MVE 220 – Reading Project

Jerome Kerviel

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Abstract
Producing this report both group members have contributed mutually. All discussions and conclusions have been made as a group.

Introduction

In this report we will describe the happening of the Sociéte Générale trading loss incident, how and why it happened, as well as what can be done to prevent a similar event from happening in the future.

The financial news in the beginning of 2008 where dominated by the credit squeeze in the US and elsewhere, but for sheer entertainment, Jerome Kerviel's loss of €4.9 billion was far more exciting. As a result of a series of unauthorized trades, he made losses that nearly brought down the bank.

Société Générale

Société Générale is a French bank founded in 1864 as a result of the industrial revolution. After the industrial revolution steelmakers and railroad companies in France needed funding and this was the main reason for Société Générale to start up. Already from the start the bank was fast growing and in the 1920s Société Générale became France's leading bank. The bank has since the start grown to be a company represented in over 75 countries all over the world. With its 33 million customers and 160 000 employees the bank is ranked as the 8th biggest bank in Europe (Société Générale, 2009).

Société Générale has three main operation areas, which are Retail Banking & Financial Services, Global Investment Management & Services and Corporate & Investment Banking. Société Générale was the first bank that started to trade with equity derivatives and a lot thanks to that French banks today controls one third of this market. This market is measured in amounts of hundreds of trillions dollars. In 2011 Standard & Poor's gave Société Générale the rate A and Fitch rated them as A+ (Société Générale, 2011).

Jerome Kerviel

Jerome Kerviel was born 11 January 1977 in Pont L'Abbe, Brittany, France. He was one of two sons in a working class family, with his mother working as a hairdresser and the father as a metal worker. Kerviel was earlier married but are nowadays separated from his wife. He has also got a big interest in sailing and Judo, where he has got a green belt and is qualified for teaching children in the sport. A childhood friend of his has said that Kerviel wasn't in the financial business for the fancy cars and clothes, but for his interest in the financial markets and how economics work. Some of Kerviel's teachers from the universities he studied at have said that he didn't stand out from other students and that if he was a genius they certainly didn't notice this. In 1999 Kerviel graduated from the University of Nantes with a Bachelor degree in Finance and in 2000 he completed a Masters in Finance at the University of Lyon. He then started working at Société Générale in August 2000 (Martin, et al., 2008).

What happened?

In the end of January 2008, Société General's Chief Executive Officer (CEO), Daniel Buton announced that under the duration of just three days, the bank had made losses of €4.9 billion due to a sequence of unlawful securities trades. According to Buton a "rogue trader" who had used his knowledge to bypass the bank's internal control structure made these trades. This "rogue trader" was no one else but Jerome Kerviel (Knapp, 2010).

In no less than two days after Daniel Buton's announcement, Jerome Kerviel was arrested. The young Parisian had pulled off one of the absolute largest frauds in the history of the banking industry. It was during the intense following 48 hours of interrogation Jerome was to utter one of the greatest understatements of our time: "I just got a bit carried away".

Kerviel's job during the time at Société General involved making "plain vanilla hedges on European stock-market indices" within the equity derivatives division, the bank's most profitable operating unit (Knapp, 2010). A plain vanilla security is the opposite of more exotic products, e.g. a standard type of option.

Starting from 2005, Jerome Kerviel began exceeding the maximum transaction size and began engaging in other unauthorized transactions. He learned several different ways to circumvent the internal controls, which sometimes meant creating fake emails from managers authorizing his transactions, preparing false documents, intercepting warning messages etc. To conceal his enormous risk-taking, he did also record fictitious transactions that appeared to be hedges, offsetting the risk taken in the first place. For example, if he had gone long in a block of securities, he did a short fictitious trade in the same assets, to make it look like the bank only suffered a small loss, at worst. (Knapp, 2010) Kerviel used this approach repeatedly to bypass the Basel II & Basel III minimum capital requirement ratio. (Aljazeera, 2010) At one point, Kerviel had outstanding positions far exceeding the stockholders' equity of €33 billion, this mainly in near-term moves that he predicted the market would take (Knapp, 2010).

