had been made. It is probably worse to have the appearance of a control structure than to have no structure at all. Then at least no one is likely to be under any illusion. To judge from the comments of persons who gave evidence to me, Peregrine's senior management thought that its exposure to credit risk was well controlled.

6.23. Apart from highlighting these two weaknesses, I am challenged to think of plausible new ways of diminishing the chances of their occurring. One way employed elsewhere is to extend external audit formally to cover systems and controls in financial institutions. How successful this would be depends very much on the quality of the audit. The danger is that if this is made a standard requirement, auditors will fear to be frank in any published opinion, and a standard form of words will be developed for reporting purposes which has very little value. I doubt whether the costs incurred in extra audit fees would be worth the gain.

6.24. The position is different for regulated institutions, subject to regulatory inspections from time to time. I have no doubt that regulatory inspections of firms' risk control systems should be aimed at least as much at identifying whether firms properly adhere to their own policies and standards, as to whether they adhere to standards imposed by the regulators.

6.25. I identify one other feature of Peregrine's risk management as worthy of general comment, because it is so fundamental. This relates to marking to market. Marking to market meant different things to different people within Peregrine, to an extent that techniques for doing it sometimes lost all connection with the basic concept of valuing assets held for trading at a price at which they could be traded by the holder. The general consensus was that marking to market should be done by reference to an external price indicator of some sort, but no one, not even John Lee, added the other crucial factor, which is the relationship of the holder to the market. But the market price will depend on the circumstances of the holder. A distressed seller will obtain much less for his asset than a holder able to wait longer before having to sell. A holder of a large quantity of the asset will often have to discount the normal market price in order to sell it all.

6.26. Thus marking to market should involve an assessment of the market and an assessment of the holder's position in relation to the market. The second factor should have meant that, as the Asian crisis gathered pace and Peregrine's liquidity weakened, Peregrine's marking to market became progressively more cautious in relation to any external indicators of the value of each asset, particularly the larger holdings. If anything, in reality the reverse seemed to occur, with Peregrine's marks becoming more optimistic in relation to the market rather than less.

6.27. PFIL's chosen market place was lower quality bonds and notes. These are often early casualties when market confidence evaporates. In these circumstances, marking to market can easily become so tenuous that the only reliable route is to actually test the market, by selling some of the asset in question into it, whatever the cost. Even selling a small quantity would help establish a basis for making further adjustments to take account of the size of the holding and assumed maximum selling period. No one suggested this within Peregrine, nor did the auditors nor did the SFC inspectors. In my view, it would have been a useful exercise, and could have drawn attention to the Group's vulnerability to illiquidity and the over valuation of its assets on a mark to market valuation basis. Risk managers, auditors and regulators should not hesitate to demand it if they are concerned whether marking to market is being done properly.

The role of internal audit

6.28. Having surveyed a number of internal audit reports prepared by Peregrine's Internal Audit department, I believe it provided a valuable independent view of work processes. In relation to the fixed income business, it produced two draft audit reports about the fixed income business which were prescient. Had the 1996 report been vigorously followed up, action – in some cases already underway – would have been given a priority which could have resulted in PFIL and PIHL being better placed to withstand the severe strains caused by the meltdown of Asian markets a year later. Instead, management's good intentions in establishing Internal Audit and staffing it with skilled personnel were easily subverted in the case of the 1996 and 1997 draft reports on PFIL, and the 1996 draft report on Group Treasury.

6.29. The actual usefulness of internal audit is likely to depend on how strongly senior management supports it as much as the inherent quality of its work. There was no mechanism in Peregrine to ensure that the findings of internal audit were noticed at board and top management levels.

6.30. The key feature of a more robust approach is openness. If the business under review knows that its reputation in the group will be damaged by a critical internal audit report circulated around top management and maybe more widely, it will take the process and findings much more seriously. The mere possibility of an internal audit is more likely to result in anticipatory action to improve. The internal auditors are likely to take a more measured and responsible attitude if they know the results of their work will be widely known.

