THE TALE OF TWO BANKS: SOCIÉTÉ GÉNÉRALE AND BARINGS

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CASE DESCRIPTION

The primary subject matter of this case concerns stories of financial fraud involving two rogue traders: Nick Leeson whose trading caused a 200 year-old institution, Barings Bank PLC, to lose almost $1 billion and go bankrupt in 1995; and Jerome Kerviel who lost over $7 billion for Société Générale in 2008. Secondary issues are the complexities of financial instruments driven by the growth in derivative markets. Additionally, there is discussion of operational risks and lack of managerial oversight. The focus is more on the managerial, procedural, and control issues than on the financial instruments themselves. This case can be used effectively in finance, auditing, information systems or management classes. The case has a difficulty level of four or five, appropriate for late undergraduate or MBA students. The case is designed to be taught in three hours and is expected to require three hours of outside preparation by students.

CASE SYNOPSIS

This case study documents the stories of two “rogue traders”, Nick Leeson of Barings Bank PLC in 1995 and Jerome Kerviel of Société Générale in 2008. The esteemed history of each banking institution adds to the drama of the case. Nicholas (“Nick”) William Leeson was the chief trader at the Singapore branch of Barings Bank PLC, while Jerome Kerviel was a low-level trader working in the Paris headquarters of Société Générale. These financial frauds led to bankruptcy for Barings (founded in 1762) and more than $7 billion in losses at Société Générale (founded in 1864). Both of these “rogue traders” did not fit the typical psychological profile of successful traders who are usually educated at top-tier universities, are gregarious, possess a sense of invincibility, work extraordinarily longs hours, are always connected to the market, sleep very little and react with joy or sadness based on the state of the market on a given day. Leeson and Kerviel were both from humble origins and earned degrees at second-tier universities and seemed far removed from the typical high-flying trading elite.

The case discusses the career path followed by each trader, the insider knowledge gained along the way, and the lack of oversight that provided opportunities for their fraudulent activities. These frauds are separated by more than thirteen years and many miles geographically, with the Barings fraud taking place in Asia in 1994-1995 and Société Générale in Europe in 2008. It seems that Société Générale failed to learn from the experiences at Barings which occurred many years prior. Discussion is included about the dissimilar impacts each of the rogue trader’s actions had on their respective banks. Questions are raised regarding
what went wrong, the lack of operational and managerial controls and how similar frauds can be prevented in the future.

INTRODUCTION

Henry Theroux, a Partner of Risk Management, PC, a consulting firm dedicated to teaching methods of controlling risks to financial institutions, was contemplating his upcoming speech to plenary of Banking Institutes International. The topic was about prevention of internal fraud through improved monitoring techniques and more rigorous auditing. Henry intended to discuss two very dramatic real-life examples of “rogue trading” and their devastating financial impacts. These stories took place more than a decade apart, yet the lessons learned from the first case were never applied to prevent the second. Henry reflected upon the stories carefully and wondered how he could utilize these stories to emphasize the importance of serious and effective oversight. What are the lessons that financial institutions should learn from these frauds? How can such fraud be prevented in the future, without undermining the trading business, which has become such an important part of banking?

Derivatives are at the epicenter of the problem. Derivative markets have grown tremendously since the mid 1980s. This growth has been accompanied by spectacular losses by both financial institutions and nonfinancial organizations throughout the 1990s and 2000s. Some of the financial institutions that suffered significant losses include Allied Irish Bank, Amaranth, Daiwa Bank, Kidder Peabody, Long-Term Capital Management (LTCM), Midland Bank, and National Westminster Bank, in addition to Barings and Société Générale that are the subject of this case study. Among nonfinancial organizations, we can mention Allied Lyons, Gibson Greetings, Hammersmith and Fulham, Mettalgesellschaft, Orange County, Procter & Gamble, Shell and Sumitomo. This has caused a backlash against “unregulated” financial markets in general and derivative products in particular, as the term “casino capitalism” became more widespread.

The high visibility of those losses is not only due to their huge size but also to the fact that a large number of them arise from the activities of a single, so called rogue, trader. These traders become well-known and may even be popular. Thus Jérome Kerviel is considered a French “Robin Hood” inside France and is extremely popular especially among young women. Although management tries to portray itself as a victim, it will be seen that, as a result of poor supervision of its traders, management must share in the blame. Henry Theroux, the presenter introduced earlier, has studied and compared two cases of financial fraud involving two rogue traders: Nick Leeson, whose trading caused a 200 year-old institution, Barings Bank PLC, to lose almost $1 billion and go bankrupt in 1995; and Jerome Kerviel who lost over $7 billion for Société Générale in 2008.

What makes those two cases particularly interesting is that the similarities between them are striking. One is led to wonder why history repeats itself and why economic agents do not seem to learn from their mistakes. Perhaps the nature of the job requires the trader to possess some psychological traits that induce him (rogue traders are generally males!) to break rules regardless of the consequences of doing so. On the other hand, could it be that management does
not understand the complex nature of the financial products being traded and thus looks the other way when traders make large gains?

The two cases elucidate some of these points. Theroux will discuss these cases extensively with his audience. In the first section he compares the two banks in order to better understand why Leeson’s $1 billion loss caused Barings to go bankrupt, while Kerviel’s $7 billion loss caused much less damage at Société Générale. The second section introduces the two traders, Nick Leeson and Jerome Kerviel, to appreciate the psychological forces that may have led them to behave recklessly. The third section compares the economic conditions in Asia in 1994/5 and in the U.S. and Europe in 2008 since traders bet on the direction of the markets in which they operate, which is itself affected by the economic fundamentals of the time. The fourth section details the strategies and positions of our two traders as both took long unhedged futures position in the hope that markets would rise. In the fifth section, the role of management who seemed to have been caught by surprise after becoming aware of the huge losses is analyzed. The sixth section discusses the difference in outcome in each to the two cases, as Barings perished while Société Générale survived. Theroux wants his audience to look for ways to prevent such fraud and to better ensure the stability of banking institutions.

BACKGROUND OF BARINGS BANK AND SOCIÉTÉ GÉNÉRALE

The British merchant bank, Barings Bank PLC, was founded in 1762. It helped to finance the Louisiana Purchase in 1803 even though France and England were at war. To finance the purchase, the US issued bonds that Napoleon sold to Barings at a discount of 87 ½ per each $100, probably a good deal for Barings while allowing Napoleon to finance his wars. However, in 1890 Barings had to be rescued at the last minute by the Bank of England following its overexposure to Argentinean and Uruguayan debt. Following this near collapse, Barings became a much more conservative banking institution with strong ties to the British monarchy. It refused to finance the recovery of Germany after WWI and helped the British Treasury finance WWII. This conservatism caused Barings to be surpassed by other banks although it still remained a significant player until its final collapse in 1995.

Since 1987, Barings had maintained an office in Singapore called Baring Securities Singapore Limited (BSS). Originally this office traded only equities until it became increasingly involved in trading futures contracts on the SIMEX (today's Singapore Exchange). Initially BSS did not have a seat on the exchange, and therefore had to pay commissions for all its transactions. This situation changed when it purchased a seat and hired traders, including Nick Leeson. Clearly this conservative institution was not ready for the highly risky speculative strategies for which Leeson became famous.