It is important to know that Kerviel did not only lose money on his bets. In 2007, he earned more than a billion euro to Société Générale. However, in the beginning of 2008, things took a downturn. The whole thing started with a vast miscalculation that the market would be sharply higher in late January. Instead, the market declined and Kerviel had a loss of €1 billion in his hands. On Friday, the 18th of January, Kerviel's trades were discovered. During the weekend, Société Générale's CEO Daniel Buton took a decision that all positions should be closed down to avoid potentially catastrophic losses. However, over the three day period it took to sell all securities, the European market fell sharply, resulting in total losses of € 4.9 billion (Knapp, 2010). This is a figure equivalent to approximately 20% of the bank's former equity capital as well as the size of the GDP in Kosovo 2011 (International Monetary Fund, 2012).

The announcement which Sociéte Générale made after closing Kerviel's open positions made stock prices fall all around the globe, and even provoked Nicolas Sarkozy to officially demand a stop to the current financial system (Knapp, 2010).

Preventive actions

So what can be done to stop these rogue traders in the future and who is responsible for taking action against this kind of exploit of the banks and the system? There are several lacks in the system and there are probably many ways to go to make the financial trading safer for all parts.

Most observers admit that banks are very limited in trying to stop determined individuals from circumventing some of the controls. However, it should be possible for banks to stop these offenders before things got as far out of hand as it did in Société Générale's case. The bank could for example have looked at Kerviel's massive gross positions, instead of just looking at net exposure (The Economist, 2008).

It is also strange that the traders and supervisors sitting next to him did not notice oddities in his behavior. With more management control and supervision of the employees there would have been a lot harder for Kerviel to carry through such big transactions and risk so much money. However, it's not just that there's a need to have more control over these kinds of things, but also a lot better quality in the control (Aljazeera, 2010).

Another issue is the computer and check systems. It was a lot easier for Kerviel to exceed his limits thanks to the insecure computer systems at Société Générale. With safer computer systems including better control of the trades and employees it would be easier to minimize the risks. (Aljazeera, 2010).

Since the 2008 financial crisis, which brought down the whole financial world, there has come up new regulations for banks and credit rating agencies to prevent similar collapses in the future. An example of new regulations for the banks is that it's now basically a requirement that they hold a capital of at least seven percent (minimum 4,5% plus capital conservation buffer of 2,5%) of their risk bearing assets, significantly more than the earlier two percent (Aljazeera, 2012).

It was not just Kerviel who bypassed these regulations, but banks all over the world are using derivatives to frequently exceed the minimum capital requirement ratios set up by Basel II (Basel III not yet implemented). Like mentioned earlier some people think that Société Générale is responsible for what happened in the Kerviel case, and these breaking of rules is one of the reasons they blame the bank (Aljazeera, 2012).

Max Keiser, financial analyst, means that Jerome Kerviel is only a "small fish" and that this problem is ongoing, since no one is taking action against the whole banks or the bank system. He means that these kinds of crimes still is a problem and that Kerviel wasn't the only one doing this kind of criminal trading. He even says that the bank and the bank system is a crime syndicate (Aljazeera, 2012).

There are also continuing discussions about how to strengthen banking supervision for higher security and to tighten up regulations between central banks and governments (Aljazeera, 2012).

Consequences

After the discovery of the biggest loss in trading history Jerome Kerviel was detained in February 2008. He was though released March the same year after winning a legal battle. In September Kerviel appeared in a court hearing under investigation for breach of trust, computer abuse and falsification. In April 2009 the CEO Daniel Buton resigned his position as CEO and Chairman of the Board, positions that was taken over by Frédéric Oueda. In November the same year Kerviel tried to postpone the trial but got rejected (Cutler, 2010).

Finally, during two weeks in June 2010, the trial against Jerome Kerviel was held and on the 5th of October Kerviel was found guilty of breach of trust and falsification and was sentenced to five years in prison, of which two is suspended. The court said in their conclusion that "Jerome Kerviel was the sole creator, inventor and user of a fraudulent system that caused these damages to Sociéte Générale," (Samuel, 2012).

Since Kerviel himself is of the opinion that he was a victim of a system that Société Générale had set up in which it was encouraged to do such trades as he did, he appealed against the 2010 sentence. In October 2012 the Court of Appeals in Paris established the 2008 sentence of three years imprisonment, with two more years suspended, and €4.9 billion in damages (Andersson, 2012).