6.31. Internal Audit's work programme was circulated to EXCO MDs for comment for the first time in 1997. Peregrine was also exploring the idea of circulating completed audit reports to EXCO, but this was overtaken by the collapse. This would have ensured that the work of Internal Audit could add value to the business. However, the process would still have been contained within executive management. If non-executive directors had been bought into the process, the Board would have been in a good position to ensure the executive management was properly scrutinised.

6.32. Internal Audit's work programme for 1997 was based on a rough and ready analysis of where the risks of the business seemed to lie. This could easily have been developed into a more comprehensive "risk map" of the Group. In my experience, such risk maps are excellent material for discussion in a board about the risk profile it wishes to set for the business.

6.33. These observations apply particularly strongly to companies in the middle stage of development like Peregrine. Their business is outgrowing the capacity of the top executives to control personally, but the working culture is still informal and its systems and controls are immature. It is a dangerous stage of development. Good risk mapping and robust internal audit reporting to and supported by the board can monitor the process of development from an independent viewpoint and help the business make a successful transition.

The role of external audit

6.34. External audit brings an independent view to the affairs of the client company. That is an important discipline imposed on the client, but it is also a potentially valuable source of information for the client about its potential weaknesses.

6.35. Peregrine's auditor, Deloittes, seems to have seen its audit work in a very traditional way. Its role was to check the figures, and the validity of the assumptions underlying the accounting policies which Peregrine had adopted. So far as I can tell, it did not consider whether it could add further value at the same time.

6.36. For example, Eliza Yuen confirmed that she had never given the management of Peregrine a commentary or observations on what she thought were weaknesses or potential weaknesses in its systems and controls. But the process of external audit involves considerable testing of systems to ensure the information emanating from them is reliable and consistent. She never met the Board to discuss the audit. It seems to me highly desirable that the audit partner should meet the board to present the audit findings personally, offer comments and answer questions.

6.37. In my view, this less mechanical view of the auditor's role could improve his relationship with the client and understanding of the aims and priorities of its board, and would represent better value for money. I would hope that in due course competition between different auditing companies would generate a more value for money conscious approach, but the process could be promoted if the Hong Kong Society of Accountants took the matter under consideration as a possible industry wide initiative. Although I have only examined the idea in relation to financial institutions, I see no reason why it should not also have some application to all companies.

6.38. Unusually, Deloittes were offered the opportunity by the management of Peregrine to work with the SFC. This was a sensible idea in the circumstances, and it was unfortunate that nothing came of it. Financial regulators and external auditors have considerable overlap in their aims, and this was an opportunity lost for all concerned. Openness between firms, their auditors and their regulators is to be encouraged by all means possible. In saying this, I do not question the right of the client to decide in what circumstances it should encourage liaison between its auditor and the regulators, but if a client does so, the opportunity should not be lightly declined.

Incentivising employees

6.39. Peregrine paid its executives well. In order to attract scarce skills and experience to Hong Kong it felt it had to, particularly in the fixed income business. In common with other similar businesses, Peregrine rewarded persons whose contribution to income could be easily measured more highly than those whose contribution was less easily valued, such as support staff. There were some exceptions to this (John Lee, for example) where support staff had to be attracted from London or New York by generous terms.

6.40. With the benefit of hindsight, Peregrine's policy of highly incentivising its fixed income executives to generate immediate revenue seems not to have been balanced by a sufficiently high counterbalancing set of incentives for its support and control staff. The impression left by the attempts to apply group credit policies and internal audit recommendations to the fixed income business is that these functions were undervalued. The higher the incentives given to the front line business generators, the higher the "counter-incentives" given to support and control staff need to be, in order to ensure that the business generated is of good quality and properly controlled.

6.41. I also suspect that the measure of personal achievement used by Peregrine's management for the purposes of setting bonuses put too much emphasis on immediate return and too little (or none at all) on return over the life of the transaction or business generated. The result was rapid growth, but lower quality business.