Société Générale, (known as SocGen in the international financial world), was founded in 1864 in order to finance the growth of commerce and industry in France. The bank grew rapidly and six years after its creation, had already 15 branches in Paris and 32 in the rest of France. A permanent office was opened in London in 1871. By 1894, the bank was a modern credit institution that not only accepted deposits from firms and private individuals but also was issuing shares of stocks, and doing business in Russia. It was the leading French bank in the 1920s,
reaching 1,457 sales outlets in 1933. When the Great Depression and the German occupation of France during WWII prevented it from growing domestically, it started to expand into Africa and the United States. After the war ended, the bank was nationalized and thus the state became its sole shareholder.

During the twenty-year period that followed WWII the French economy grew rapidly. However this high growth was accompanied by balance of payments disequilibrium and high inflation which were dealt with by controlling foreign exchange transactions and limiting credit. In spite of such curbs, international trade and production continued to grow, allowing Société Générale to increase the range of services it offered to its customers. It was also able to take advantage of its presence in London, benefiting from the additional flow of business generated by the Marshall plan. It also moved into additional countries including Mexico, Italy, Belgium and Spain and to Africa, exporting its technical expertise and providing services to a rapidly growing number of multinational corporations.

European banking regulations were significantly changed in 1966 and 1967. The separation between deposit (retail) and investment banking was abolished and the home mortgage market was created. This is significant because the Glass-Steagall Act, that ended the separation between the banking, securities and insurance companies in the U.S., was not abolished until 1999. Interestingly enough, some economists, such as Robert Kuttner (2008), have criticized the repeal of this act for its role in contributing to the 2007-08 subprime financial crises in the U.S. even though European banks had been unconstrained more than 30 years earlier. Société Générale took an early lead in these new activities thanks to the regulatory changes in Europe. At the same time, information technology was introduced in banking thereby allowing the further expansion of SocGen’s international network through telecommunications capabilities. In 1973, SocGen opened a representative office in the Soviet Union. In the 1980s, SocGen took advantage of the increasing pace of financial deregulation and the explosion of technological innovations to expand both its network of retail outlets and its investment activities both at home and abroad. On July 26, 1987, Société Générale was privatized after some 42 years of belonging to the state.

In 1997, SocGen embarked on an acquisition spree in order to expand its retail banking in France and outside France. It first bought Credit du Nord, another French bank. Then in 1999 it attempted to merge with Paribas which was instead purchased by its main competitor in France, Banque Nationale de Paris (BNP). BNP-Paribas is now the largest French banking institution just ahead of SocGen. Between 1999 and 2004, SocGen acquired banks in Eastern, Central and Southern Europe - Romania, Bulgaria, the Czech Republic, Greece and Slovenia – and Africa – Madagascar, Morocco, Tunisia, and Ghana.

Today the Société Générale Group is the 4th largest bank in the euro zone in terms of assets under management. The Société Générale Group has three main core activities: Retail Banking and Specialized Financial Services, Global Investment Management and Services, and Corporate and Investment Banking. In February 2004, Société Générale set up a new division named SG Global Securities Services for Investors, or SG GSSI, to provide full investor services on securities and listed derivatives around the world. Société Générale employs about 7,600
people in its global investment management activities and is now a global leader in equity derivatives, surpassing BNP-Paribas in this activity.

Clearly Société Générale is a lot more sophisticated banking institution than Barings was before its collapse and is one of the top equity derivatives trading houses in the world. Thus, though one could perhaps make the case that Barings managers may not have understood what Leeson was up to, the same could certainly not be said of SocGen’s managers whose expertise in derivatives trading was indisputable.

At the heart of the problem may have been the fact that in 1999, following the failed merger with Paribas, SocGen became more vulnerable. In order to offset this weakness, its CEO, Mr. Bouton, adopted a somewhat risky strategy which consisted not only of investing in Eastern Europe but also of pushing his traders to become much more aggressive. Until the rogue trading scandal surfaced, this strategy paid off as risk taking was handsomely rewarded with huge profits.

NICK LEESON AND JÉRÔME KERVIEL – TWO ROGUE TRADERS

Who were those traders? By and large, a successful trader is someone who believes that he is invincible, a characteristic that most senior managers find profitable to encourage. Generally, they are young and quit the business before they get old. The average age is 28 years. Every day they get to work by 6:30 a.m. and do not go home until 9:00 p.m. They do not have time to eat lunch as they must remain continuously aware of market activities and be able to react to market changes as needed. They rarely sleep more than four hours per night as there is always a market that is open somewhere in the world and they are always on the lookout for good deals. When they get home they are connected to the markets via their blackberrys. Their mood can shift from depression to euphoria as markets fluctuate. Stress is a constant (Oberlechner and Nimgade, 2005).

During weekends or evenings, traders must keep up with financial news and analyze each word pronounced by Ben Bernanke, Chairman of the U.S. Federal Reserve Board, or Jean-Claude Trichet, President of the European Central Bank, in order to more accurately predict the direction of interest rate changes. Although they receive bonuses in the millions of dollars if they are successful, money is not necessarily their most important goal. Instead their main objective is to compete and to win, and the size of their bonuses is only important to the extent that it is a reflection of their competitive successes. They tend to be gamblers willing to take huge risks in order to win big when the market moves in the direction they had predicted.

Traders often have huge egos and believe that their feats are due to their special talent as individuals. In fact, reporting on rogue traders differs around the world with North American newspapers focusing primarily on the individual rogue traders while Asian newspapers tend to refer to the organization as the principal agent facilitating the frauds through lack of proper oversight (Mennon et al 1999). Rogue traders generally do not entertain the possibility that their previous successes may have been due to luck rather than their superior trading skills and ability to predict the future direction of the market. Many have a superior sense of control and yet, research has shown that illusions of such control are maladaptive, particularly for traders,
frequently resulting in significantly lower performance (Fenton-O’Creevy, et al 2003). The best traders also tend to come from the best universities worldwide where they study financial mathematics rather than business and commerce. Successful financial traders are the banking equivalents of film stars who command huge salaries (Bacqué & Gatinois, 2008). Thus trading is one of the most coveted jobs in the financial markets. A good trader can make tens of millions of dollars for his company every year and take home vast bonuses. At the same time, it is a stressful job, knowing that one wrong move can wipe out profits and destroy reputations.

Nicholas (“Nick”) William Leeson was the chief trader at the Singapore branch of Barings Bank PLC, while Jerome Kerviel was a low-level trader working in the Paris headquarters of Société Générale. How do Leeson and Kerviel fit the portrait of a typical trader as described above?Actually, they are both somewhat atypical. Both Leeson and Kerviel are of humble origins, compared to most other traders.

Leeson was the son of a plasterer; he first worked as a clerk at Barings. He then was sent to the Barings office in Indonesia to work in the back office where a large number of stock trades did not reconcile due to the rapidly growing trading volume on the Indonesian stock exchange. Leeson was charged with cleaning up the mess in the back office and he did that by following the bank’s practice of posting all non-matching trades to a special account called the ‘errors account.’ By suspending all discrepancies into this account, the bank’s financial statements would balance. The discrepancies could then be dealt with separately. While working for the back office of the Indonesian branch, Leeson realized how poorly supervisors monitored the errors account.