After the Kerviel story Société Générale has spent € 130 million on making their controls better to reduce the risk for similar things to happen in the future. Even though this seems like a big investment Britain's Financial Services Authority (FSA) meant Société Générale still in 2010 had problems with the information of their financial transactions and was fined for their poor job making a solution to this. Société Général aren't the only bank having these problems and mistakes do occur, not least when it is humans working with the transactions, which should make a warning to other banks dealing with this type of transactions (The Economist, 2010).

Opinions and conclusions

Jerome Kerviel is the French trader who in three days made losses of € 4.9 billion for his bank, when this was discovered in January 2008 Kerviel was immediately arrested. In October 2010 Kerviel was finally found guilty of breach of trust and falsification and sentenced to five years imprisonment and an enormous amount in damages. Kerviel appealed against this sentence but in October 2012 the Court of Appeals established the 2010 sentence.

Who is to blame?

Today, almost five years after the catastrophe it is still being discussed who should bear the guilt. Was Jerome Kerviel a villain or a victim? He did although not benefit from the unauthorized trades personally. Perhaps was Kerviel's urge to succeed as a trader just too big, in a culture that offered huge rewards for risky deals.

One of the reasons some critics are raised against the sentence to Kerviel is that it wasn't just Kerviel who made these rogue trades. Another possible problem could be that that rogue traders don't get any critics from their supervisors as long as they make money for the bank, but when they start to lose a lot of money they get caught and is hung out as criminals. This point of view of course assumes the bank did know what was going on, but didn't do anything about it as long as everything went well.

We believe this may be part of the truth, as long as everything is going well and no big losses occur the bank has incentives to keep it going. It does also seem a bit odd that the bank didn't react when Kerviel made such big profits just by trading with plain vanilla hedges, some of the simplest of all derivatives. In the end it was although Kerviel himself who broke the laws and made trades in the dark. From our point of view we consider that both the bank and Kerviel are responsible for what happened and should both be criticized.

It is nevertheless clear that the French court considers Mr. Kerviel to be guilty single-handed. Fortunately for Société Générale, this also means that it will be more difficult for the shareholders to sue the bank.

The future

The president of investment banking at one of Europe's biggest groups said: "Is there something wrong with banking? I think so. There is no longer a culture of banking. There's a culture of prima donnas. They all just want the power; they want it bigger and faster." (Treanor, Finch & Seager, 2008).

With these words in mind, it is easy to believe that a change in culture is necessary to prevent similar events from happening in the future. This may very well be correct, but we do also think that there are a lot of other considerations to have in mind. The culture isn't a factor that you can change overnight, it requires a long time of persistent, concurrent work.

To in some way stop this kind of risk taking there must be strict rules in place. Thanks to Basel III the system has come quite a bit in the right direction regarding this but it's obviously still a long way to go. The banks also need more internal rules, which must be harder to circumvent than previously. We do also recommend them to look at the gross positions, instead of just net exposure.

The most important part according to us is to improve the communication within the company. By this we do not mean that every employee should be conversant with all of the co-workers trades, but we think that at least the closest managers and co-workers should be fairly aware of one another's trades and exposure. This to improve knowledge in what the colleagues are working on to easier discover potential frauds.

In all of the above-mentioned areas we believe we can see some progress. The financial world is losing some of its former prestige and status, as leaders around the world tries to unglorify the branch. There are also progress in the rules and regulation part, if not as much as wanted. Legislature organs establish new laws concerning the financial sector, and the banks tries to update their internal regulations, but it is hard to keep pace with the development of financial products and the technology.

As Holger probably would have said: it is impossible to eliminate all of the risks.

Reading guide

Since the Jerome Kerviel scam at the time had a great news value a lot of information about it is to be found in the newspapers of the time it happened. Some newspapers with weight that has written about the scandal are for example The Economist, The Guardian and The Telegraph.

If one is interested in a bit deeper discussion about how it all could happen and whose fault it might be Aljazeera's English division has an interesting debating program called "Jerome Kerviel: Villain or Victim?". In this program an ex-rogue trader at Barings Bank and a couple of financial analysts are invited to discuss this.

The book Contemporary Auditing: Real Issues and Cases, by Michael C. Knapp have the Jerome Kerviel story as an international case where they discuss different thoughts about the fraud. Another book for anyone who wants to know more about how to close these loopholes is Security Lessons Learned from Société Générale by Epstien, J.

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