6.42. Remuneration and incentive schemes are always tricky to manage. Aspiring businesses like Peregrine are particularly prone to their unintended consequences and damaging effects. They have to pay above the market for the skills, and they have too little home-grown culture to moderate the damaging effects of strong incentives. But this just makes it all the more important that they pay special attention to the design of remuneration structures to ensure they promote long term rather than transitory benefit to the business. Peregrine paid bonuses in cash, at the end of each year. This is such a common practice in the financial industry that it is very difficult for any one firm to resist. But other industries, such as IT, seem to handle this issue better, by slanting remuneration heavily towards future rights to shares in the business.

Lessons and recommendations for Hong Kong regulatory and supervisory arrangements and the regulatory system generally

6.43. The Peregrine group was a complex fit into the Hong Kong regulatory structure. PIHL was registered in the British Virgin Islands, and so exempt from Hong Kong Companies Ordinance requirements. However, it was listed on the Hong Kong Stock Exchange and therefore subject to the Exchange's regulation to ensure adherence to listing rules. However, many of its subsidiaries were registered in Hong Kong, including PFIL. Neither PIHL nor PFIL were subject to financial regulation in Hong Kong, but the Hong Kong based equity broking and asset management subsidiaries were regulated by the SFC.

6.44. I will consider lessons and recommendations in the following order:

- Company law
- Listing requirements
- Financial regulation

Company law

Protection from creditors

6.45. PIHL and PFIL cited inability to pay debts as they fell due as the reason for their applications for the appointment of provisional liquidators. At the time, the directors were of the view that assets exceeded liabilities, and that the Group had positive net worth. The liquidators have since sharply downgraded estimates of the recoverable worth in the two companies, which are now significantly less than the value of the liabilities. The question arises whether an alternative to liquidation might have produced a better result for creditors, and perhaps even shareholders.

6.46. Hong Kong is in contrast to many other international financial centres in not having an intermediate regime between going concern and liquidation. However, a proposal to introduce one has just been announced, in the Companies (Amendment) Bill 2000 just tabled in the Legislative Council. The proposal is that companies which are unable to pay their debts as they fall due should be able to apply for a moratorium on payments, lasting up to six months, to give them time to complete plans to reschedule their debts or introduce new funds. During the moratorium, a "provisional supervisor" would be appointed to oversee the company's affairs.

6.47. It is possible that a different outcome might have emerged if this procedure had been applied to Peregrine. The directors would certainly have sought to use it. It is unlikely that Peregrine would have survived intact, given the withdrawal of Zurich and severity of the crisis in its main markets, but it might well have been possible to realise more value from the assets and derivative positions. The latter are notoriously complex to deal with once an event of default has occurred, and allowing more time before default occurred might well have made the job of realising maximum value much easier.

6.48. Similar procedures work well abroad, and I welcome the intention to introduce one in Hong Kong.

Status of subsidiary companies

6.49. Although Peregrine was managed on a group basis, its legal structure was that of a holding company with many operating subsidiary companies. Each company, of course, was obliged to have a board of directors, each of whom owed legal duties to the company. In practice, these duties are easily lost sight of when the legal structure of separate companies is overlaid by practical management on an integrated group basis. PFIL was a case in point.

6.50. I found it surprising and very worrying that an executive of John Lee's calibre and experience apparently did not realise that his duties as a director of PFIL were real ones, despite its role as an operating division of the wider group. I suspect John Lee was not alone, and that many directors of subsidiaries are unclear about their duties as directors. But I do not see why the duties of directors of a subsidiary in a group should be any different to those of an independent company, even if the subsidiary is actually managed as if it was a division of the group rather than as a stand-alone company. The circumstances in which those duties operate are, of course, very different in the two cases, but that is a separate matter.

6.51. More education seems to be needed. Some material is already in the public domain. In 1995 the Hong Kong branch of the Institute of Directors published "Guidelines for Directors", and the Stock Exchange's listing rules set director's duties for listed companies. However, the message is not yet getting through.