In January 1992, after his managers noted his excellent performance in Indonesia, he applied for a position at the newly opened branch of Barings Bank in Singapore (BSS). Not only was he approved, but he was made the chief trader and floor manager for BSS on the Singapore International Monetary Exchange (SIMEX) as well as the head of trade settlements, thereby being charged with hiring both front office (traders) and back office (accounting and IT) staff. Thus, in spite of being only 25 years old at the time and having no previous trading experience, he arrived at BSS in 1992 and started hiring local staff. Since he had not been a trader previously, he quickly took the required exam so that he would be qualified to trade on SIMEX along with the small team of traders that he had hired.

Thus within a very short period of time, Leeson ended up being the head trader, in spite of his lack of trading experience. And he was also the general manager of the back office, thanks to his knowledge of back office operations acquired in Indonesia. It is astonishing that Barings’ senior management in London did not seem to be aware of the obviously flagrant conflicts of interest that their negligence had fostered – negligence that would prove fatal to the bank. In the defense of management, one might argue that it was obviously not possible to know that Leeson was an expert and talented liar. He did not hesitate to falsify records, fabricate letters, invent elaborate stories, and was able to trump not only upper management but also auditors and representatives of SIMEX. He was unusually adept at exploiting other people's naïveté.

Given his lack of experience, and to some extent lack of luck as a trader, Leeson very quickly got himself in trouble. Prior to 1995, he systematically made wrong bets and by mid February 1995 he had accumulated a huge long position in futures contracts through his
purchases—half the open interest in the Nikkei (Tokyo stock exchange) index futures contracts and 85% of the open interest in Japanese Government Bonds (JGB) futures contracts. It is likely that other market participants were aware of his enormous unhedged positions and made his life more miserable by trading against him. Nevertheless, he remained arrogant and sure of himself until the very end, always believing that he would eventually succeed against all odds.

Jerome Kerviel is the French version of Nick Leeson and like Leeson, he does not quite fit the typical profile of a trader. Unlike Leeson however he was rather shy, reserved, quiet, and introverted, and did not show off. He had been a serious child, placing first in mathematics at his High School (Lycée) and was talented in English. Like Leeson, he is of modest origins, his mother being a former hairdresser in the small town of Pont l'Abbé in Western Brittany and his father a blacksmith. Pont l'Abbé, where Kerviel grew up with his brother and parents, is a picturesque town of grey granite houses with 8,000 inhabitants. He would hang out at the traditional Breton créperies and work during his school holidays at his mother's hairdressing salon.

Kerviel’s managers at SocGen claimed that he seemed to have been deeply affected by setbacks in his personal life including his father’s death in 2006, a failed marriage a year later, and his recent break up with a girlfriend. Like Leeson, he did not graduate from a top-notch university but obtained degrees from second-tier universities in Nantes and Lyon. Thus he was far removed from the highly educated and highly paid mathematicians who made up SocGen’s trading elite. His highest degree was only a Masters in Finance from the University of Lyon 2 which specializes in preparing students for back office operations in financial institutions. France’s largest banks supported these essentially vocational programs, and in 2000, Kerviel joined the compliance department of Société Générale as a member of the middle office support and control unit of the investment bank, earning a modest salary of €35,000 a year.

Although he was quiet and reserved, Kerviel did not lack ambition. In the second half of 2002, he got closer to the action by taking a job as a trading floor assistant. By 2005, he had become one of the few people to matriculate from the back office into the front office by becoming a junior trader. He was part of the Delta One products team in Paris dealing with program trading, exchange traded funds (ETFs), swaps, index and quantitative trading. Specifically, he was assigned to arbitrage discrepancies between the price of equity derivatives and that of cash equity, an unassuming job that seemed to fit his reserved personality but that he took so seriously that it dominated his life. Kerviel was known for being always well dressed and hard-working. He spent most of his time in front of four screens and two telephones on the sixth floor of the elegant, modern building of Société Générale in the La Défense suburb on the West side of Paris. He would travel to Brittany most weekends to spend time with his mother.

Both Leeson and Kerviel most certainly wanted to become star traders, though lacking the necessary qualifications. They probably both acted in a financially rational manner. In particular, it was easy for Kerviel to look across the trading floors and try to imitate the star traders taking positions in complex over-the-counter derivatives and structured products while earning 10 or 20 times what he was earning. Given these two traders’ lack of expertise, and inappropriate schooling, it was unlikely that they would be given a chance to join the star traders. The only way they could achieve stardom was to prove themselves to top managers by making
huge amounts of money for their banks. In order to achieve this, they would take huge unhedged bets on futures markets and hide their trades.

Furthermore, when one looks at the risk and return of their strategies to become stars, their behavior is not actually irrational. By shifting from low-risk arbitrage to high-risk speculative strategies, they could double or triple their bonuses and achieve stardom, on the upside; on the downside, they ran the risk of perhaps being caught, but they would still become famous. Thus either way, by winning big or losing big, they would be notorious. At worst they would spend a few months or a few years in jail while their employers would bear most of the blame for not supervising them closely enough. It was worth the gamble, especially for individuals who were predisposed to believe in their own invincibility. As long as management does not realize that there are huge incentives to become rogue traders, they will continue to be attracted by banks and financial institutions that trade derivative instruments.

THE ECONOMIC ENVIRONMENT

Japan 1994-95

After growing at a rate of 10% in the 1960s, 5% in the 1970s and 4% in the 1980s, the Japanese economy suffered a decade long recession, due to the effect of overinvestment and speculative bubbles in the stock and housing markets in the late 1980s (Nakaso, 2001). Focusing on the 1990s, output declined in 1992-1995, recovered in 1996 and 1997 and fell again during the Asian financial crisis in 1998-1999. Overall, Japan suffered from deflation during the decade of the 1990 causing real interest rates to be relatively high. This resulted in a drag on consumption, an increase in debt burdens and a rise in uncertainty for investment. The problem was made worse by the fact that standard monetary policy tools could do nothing to stimulate economic growth since nominal interest rates were already approaching zero.

It took a fairly long time for the central bank to finally succeed in changing inflationary expectations; it was only in 2003 that the central bank governor pledged not to raise interest rates until inflation was positive again. Moreover, even if nominal interest rates could not be lowered, the central bank could still provide additional liquidity and did so fairly effectively, if somewhat belatedly, in March 2001 under the so called Quantitative Easing Monetary Policy (QEMP). Under the QEMP, the Bank of Japan played the role of a money broker by allowing financial institutions with funds shortages to borrow at a discount rate (that was lower than the market rate), while amassing the funds of institutions with surplus funds. Unfortunately, the Japanese regulator, the Financial Supervision Agency, did not simultaneously force banks to write off bad loans and recapitalize their balance sheets. Those bad loans, which resulted from the failure of bank regulators and markets to enforce discipline during the boom years, were now a drag on the economy. In that sense, there are similarities between Japan in 1994-5 and the U.S. in 2007-8, although the U.S. authorities were quicker to take decisive action to alleviate problems.

During the time between Leeson’s arrival in Singapore in 1992 and the Barings collapse in 1995, the Japanese recession was at its worst, before the QMEP had been put in place. In addition, the Kobe earthquake, the largest earthquake ever recorded in Japan, struck on January

Although one cannot blame Leeson for failing to predict the Kobe earthquake, he was responsible for underestimating the severity of the Japanese slump and the slow reaction of the Japanese government to that downturn. If he had not underestimated the severity of the Japanese recession and overestimated the Japanese government’s ability to stimulate an economic recovery, he would have predicted that the stock market would continue to fall and closed his positions, thereby reducing losses. Instead, he stubbornly held that the stock market would rebound and allow him to recoup his losses. It eventually did (in July 1995), but by then it was too late for Leeson and for Barings.

