Société Générale´s costly trade

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The staggering 4.9 billion euro poses questions of complicity, corporate culture and risk management in the banking world.

A young man from a small French town worked his way up in one of the country's most reputable banks, Société Générale. Claiming he only wanted to make money for the bank and wasn't seeking any personal gain, Jerome Kerviel ended up being charged with forgery, computer abuse and breach of trust for losing the bank billions in 2008.

Described as a "mediocre trader," Jerome Kerviel has now gained international notoriety similar to that of Nick Leeson, whose rogue trading brought down Barings Bank in 1995.

Despite the charges leveled against Kerviel, many specialists and journalists agreed he could not be held totally responsible for the loss. The bank itself should be on trial, some say, for allowing such a thing to happen in the first place. How could such an important institution be so unaware, if indeed it was? How could its security controls and management systems have failed to prevent such a catastrophe?

In the case study, "A Trader Gone Mad," IESE Prof. Alberto Ribera examines the background to this story and opens the discussion of whether there was anything about SocGen's culture, attitude to risk and control systems that made this event inevitable. The case gives an overview of Kerviel's history and personal characteristics, and describes the financial environment in which this event happened. It also examines the bank's hierarchy and compensation policies, as well as supervisors' and management's attitudes towards employees.

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How did it happen?

Kerviel was not a high-profile trader nor had he the possibility to earn the enormous bonuses the "stars traders" did. He had, unusually, worked his way up from the back office, in a company where most traders are brought in straight from top universities.

He sat on the futures trading desk. His job was to invest in portfolios that took "opposite bets on the direction of the markets. The bets essentially were supposed to offset each other in what is typically a low-risk way of making a small profit."

What he did, however, was to make bold trades in one portfolio and then covered the positions with a fictitious second portfolio. This created a neutral trading account that wouldn't draw attention.

When he was found out, accusations began flying, not all aimed at Kerviel alone: "How has a trader managed to take risks equivalent to the market capitalization of the bank for more than two years without being noticed? It is just not credible."

Kerviel says the first time he used the idea of a "deal" to cover his position, he made half a million euros, which surprised him but also made him feel proud. In January 2007, he took a short position on the German DAX and unwound it the next month. By the end of February, he had made 28 million euros, unbeknownst to SocGen.

Around this time, articles on "subprime" started appearing. Kerviel read that there was no risk to the wider economy. He then took the opposite position. By the end of July 2007, he had made 500 million euros, which he never declared to the bank.

He says, "I found myself quite intimidated by this 500 million euros and how to announce it."

By the end of 2007, he had an undeclared profit of 1.4 billion euros, which represented 50 percent of the total result of the derivative-index division of SocGen.

Not knowing how to deal with it, he hid the sum and created a number of fake trades showing losses of 1.4 billion euros.

In January 2008, he massively increased his positions and built up 50 billion euros in unhedged positions, betting that European stock markets would rise. When SocGen finally discovered what he was doing, the stock markets were beginning to collapse. On January 21, the bank unwound his positions and lost 4.9 billion euros.

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Tacit encouragement, lax supervision?

In the wake of the loss, Kerviel made several comments implying that upper management understood that he was not running his portfolio as he should. In one interview, he stated that he was generating a lot of cash for the bank in the second half of 2007. In one day he made 600,000 euros. Such a profit would have been impossible with small positions, and he argues that his supervisors closed their eyes to the methods he used and the volumes he was trading.

Kerviel says he regularly received risk messages saying that he had greatly exceeded his nominal cover. But a few minutes later a counter-message would be sent. "Because I was generating cash, the signals didn't worry them," he said.

The case reviews the corporate culture and attitude to risk at SocGen. Interviews with employees suggest risk taking was embraced as long as it made money for the bank - and that this culture created major flaws in its operations.

The bank, of course, denies any complicity in the scandal and rejects the idea that everyone knew what Kerviel was doing. SocGen's chairman, Daniel Bouton, does not acknowledge any institutional failure. "What people do not understand is that what we suffered from is not a huge trading loss, as if our risk-measurement system had been false. It is an operational fraud of the 21st century."

Kerviel maintains he was merely pursuing profit motives of making money for the bank, though he admits that the methods he used are "debatable."

His trial may reveal just how much his superiors actually knew and if anyone had, in fact, turned a blind eye. It may also settle just how much responsibility an individual versus the institution should bear in such situations.

Either way, it is a salient reminder to make sure that adequate controls and monitoring are always in place. It also underscores the importance of interpersonal relationships at work for leaders to get to know their employees, their motivations and what they are doing - because, to paraphrase a French philosopher, human judgment and the heart have reasons which reason does not know.

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