6.52. One idea is to have a statutory statement of directors' duties. This has attracted support in Hong Kong. If it helps directors who are not legally trained to understand their duties, I thoroughly endorse it. However, the most pressing issue arising out of the Peregrine case is a simpler one: to ensure that directors understand that subsidiaries within a group are identical to any other company so far as directors' duties are concerned.

6.53. I regard this matter as sufficiently important to recommend an interim measure, pending completion of consideration of the idea of a new statutory statement of directors' duties. The interim measure I have in mind is that new directors of all companies should be sent a "child's guide" informational leaflet, setting out in simple terms what is expected of them in their new positions, whatever the status of the company within a wider group. As all new directors must register with the Companies Registry, it seems best placed to take on the job of distribution, but the SFC may be better placed to decide what the guide should say. The guide could either be written specially for the purpose, or be drawn from something that already exists, such as the Institute of Directors' "Guidelines for Directors". Such an interim step might provide valuable input as to what, if anything, is needed in any more comprehensive revision of company law.

6.54. I am conscious that some lawyers argue against describing such a complex area as the duties of directors in simple terms. In simplifying, there is a danger that misunderstandings and misinformation may arise. If that is truly the case, then I believe the law is unsatisfactory and should be changed. To be fit for their purpose, directors' duties must be capable of being readily understood by ordinary businessmen. If the present duties do not meet this test, a debate needs to be initiated between lawyers and businessmen to close the gap between what directors believe is possible and what the law dictates. However, I suspect the issue is more educative than a fundamental mismatch between what is legally required and what is practically possible.

Listing requirements

Quarterly reporting

6.55. It has been suggested to me that the disclosure requirements of the listing rules should be improved. The argument runs that quarterly reporting of results, perhaps accompanied by more intensive scrutiny of those results by external auditors, would improve the quantity and quality of information in the market place.

6.56. These may be good ideas, but it is not possible to draw any conclusions about them from the Peregrine case. Peregrine voluntarily committed itself to a further interim statement of results for the first 10 months of 1997 and to the bringing forward of its Annual Report and Accounts. It did this having made a statement about its trading results for the first 6 months of 1997. Furthermore, the 2^{nd} interim results had been reviewed by the auditors, although not formally audited. In my opinion, it would have made no difference if the listing rules had required more frequent interim statements or more onerous auditing requirements.

Non-executive directors and Audit Committees

6.57. The Stock Exchange now requires (with certain transitional reliefs) listed companies to have two non-executive directors. PIHL had two non-executive directors, but neither played a significant role in directing the business. My impression is that, despite their presence, the Board decayed as a governing body after the establishment of EXCO.

6.58. I am not much surprised by this, but I am also not discouraged. An element of non-executive oversight cannot be guaranteed to work. Much will depend on the nature of the relationship between non-executive and executive directors. Hong Kong companies have been characterised by strong executive leadership, with non-executive directors appointed primarily for their ability to help business generation, rather than to improve internal control. One should certainly not expect much benefit in the short term, as it takes time for such "cultural" beliefs to shift. I am fairly confident this will happen.

6.59. I have already stated my support for strengthening senior management sponsorship and support for internal audit, and for larger companies it is right that the board should delegate the function to an audit committee. I believe it is also right that the non-executive directors should play a leading role in sponsoring internal audit, since any of the executive directors could potentially be the subject of comment in an internal audit report, and face a conflict of interest. For the same reason, the committee's chairman should be a non-executive director. The audit committee would also be a natural home for more active liaison between non-executive directors and the external auditors. Both tasks give non-executive directors a definite role, and a potentially good source of information about the way in which the company actually works. I favour proposals on these lines. If both requirements had been applied to Peregrine, they would have provided powerful encouragement to recruit more experienced non-executive directors, and to involve the Board more actively in corporate governance. That might well have made a difference. I understand the Stock Exchange has considered imposing a requirement for listed companies to have an audit committee with a majority of non-executive directors, but has preferred recommending it as best practice for now. I recommend moving towards making this a requirement for listed companies, and requiring a non-executive director to be chairman of the audit committee.