**United States 2007-08**

SocGen's problems coincided with some of the worst stock market declines since the 9/11 attacks in 2001. The negative sentiment impinging upon world stock markets resulted from a financial crisis that started in the U.S. in the summer of 2007. It was largely the result of ongoing loose monetary policy combined with more than two decades of deregulation and inadequate supervision of financial firms, leading to questionable lending practices to US consumers and home buyers of dubious creditworthiness.

The financial crisis that started in the U.S. and spread to other countries, including in Europe, owes its origin to the rapid increase in subprime lending after 2003 which made it possible for risky borrowers to obtain mortgages. The problem arose because low and middle income families were pushed to buy over-priced homes in bubble-inflated markets. To make matters worse, these loans started with relatively low teaser rates and no down payments. When these mortgage interest rates were later adjusted upwards, the mortgages became unaffordable. The problem is compounded when housing prices fall so that home values are lower than the money owed on their respective mortgages. When this happens, many borrowers simply quit paying their mortgages, abandon their houses and send their house keys back to the lender (‘jingle mail’), precipitating a foreclosure. The increased rate of foreclosures causes further housing price declines that lead to more foreclosures and so on. The banks that issued the loans take large losses on the foreclosed homes. To make matters worse there were also rumors that bond insurance companies (called ‘monolines’), the firms that provide banks with protection against losses on fixed income investments, were hovering close to bankruptcy as well.

This financial innovation was supposed to disperse the risk of subprime loans away from core depository institutions and into the financial markets. Thus, those loans were “sliced and diced” before being securitized, that is repackaged into mortgage backed securities that would be held by financial institutions worldwide thereby spreading (and hiding) the risk. Securitization generated huge fees for issuing institutions while the credit rating agencies failed to properly monitor and price the risk of such asset backed securities. It was only a question of time before banks in the U.S. and Europe, including Société Générale, started to accumulate large losses on their portfolios of mortgage backed securities. Bear Stearns failed; Lehman Brothers was
liquidated; and the two giant mortgage finance companies, Freddy Mac and Fanny Mae, which own or guarantee $5 trillion of debt, collapsed. These events and the huge losses at AIG forced the U.S. Treasury and the Fed to intervene aggressively (unlike the Japanese authorities in the 1990s) to try to boost confidence in the health of the U.S. and global financial markets.

While the U.S. financial crisis was running its course, several external shocks were also impacting the real economy. Both oil and commodities prices had been rising, causing inflationary fears, before falling during the second half of 2008. As those prices were rising, the dollar was falling, further boosting inflationary expectations. Concurrently both the U.S. consumer and government were spending at an unsustainable rate, and the U.S. current account deficit was getting increasingly larger. As financial conditions were deteriorating and uncertainties rising, firms responded by cutting back on investment spending and hiring. There was fear that the consumer would stop spending and that a recession would be unavoidable. The U.S. Congress passed a temporary tax cut while the Fed reduced interest rates. So bad was the sentiment that on Tuesday January 22, 2008, the US Federal Reserve took drastic action and slashed its main interest rate to 3.5% from 4.25%, its biggest single cut in 25 years. This was remarkable given that inflation was a serious threat and that the housing bubble and over borrowing by both consumers and home buyers had been partially caused by low borrowing rates resulting from a loose monetary policy and the mispricing of risk.

During this same time period the European business cycle appeared not to be synchronized with the U.S. cycle. European economies were for the most part growing strongly at the beginning of 2008 in spite of the slowing down of the U.S. economy. The German and French economy did not start slowing down until the summer 2008 while the British and Spanish economy had started to slow down a little earlier. However, the European Central Bank (ECB) was still very concerned with the impact of rising oil and commodity prices on inflationary expectations. This concern caused the ECB to follow a tighter monetary policy than the U.S. Fed in order to bring the inflation rate back down toward its official target of 2%.

Such were the basic economic fundamentals that Kerviel had to bear in mind when betting on the direction of European stock markets, taking into account the lack of synchronization between the US and European economies. This would not necessarily imply that the stock markets would not move together. As a matter of fact, European financial institutions were widely exposed to the U.S. subprime crisis, implying that European stock markets could be expected to underperform relative to the performance of the real (rather than financial) sector of the economy in early 2008. The worldwide integration of financial and stock markets, causing prices to be highly correlated, is probably more complete than that of the real sector of various countries since barriers to the movement of goods and people are still extensive. Did Kerviel fail to properly evaluate the dangerous economic conditions that were prevailing in late 2007 and early 2008?

When the recession became global in the third quarter of 2008, after spreading from the U.S. to Europe and on to emerging economies, the price of raw materials, including oil, fell drastically and fear of inflation disappeared. The fall in inflation reflects the severity of the ensuing global recession. But at the time when Kerviel lost 4.9 billion Euros, the recession was not yet evident.
DETAILS OF THE FRAUDS

The similarities between the trading losses at SocGen and those that caused the collapse of Barings more than a decade earlier are striking. In both cases, a young man responsible for exchange-traded equity futures, trading on behalf of a major bank, ended up accumulating huge hidden positions of which the banks were unaware. In each case, a trader who previously worked in the back office had advanced to a trading position. Each used knowledge of back office procedures to conceal questionable actions. The activities of Nick Leeson caused the collapse of Barings and those of Jerome Kerviel inflicted huge losses on Société Générale. However, those disasters should never have happened because those two rogue traders were supposed to be simple arbitrageurs in the pursuit of low profits with little risk.

Nick Leeson was trading future contracts on the Nikkei 225 stock index, the 10-year Japanese government bonds, and euro-yen deposits. The Nikkei 225 index is based on the share prices of the 225 largest companies trading on the Tokyo stock exchange. As these contracts were trading simultaneously on the Osaka Securities Exchange (OSE) and the Singapore International Monetary Exchange (SIMEX), Leeson was charged with arbitraging between these two markets. Barings called this arbitrage “switching”, an activity that has little market risk since positions are always matched. Arbitrage trades take advantage of price discrepancies between two markets and carry no risk since a long position in one market is offset by a short position in the other. This is a routine activity that earns a low rate of return.

Leeson who was both clever and unscrupulous determined not to follow such a boring and low risk strategy, especially since he was far from the London headquarters and its oversight. Instead he took unhedged positions on both the OSE and the SIMEX. Consequently, he was betting on the rise of the stock indexes and interest rates by taking respectively long futures positions on the Nikkei and short positions on Japanese Government Bonds in both markets. In addition, shortly after arriving in Singapore, he opened an 88888 Error Account like the one he discovered during his stay in Indonesia. The difference was that Leeson did not use this 88888 Account only to settle discrepancies but instead to hide his unauthorized money-losing trades. To make sure that the managers in London did not know what he was up to, he modified the software controlling the 88888 Account so that the transactions in the account would not be reported daily to management in London.

While he was secretly accumulating losses in account 88888, he was publicly recording profits in three arbitrage trading accounts, numbers 92000, 98007 and 98008. This was accomplished through cross-trades with account 88888. A cross-trade is a transaction executed on the floor of the exchange by one member (Barings) who is both a buyer for one customer and a seller for a different customer. The transaction is executed by matching (crossing) both clients’ accounts. A cross-trade must be executed at established bid and ask market prices. However Leeson would execute cross-trades and then would order his staff in the back office to break the total number of contracts traded at one price into several different trades at fictitious prices, crediting the (fictitious) profits thus generated to the three arbitrage trading accounts while recording the offsetting losses in the 88888 account.
Thus the pairs of transactions recorded in the books of Barings Singapore bore no resemblance to those executed on the floor of the exchange. The entries recorded in the three arbitrage accounts reflected spurious contracts transacted at prices different from those transacted in the exchange market. Additional losses from unauthorized positions were also recorded in the 88888 account. During 1994, Leeson thus booked 28.5 million British pounds in false profits. This was a huge profit to earn from futures arbitrage, but it would ensure that Barings employees earned bonuses that year. Leeson himself was to be paid a bonus of $720,000, which he did not receive because the bank failed before it could be paid. Needless to say, nobody around Leeson would question his unusually high arbitrage profits. He was viewed as a star trader who should not be held back. In reality, in 1994 alone, Leeson had lost Barings US $296 million while his supervisors thought he had made a profit of US $46 million.

As if falsifying records and betting on the direction of the market was not enough, Leeson engaged in additional risky steps. He used a lot of leverage, meaning that he bought Japanese stocks index futures and sold Japanese government bond futures fulfilling his margin requirements with borrowed funds rather than Barings’ own funds. At times when the Japanese stock market and interest rates were both rising, leverage amplified his gains and this success increased his credibility with his managers who then failed to scrutinize his subsequent trades. Unfortunately, when the Japanese stock markets began to sink in 1994, instead of closing his long futures position by selling stock index futures, he continued with a long position, betting that the market would turn around and start rising again. As his losses were hidden in the 88888 Account, he was able to continue reporting profits in his regular accounts and was thus able to maintain his reputation as a star trader while remaining free of the bank’s controls. As his losses became larger and larger, exceeding $100 million, he was facing margin calls and did not have the cash that he needed to meet them. Remarkably he managed to convince Barings to transfer the funds from London, an amazing achievement that should have set off warnings in London given that, as an arbitrageur, the losses on his long futures position should have been offset by gains on his short futures position, requiring very little additional margin.

In addition to receiving funds through wire transfers from London, Leeson also sold options on the Nikkei index, both calls and puts (such a combination is called ‘a straddle’) in order to obtain cash to meet his margin calls on his losing futures contracts. However, as the Nikkei index kept falling, his losses on the short put portion of the straddle further compounded his losses on the long futures position. The premiums received from selling the straddles were not sufficient to offset the huge losses on the long futures and short puts. In order to be able to continue funding his margin calls he had to sell more options. At this point there was no way he could ever hope to recoup his losses. Even if the Nikkei index turned around and rose, the losses on his numerous short calls would be greater than the gains on the long futures position. In a last desperate move in late January 1995, he bought some 20,000 additional futures contracts to try singlehandedly to turn the Japanese market around. The market fell 1,000 points! He continued to try to raise Japanese stock prices into February 1995 having purchased more than 61,000 futures contracts by February 22, 1995. By then the margin calls reached $1.2 billion. As the market continued falling, Leeson left the mess he had created behind and went on vacation with
his wife, Lisa! The Japanese market did eventually rebound but not until July 1995. Barings did not last that long as it was bankrupt by February 1995.

Kerviel at Société Générale was also not supposed to be a speculator. Instead, as an employee on the Delta One trading desk, he was supposed to look at the bank’s portfolio and trade in the opposite direction, to hedge some of this risk. A delta neutral portfolio is one whose value does not vary as the price of the underlying assets changes. Thus the name Delta One trading desk suggests that Kerviel was supposed to take low-risk positions. If SocGen's other traders had bought into the equity market, expecting a rally, Kerviel was expected to hedge by selling stock index futures. But instead of neutralizing risk, as he was supposed to do, he took directional positions instead, betting on the rise in various European stock indexes. More precisely, he took unhedged long future positions in various European stock market indexes, the UK’s FTSE 100, the Euro Stoxx 50 (an index of Europe’s biggest companies), Germany’s Xetra Dax and the French CAC40. These strategies would have been profitable if markets had been rising, but markets instead collapsed causing huge losses that Kerviel hid in fictional transactions imitating Nick Leeson.

As an arbitrageur, Kerviel was supposed to purchase one portfolio of stock index futures and simultaneously sell a similar mixture of index futures with a slightly different value, as a hedge. But while Kerviel, according to the bank, put sizable, real purchases in one portfolio, he created fictitious sales transactions in the second, offsetting portfolio. This gave the impression to risk managers that Kerviel was arbitraging between the two portfolios and that the risks in the first portfolio had been hedged when in fact they had not been.

Kerviel initiated his first unauthorized transactions at Société Générale in 2005, not long after moving to the trading desk from the risk-management department. He sold short shares in Allianz, the German insurer, betting on a fall in the market. Shortly afterwards, on July 7, terrorists bombed the London Underground causing the market to fall, and allowing Kerviel to earn €500,000. This first success convinced him that he should continue his unhedged trading in order to continue making profits similar to those earned by the star traders who were dealing in more exotic products.

Accordingly, Kerviel shorted the Dax index in January 2007, making €28 million. In February 2007, he bet that the subprime crisis would spread and harm the real economy and he shorted European stock indexes. At first his position lost money as the market temporarily rose. Eventually his prediction proved correct and the market fell in July. His short position became profitable and by the time he had earned €500 million he was too nervous and frightened to explain to his superiors how he had made so much money. He turned to hiding his large winning bets with fake “hedges”, by taking positions in the opposite direction, thereby appearing to balance out the his abnormal profits.

After the market had fallen substantially, Kerviel bet that it had gone too far and that a correction was imminent. He took long positions as the market turned around and by the end of December he had amassed large profits. Then the European market turned down again and his losses mounted. Over time, Kerviel had increased the size of his bets and had hedged his positions on paper with falsified documents and e-mail messages. Nevertheless, he remained convinced that the market would rebound. His earlier successes had made him believe that he
was some kind of financial genius who could predict the direction of the market and that he would eventually be successful and impress his supervisors. He was also hoping to get a bonus from his winning positions.

Unfortunately Kerviel was caught on January 18, 2008. By then he had accumulated positions which were worth €30 billion on the Euro Stoxx, €18 billion on Germany’s Dax and €2 billion on the UK’s FTSE. The cumulative size of his trading positions was close to €50 billion, an amount larger than the bank’s entire market capitalization. Kerviel’s trades caused Société Générale to report a loss €4.9 billion, the largest loss from fraudulent activity in banking history, and four times larger than Leeson’s malfeasance. As a matter of fact, his losses were even greater than the €4.9 billion originally announced by the bank. SocGen actually incurred a €6.3 billion loss as it carried out a three-day secret fire sale between January 21 and 23 while the market was falling. The bank defended its actions, saying it could not risk keeping the positions open. It was able to reduce the size of the loss by offsetting it with a profit of €1.4 billion made by Kerviel through other unauthorized trades in 2007 (Gauthier-Villars et al, 2008).