Additional disclosure

6.60. In view of my criticisms of Peregrine's risk management policies and procedures, it is legitimate to ask whether additional disclosure of listed companies' risk management arrangements might help investors and other users of accounts, and prompt better practice. A description could be required in the annual report of the company's main risks of business, how they arise, and how the company controls and monitors them.

6.61. The danger of such a requirement is that it would degenerate into a routine standardised form of words. That would be unlikely to be informative, or worth the effort of producing it. However, companies' "risk maps" and the use made of them are potentially valuable information for their stakeholders, enabling them to make better judgments about the risk profile of the company and the capabilities of management to manage them. I recommend that the Stock Exchange should consider if disclosure requirements could be framed for listed companies which would lead to a competition for excellence in disclosing risk management policies rather than degenerating into a standardised formal – and largely useless - form of words of assurance.

6.62. Peregrine's 1996 Annual Report contained a lengthy, and largely comforting, description of its risk management processes. In my opinion, it was optimistic and inaccurate. It would be an important safeguard to require the audit committee described above to supervise preparation of any risk-related material being disclosed. If Peregrine had had an audit committee, it would have known from the internal audit work on PFIL done in 1996 that the 1996 Annual Report was inaccurate and very superficial.

Financial regulation

6.63. Although the Peregrine group contained important regulated businesses, at the time it collapsed it was not subject to consolidated supervision and as a business group is best described as having been unregulated.

6.64. The consequences of this were benign. The regulated businesses were restarted under different ownership with minimum inconvenience to their customers. The unregulated businesses have remained closed, and their creditors are still owed most of their claims. However, this has not given rise to any disturbance to confidence in the Hong Kong financial system, although the collapse occurred in very nervous markets.

Should Peregrine have been rescued?

6.65. Peregrine's directors did approach the Hong Kong Monetary Authority for help after the restricting of Peregrine's regulated business by the SFC in response to the withdrawal of Zurich, and after approaches to several other financial institutions had been rejected. The HKMA declined to become involved. This was in my view wise. Hard though it may be, it is vitally important that the authorities should leave the normal processes and disciplines of competition and the market place to work intact whenever possible. It is possible, although in my view very unlikely, that Peregrine might have been saved had the HKMA provided bridging finance. But even if saving Peregrine had permitted a company which added value to Hong Kong's financial centre to be restored and to prosper, it would have sent all the wrong messages to other businesses, and weakened general financial discipline. Rescues of this kind should be reserved for the situation where monetary policy objectives are seriously at risk. That was not the case here.

The boundaries of regulation by the Securities and Futures Commission

6.66. Peregrine is an illustration of the complexity which can arise when regulated activities form an integral part of wider group activities. In many other countries, Peregrine would have been fully regulated, either because more of its activities would have fallen within the regulatory net, or because such businesses are regulated on a fully consolidated basis.

6.67. Two questions arise from this. The first is whether the boundaries of regulation should be extended to cover the whole of a business which, like Peregrine, has some regulated activities within it? The second is whether, if the answer to the first question is negative, the SFC has sufficient powers to deal with any circumstances which might arise?

6.68. With regard to the first question, I start from a general position of preferring less rather than more regulation. Financial regulation is never a wholly benign activity. It too easily gives rise to unrealistic expectations, and creates undesirable "moral hazard". It does not and cannot directly generate wealth, but it always incurs extra costs to the community. These costs are both direct (by which I mean the actual costs of the SFC and other regulators) and indirect (the costs to firms of complying with regulatory requirements and if necessary of forgoing business not permitted under those requirements which would have been profitable). It is important not to overlook the fact that the indirect costs are much larger than the direct ones, of the order of four times larger according to estimates made in London; but they are largely hidden and cannot be easily measured. The damaging effects of such costs are likely to become more pronounced, for the information and communication revolutions make it easier for either the demand for services or the supply of them or both to relocate elsewhere. This argues for a lighter, rather than heavier touch to regulation in future.