How did Kerviel manage to take such risky positions? He was able to hide his large speculative bets on European stock indices by entering false hedges into SocGen’s risk management system. This was possible because, like most banks, SocGen assesses the risk of its traders’ positions on a net basis instead of a gross basis. Thus a trader can buy €50 billion of equity derivatives, as long as he also takes offsetting short positions. The problem was that Kerviel’s offsetting positions were fictitious and thus did not really exist. He used other people’s access codes and “falsified documents” to create fake hedges, leaving the bank exposed to the full downside. He managed to get away with such fraudulent activity thanks to his knowledge of back office operations and trade processing, having been previously employed in the bank’s back office. Thus, he was able to hack into the bank’s computer systems and set up trades using false identities in order to circumvent the compliance team that is in charge of monitoring traders’ accounts. This allowed him to make unhedged unauthorized trades betting on future share price movements throughout 2007. The combination of high trading volumes (supported by leverage) and fraudulent activity generated huge losses.

Kerviel was also helped by the fact that long delays are required to confirm trade settlements as the hedge documents are bounced back and forth between the exchange (Eurex – Europe’s largest futures exchange), the clearing corporation, the broker, and the bank’s back office. Due to these long delays in settling trades, Kerviel’s fake trades were never settled. An annual International Swaps and Derivatives Association (ISDA) report states that over the calendar year 2007, it was taking about 14 days on average to settle unconfirmed trades in equity derivatives and five in credit derivatives (ISDA, 2008). Such delays are caused by mistakes contained in the paper work of a significant fraction of derivatives trades. In spite of pressure from regulators such as the New York Federal Reserve, banks have made little progress in improving their back office procedures. Under those circumstances, the exchange is unable to determine whether the customer should add cash or securities to his margin account to offset any loss in value of the futures positions. Normally, if the margin is insufficient, the customer is not allowed to trade until additional funds are added to the account; if funds are not added, the
exchange can liquidate part or all of a trader’s position. Kerviel was able to take advantage of such delays in processing and was able to postpone or even avoid margin calls.

To recover his losses, Kerviel, like Nick Leeson, was using a doubling strategy based on doubling a bet after every loss. However for such a technique to work, a trader needs to have unlimited funds at its disposal, something beyond SocGen’s reach. It is hard to imagine that such risky behavior did not attract the attention of management at both Barings and SocGen.

LACK OF MANAGEMENT CONTROLS AND RISK MANAGEMENT FAILURE

The losses at both Barings and SocGen did not develop over a short period of time. The two rogue traders had been speculating for a long time without the supervising authorities, i.e. risk managers, compliance officers and settlement people, apparently being aware of the types of activities in which their institutions were engaged. As long as Leeson and Kerviel were making huge profits, no questions were asked to find out whether these high profits were the results of taking huge risks or of exercising superior trading skills. It is inconceivable that the losses that eventually materialized would have occurred if management had controlled the activities of the two traders. After all, these two rogue traders were supposed to be simple arbitrageurs pursuing low but riskless profits. Therefore, the big question is: Why did the system break down in the case of Barings in 1995 and then again in the case of Société Générale in 2008?

This is the way it was supposed to work: Banks have checks and balances, and controls to make sure that unauthorized trades are exposed. Operationally, there are three units, the front, intermediate and back offices, that are supposed to be distinct from one another. The front office consists of the traders who execute trades and take positions. The middle office consists of risk managers who monitor the traders to make sure that they do not exceed the trading and risk limit defined clearly and unambiguously by the Board. Both Barings and SocGen had limits in place that were not enforced.

This monitoring of risk limits by risk managers is critical since financial derivatives can either be used to reduce risk or to take on additional risk in order to try to boost profits. So, an arbitrageur can be tempted to become a speculator in order to enhance his earnings if he is not closely monitored by risk managers. The back office consists of record keeping and accounting. These are non-trading bank employees that compile daily trading activities in order to determine how much the bank is earning or losing each single day. In addition, at many banks, back-office controllers (like traders) are organized into teams (also called ‘desks’) that monitor the trading of particular products, such as stocks, bonds or currencies. Each time one of Kerviel's trades raised an alert at SocGen, it appeared to be an isolated case because those various alerts were not consolidated across different products. No cumulative record of each trader's alert history was available making it impossible to detect violation patterns. Senior managers could not readily verify the bank’s actual risk levels and force traders to close positions that exceeded preset risk limits.

One of the big mistakes at both Barings and SocGen was the lack of separation between the front, middle and back office. As both Leeson and Kerviel had been previously employed by the back office, they were fully knowledgeable about the operations of both the front office and
the back office in their respective banks. In fact, Leeson had been employed at the back office of Barings’ office in Jakarta, Indonesia. In Singapore, he was put in charge of the back office even though he was also the head trader. This understanding of back office systems and procedures made it relatively easy for Leeson and Kerviel to hide their loss making trades from their superiors, while their profitable trades were properly recorded and visible. Both traders were able to switch from being arbitrageurs to speculators as control systems at both banks were so inadequate that they were able to take highly risky positions without attracting the attention of anyone, even their immediate supervisors.

One of the techniques used by Kerviel to dissimulate his speculative positions is called the ‘matelas’ or ‘mattressing’. This practice, according to Kerviel, is commonly used by traders to hide their results so that they do not attract the attention of risk managers and controllers. Thus when a desk (team) has reached its profit objectives, all future transactions that drive the profits beyond the target are hidden by being recorded into the following year’s accounts. Mattressing was used by Kerviel in addition to entering into fictitious positions to hide previous trades. As only the size of net positions is reported, this allows traders to keep their unhedged positions open without drawing managers’ attention.

Such fraudulent activities would be less likely if employees were not promoted from back office positions to traders. Although an audit report in 1994 revealed the danger of having Leeson in charge of both the front and back office, managers at Barings chose to ignore the recommendations of the report. The cost savings generated by having the same person running both the front and back office was supposed to make up for the additional risk of fraud. After all, there is very little risk in arbitraging! Likewise, the prime failure of SocGen was to allow a back office employee to become a trader. The two types of jobs entail very different career paths and salaries, the salary of the trader being larger than the salary of the back office employee by a wide margin. This large difference in salary increases the pressure to promote an excellent back office employee to become a trader.

Using his knowledge of SocGen’s back office and control systems – that utilized a computer system called ‘Eliot’ – Kerviel was able to enter fictitious hedging contracts to make it appear that he was taking minimal risks. By logging into the system under different names, he then cancelled the fabricated contracts before they were supposed to settle, and replaced them with new fake ones. As a result Kerviel was able to roll over one bogus transaction into another and thus avoid managerial scrutiny.

A method commonly used by banks to detect fraudulent trading activities is to force traders to take holiday breaks so that their portfolio can be monitored by other traders (Moullakis, 2008). When SocGen’s human resource department realized at the end of 2007 that Kerviel had not been on holiday for eight months, except for four days in August, his boss was notified. However after being asked to take some leave, Kerviel managed to convince his boss to allow him to wait until January arguing that December was the anniversary of his father’s death and that he did not want to be alone then.