6.69. The main benefit of financial regulation is to help prevent significant wealth destruction on a community wide scale. This happens rarely, but when it does, it is either enormously damaging, or enormously expensive to avoid. Peregrine's failure caused no hardship to the general public, other than its shareholders, and it is not the purpose of financial regulation to protect shareholders. Its unregulated investment banking activities involved no interface with the general public, and it took no deposits from the general public. The financial institutions which lent to Peregrine were well able to judge for themselves the risk they took in doing so.

6.70. I do not believe the Peregrine case provides evidence of a need to extend the reach of regulation and, without that evidence, I am strongly opposed to it.

6.71. With regard to the second question, the SFC already has powers under sections 30 and 29(a) of the Securities and Futures Ordinance to inspect, investigate and gather information in a variety of circumstances. Its powers under section 30 apply to regulated businesses and other persons if they have information needed by the SFC for the purpose of ascertaining whether a regulated person is complying with regulatory requirements. This seems adequate to deal with a case where, like Peregrine, the SFC considers it necessary to gather information about unregulated businesses in a group whose activities it fears may impact on the financial resources of the regulated businesses. It worked well enough in the Peregrine case, although it has to be said that Peregrine's management agreed to cooperate with the SFC's inspectors rather than challenge its authority.

6.72. The SFC's powers under section 29(a) apply to listed companies and their affiliates where, broadly speaking, there is a suspicion of intent to defraud or act oppressively or wrongly towards the shareholders. The SFC used these powers in investigating Peregrine in 1998, after provisional liquidators had been appointed. Unlike section 30, these powers only extend to the listed company and its affiliates, and exclude unrelated third parties who may have relevant information. Given the broad purpose of section 29(a) powers, I think this limitation is unwise. In my view, the powers should extend to unrelated third parties who may have relevant information, and the opportunity is presented by the introduction of the new Ordinance governing the SFC's activities into the Legislative Council to change the law. I recommend doing so.

6.73. The Peregrine investigations challenged the skills and experience of the SFC's staff, and it relied significantly on the prior commercial experience of one senior executive who has since left. His departure may have left a serious skills gap which should be filled. Maintaining up to date technical skills in a fast-moving market place is always difficult for regulators. These skills are scarce, and therefore expensive. Alongside this, the same skills are increasingly needed in each of the present financial regulators, as banks, securities trading and investment houses (and insurers, although Peregrine did not touch this activity) borrow each other's business techniques and form closer links. As a result, financial regulation is increasingly an activity where economies of scale operate.

6.74. As the business of banks, securities traders and investment houses converge it will also be increasingly important that their regulators closely coordinate their policies, rules and regulation. Otherwise a potentially damaging degree of regulatory arbitrage will develop, with regulated institutions tempted to search for the laxer regime.

6.75. The result of these influences will be increasing pressures for regulators to follow the example of the industry and consolidate. For me, the question is less whether this is the right road, and more how far one should travel down it now.

6.76. It makes no sense to me to think of merging the regulatory activities of the HKMA and the SFC at present. So far as I know, both are performing effectively and are respected for their distinctive qualities. But I do recommend that thought be given to closer association between the two, in order to use their respective skills and experience as efficiently as possible. I have in mind that, as a minimum, one should be able to borrow staff from the other in order to harness particular skills and experience. As a corollary to the Government's initiative to improve the performance of Hong Kong's financial markets, something more ambitious may be needed. The possibility of forming a common team of people with special experience in the review of market trading related risks should perhaps be explored.

6.77. The other relevant regulatory interface is between the SFC and Stock Exchange listing department. The issues about disclosure and provisioning in Peregrine were as much about meeting listing requirements as about financial regulation., and the Stock Exchange was enquiring about them alongside the SFC when Peregrine collapsed. At some point, the question of whether listing should continue to rest with the Stock Exchange or should be transferred to the SFC will need to be considered. I feel unqualified to offer a view, as an important determinant will be issues not strictly related to regulation and wholly unrelated to Peregrine, such as the Exchange's commercial interests and its competitive position relative to other organised exchanges.