The responsibility of managers at SocGen was exacerbated by the fact that, aside from failing to implement its own controls, it missed external warning signs concerning Kerviel’s suspicious trading activities. Typical banking policies regarding out of the office vacation time
were ignored (Global Employment Law Ticker, 2008). Thus in March 2007, France’s regulatory banking commission, after several inspections, twice wrote to SocGen’s CEO, Mr. Bouton, about the need to reinforce SocGen’s controls, particularly in the equity derivatives section where Kerviel happened to be working. SocGen did not take note of those warnings. Then, in November, a surveillance officer at Eurex, the pan-European derivatives exchange operated by Deutsche Borse, the German stock exchange, emailed Société Générale’s compliance department raising questions about the purchase of 1,700 Eurostoxx futures and 2,000 Dax futures by Kerviel. As usual, Kerviel was able to provide fake documents to demonstrate to his gullible supervisors that nothing was wrong.

Kerviel’s deceptive practices were finally revealed when on Friday January 18, 2008, compliance officers at SocGen uncovered problems with a €30 billion trade in the bank’s equity derivatives division and contacted Jean-Pierre Mustier, chief executive of corporate and investment banking at Société Générale. This trade, which consisted of a futures contract on Germany’s Dax stock exchange index, had aroused suspicions because it was far too large for the fictitious counterparty, a small German lender, Baader bank. It would have required Baader to make a margin payment to Société Générale that would have exceeded Baader’s credit limit. When Kerviel was questioned about the transaction, he claimed to have made a mistake and produced an e-mail indicating that the counterparty was instead the much bigger Deutsche Bank. However, when the bank officers, still suspicious, tried to reach Deutsche Bank, first in Frankfurt and then at its New York’s office, they realized that Deutsche Bank was not the counterparty. The fraud was finally uncovered and SocGen immediately decided to liquidate the €50 billion (US $74 billion) unhedged trading position amassed by Jérôme Kerviel over the following three days even though it was the worst possible time as markets were falling. The position was unwound in almost total secrecy to prevent the news of the fraud from leaking and thereby triggering a run on the bank. Only the French regulatory authorities, not even the French government, were informed. By the third day, the bank had lost huge sums of money although it avoided total disaster in large part thanks to the US Federal Reserve three-quarter-point interest rates cut.

SocGen announced the fraud once the bank had closed all of Kerviel’s remaining positions. Was the bank right in closing Kerviel’s positions while markets were falling? Some have argued that the bank could have waited until markets recovered before selling; however it was unlikely that the fraud could have been kept secret long enough for the market to recover and avoid a run on the bank. The bank was backed into a corner from which it could not extricate itself without serious damage. By waiting, it is likely that news of the fraud would have become public before positions could be closed, causing an exit by depositors. Closing the positions right away while markets were falling, but before the news of the scandal became public, was thought to be less risky. Thus SocGen chose to unwind these positions within the span of three days and in such a way that its trades would be limited to less than 10% of total trading volume in order to minimize impact on the market. According to the head of Bank of France, Christian Noyer, “The way Société Générale has handled its affairs to unwind positions in a very short space of time, and without moving the markets […] because they remained within normal trading limits […] was very professional” (Noyer, 2008).
THE AFTERMATH: DIFFERENT OUTCOMES

By February 27, 1995, Barings had lost $1.4 billion while its capital was only $900 million. A Dutch bank, ING, purchased Barings for the nominal price of £1.00 and assumed all of Barings liabilities. In 2001, ING sold the US operations to ABN Amro for $275 million. The rest of Barings became part of ING European operations. In 2005, ING split Barings Asset Management (BAM) and sold BAM’s investment management activities to MassMutual, and BAM’s Financial Services Group to Northern Trust. MassMutual acquired the rights to use the Baring Asset Management name. Thus the Barings name still lives on as the MassMutual subsidiary, Barings Asset management, while Barings bank no longer exists.

Immediately after the collapse of Barings in February 1995, Nick Leeson flew out of Singapore with his wife. Six days later, he was arrested in Frankfurt trying to make his way back to London. He was extradited back to Singapore to stand trial. Convicted of fraud, he was sentenced in December 1995 to spend six and a half years in Singapore's Changi prison. His wife, Lisa, got a job as an airhostess to be able to visit him regularly in prison. At first their marriage survived the strain of being apart, but Lisa divorced him in 1997 after she learned of his infidelity with Geisha girls. Soon afterwards, in early 1998, he was diagnosed with colon cancer that had spread to his lymph nodes. He had colon surgery in Changi General Hospital and underwent six month of chemotherapy. He was released from prison in July 1999 and was given a clean bill of health some five years after his surgery.

While in prison, Leeson wrote an autobiography, Rogue Trader, in which he condemned the practices that allowed him to gamble unchecked with large amounts of money. Later the story was turned into a movie, starring Ewan McGregor. After his release from prison, he earned a Psychology degree from Middlesex University. In June 2005, he released a new book, Back from the Brink, Coping with Stress, published by Virgin Books. In 2006, he was appointed chief executive officer of Galway United FC, a football club in Galway, Ireland, where he currently lives with his second wife Leona, whom he married in 2003. The Leesons live with their three children, a son who was born in 2004 and two other sons from Leona’s previous marriage. Nick Leeson also does charity work and gives speeches on topics such as risk management, stress, and the Barings failure.

Soon after the scandal at SocGen, the BBC interviewed Nick Leeson about the losses suffered by the French bank at the hands of Jérome Kerviel. Interestingly enough he remained as unapologetic as ever, failing to acknowledge his own mistakes or those of the SocGen traders, blaming instead the banks’ managers and arguing that nothing has changed since the Barings collapse.

"I think rogue trading is probably a daily occurrence amongst the financial markets. Not enough focus goes on those risk management areas, those compliance areas, those settlement areas, that can ultimately save them money." Nick Leeson
Unlike Barings, Société Générale was able to survive its scandal more or less unscathed. One reason is that it was a much stronger institution than Barings at the time. SocGen experienced not only a €4.9 billion in trading loss that Kerviel generated through unauthorized transactions but also a €2.6 billion write down related to US subprime investments soon afterward. This last figure includes a loss of €1.25 billion on its portfolio on non-hedged collateralized debt obligations (CDOs), €947 million in default risk related to bond insurers, and €325 million in trading losses on its investments in residential mortgage-backed securities (MBS). In spite of this, the bank ended up with a profit of €947 million (US $1.4 billion) in 2007, down from €5.2 billion the previous year (an 82 per cent drop). SocGen used the so called “get-out” clause to book Kerviel’s losses in 2007 rather than 2008. Up until December 31, 2007 Kerviel’s trades were showing a profit of about €1.4 billion while the losses were realized in late January 2008 when the bank unwound the trades. Thus the bank booked a net loss of €4.9 billion in 2007 arguing that taking a profit in 2007 and a loss in 2008 would present a misleading picture. The French regulators approved the move.

Another reason why SocGen survived was that many of its competitors suffered even greater losses from their exposure to mortgage backed securities backed by U.S. subprime loans. There was no potential buyer strong enough to purchase the wounded bank although several candidates were often mentioned in the press. It was speculated that the bank could be taken over by a foreign bank such as Barclays and HSBC of the U.K., or Banco Bilbao Vizcaya Argentaria (BBVA) of Spain. However, given the nationalist economic policies of the French government headed by President Nicolas Sarkozy and Prime Minister Francois Fillon, it was unlikely that Société Générale would be allowed to fall victim to a foreign takeover, regardless of whether or not this was in the interests of shareholders. A more likely suitor would be a local rival such as BNP-Paribas or Crédit Agricole, since both banks had clashed in the past over their desires to merge with SocGen. It could perhaps be argued that from a purely economic perspective, a French bidder would be willing to pay a higher price as higher cost savings may result through combining the branch networks of two French banks. However a BNP-Paribas SocGen combination would also create overlap in investment banking causing the combined banks to lose clients. In order to reduce their exposure to the new group, it was feared that many of the clients of both BNP-Paribas and SocGen would switch to another bank. Thus BNP-Paribas claimed to be no longer interested following the damage suffered by SocGen’s previously stellar investment banking division and the risk of contagion remaining from the continuing subprime crisis. Likewise, a bid by Crédit Agricole, although it would have made it a big player in Eastern Europe, would most likely have been rejected by both the European competition authority and the regional banks that control Crédit Agricole.

Finally, the resolution of SocGen rights issues in February 2008 not only allowed it to restore its balance sheet by raising new equity, but also assured that it would probably survive as an independent entity. The success of the rights issue also repaired a portion of the damaged reputation that had been suffered by SocGen. In a rights issue, existing shareholders have the right of first refusal over the newly issued stocks. If they choose to exercise their right and buy the shares at the subscription price, their holdings will not be diluted by the issuance of shares to new investors. Moreover, SocGen obtained from its underwriters, JP Morgan and Morgan
Stanley, the guarantee that they would purchase any shares that existing shareholders would not acquire and which could not be sold to outside investors. The underwriters, therefore, agreed to assume most of the risk if the rights issue failed.

The fact that SocGen was able to negotiate such a seemingly advantageous deal was largely due to its reputation and importance as a client. The underwriting banks minimized their risk by pricing the issue at a big discount to increase the chance that existing shareholders would exercise their rights and buy the new shares. Under the terms of the agreement, shareholders could buy one new share in SocGen for every four shares they already own at a subscription price of €47.50 ($68.96), a 39% discount. The success of the rights issue depended largely on the subscription price staying below the market price in order to attract wide shareholder participation and fend off any takeover attempt. In order to raise the intended €5.5 billion (nearly $8 billion), 117 million new shares would have to be sold. The successful rights issue allowed SocGen to raise its Tier 1 capital ratio to around 8% from 6.6% at the end of December, 2007. Tier 1 capital includes the most liquid holdings such as equities and provides a cushion to absorb potential losses. The issuance of new shares, by reducing future earnings per share, could have pushed current shareholders to sell their preferential rights to the new shares on the Euronext exchange, thereby allowing outside investors, including potential bidders, the chance to build up a stake in the bank. They could have done so between February 21 and February 29, 2008. However, it did not happen and the bank remained independent.

In the end, the rights issue generated strong shareholder demand and proved to be successful as subscription orders amounted to €10.2 billion, making it oversubscribed 1.8 times. Thus recapitalization of the bank was completed under the responsibility of the same management team under whose watch the losses had occurred. Nevertheless, as explained below, the bank’s shareholders would insist upon the resignation of Mr. Bouton, SocGen’s CEO in spite of the success of the rights issue.

So far Jérome Kerviel did not have to pay a high price for his responsibility in causing the largest fraud in banking history. Unlike Leeson, Kerviel did not run away, flee the country, or try to hide from the police. Following the discovery of the fraud, the police raided his apartment in the Paris suburb of Neuilly sur Seine to seize his computer files, and took him into custody the next day for 48 hours. On January 28 he was charged with fraud, breach of IT controls, falsifying documents and breach of trust. The charges filed against him carry a maximum five-year prison term and €375,000 in fines.

Kerviel was jailed on February 8 and released on March 18 after spending five weeks in pretrial detention. As a condition of his release, he is not allowed to step into a trading room or an exchange or to engage in any activities related to financial markets. While waiting for his trial, he started a new job in mid April as a trainee at Lemaire Consultants & Associates, a firm which specializes in computer security and system development. At the time of this writing, Kerviel has changed out his entire legal team and he is awaiting trial which, after being postponed several times, could be held in the first half of 2010. In the Barings fraud, Nick Leeson wanted to be tried in the United Kingdom; however, unfortunately for him, he was extradited to Singapore where justice is a lot more expeditious than in Europe.
Although Société Générale did not suffer the same fate as Barings, and the last chapter of Kerviel’s trading scandal has not yet been written, significant changes have taken place at the top of SocGen’s hierarchy. After 15 years in the job, Daniel Bouton was replaced by the Finance Director, Frédéric Oudéa, as chief executive officer. Didier Valet, a former banking analyst and head of strategic performance management at SocGen, replaced Oudéa as Finance Director. Mr. Bouton remained as chairman until his resignation in May 2009, a position he occupied while he was CEO. Although Bouton would not receive a severance package upon his final departure from the bank in May 2009, he would still receive a €730,000 pension per year.

Starting in May 2009, Oudéa occupied both position of CEO and chairman. It was thought that Jean-Pierre Mustier, the head of Investment Banking, would have replaced Bouton as CEO. However, his reputation had been too badly damaged by the Kerviel scandal and the €2.6 billion in subprime related write downs. Instead Mustier was replaced by Michel Péretié, who had been with Banque Paribas since 1980 where he created and developed its derivatives group, before merging with BNP in 2000. Subsequently he joined Bear Sterns as head of fixed income and derivatives for Europe and Asia before becoming the chief executive of Bear Sterns in Europe and Asia. Mr. Péretié also became a board member at Bear Sterns in January 2007.

Mr. Kerviel’s immediate manager, Eric Cordelle, and Martial Rouyère, the head of the Delta One desk, have been fired. Rouyère's boss, Pierre-Yves Morlat, the head of trading, and Morlat's superior, Luc François, Société Générale's former head of equities and derivatives, have both resigned and left the bank. Did the bank make scapegoats of its middle managers?

The French banking regulator fined Société Générale €4 million ($6.3 million) in July 2008 for failures of the bank’s internal control procedures. This is the biggest penalty imposed by the French Banking Commission with a finding that the bank had violated its own rules regarding the separation of its trading and control staff, the security of its computer system, the enforcement of trading limits and the provision of adequate qualified staff to monitor trading. Additionally, the regulator blamed the bank for being too focused on market risk and not enough on risk of fraud and abuse in its operations. Following the scandal, SocGen has announced measures to improve controls and raise awareness of fraud in its surveillance teams, and earmarked €100 million for investment in its control and information systems. Is this going to be enough?

REPRISE

Henry Theroux, speaking at the Banking Institutes International meeting, was eager to enlighten members about prevention of fraud. The stories of two rogue traders offered an opportunity to teach auditors and those responsible for oversight of banking operations about the practices to prevent such situations. Should auditors do more than evaluate the validity of numbers? Do they need to evaluate management practices, internal checks and balances, and controls on exposure to risk? The trading business is very complicated and many top managers may lack experience with trading, providing fertile ground for fraud. What can be done? What is the role of the global regulators in the frauds at Barings and Société Générale? What about reporting structures in the organizations? What about remuneration structures? All of these
questions were in Henry’s mind as he worked to put together his training program for the members of Banking Institutes International. It was time for these frauds to be prevented and Henry was serious about helping to make this happen.

REFERENCES


