

SOCIETE GENERALE DEBACLE: THE EMPEROR HAS NO CLOTHES OR THE GHOST OF NICK LEESON

If we are to believe reports in the press Jérôme Kerviel, a stock market index futures trader at Société Générale (Soc Gen) in Paris lost the bank in excess of € 3.7 billion (USD 7 billion) in a matter of weeks from late 2007 to early 2008. Apparently Kerviel, acting alone, took out colossal positions in the market with fairly simple “plain vanilla” futures which were hedged (i.e. covered) by fake transactions, leaving Soc Gen with open positions in a falling market. If the loss figure of € 3.7 billion is correct and we factor in the decline in the markets, Kerviel must have had open positions of some € 50 billion by the first week of January – twice the Bank’s market capitalisation. Other than questioning the sheer size and volume of Kerviel’s position, as an increasing number of commentators are saying, something doesn’t ring true in what we have learned so far. Either that, or there were massive lapses in Soc Gen’s basic internal control systems let alone the apparent break-down in the myriad “intelligent” risk management computer systems banks now use to identify exceptional or anomalous trades.

- Futures trading is conducted on margin i.e. a small amount of the contract only is paid up front. This margin varies over time with market movement – if the contract is loss making increased margin is required. This process is dealt with in the back-office well away from the traders. Kerviel’s scenario would have meant that the bank was paying out increasing margin calls as the market dropped and would also have expected to see an inflow of margin payments from the trader’s hedge deals that supposedly neutralised his open market position. However if these were fictitious there can hardly have been the required cash inflow. The increasing margin outflow and lack of compensating inflow was apparently not picked up.
- It is standard practice that all market trades are “confirmed” i.e. the counterparty with whom the deal is done confirms the transaction back to the initiating party. Again, this key daily control is conducted independently of the traders in the middle or back-office and in most cases is fully automated. Here also Soc Gen should have been confronted with a mass of “unconfirmed” contracts. When they accounted for Kerviel’s fake trades in their own books they would have found no incoming confirmation from the counterparty. Indeed the traders misdeeds were finally discovered on the 18th January when a Soc Gen risk manager queried a transaction with a counterparty and discovered that there was no such trade. Or are we to believe that Kerviel had access to a host of the bank’s systems (possibly with passwords dating back to his time in the back-office) that allowed him to

confirm all his fake trades manually? In which case the bank was amiss in not removing his back office systems access when he left this area of the bank.

- We are told that Kerviel rarely if ever took holidays and if he did leave the office would not allow other traders to take over his position. It is standard practice in most major banks to enforce a “two week holiday rule” whereby all employees (especially traders) have to take a continuous period of 10 days holiday every year. Although this measure would not necessarily have spotlighted the traders misdeeds in this specific case, it might have helped to discover the problem earlier. This especially as there are indications that Kerviel may have been trading over-limits as early as 2005 or 2006.
- We are also led to believe that Kerviel created a fictitious client for certain of his trades. Here one would question the rigour of the Soc Gen credit control process. All clients dealing with a bank are normally screened for creditworthiness by a department quite separate from trading and the client profile actually input into the systems via application to which traders should have no access. Again did he keep his old access rights from when he worked previously in the back office or was he allowed to interfere in the work of numerous other departments contrary to all the basic rules of segregation of duties?

The fact that Kerviel might have used the accounts of other traders as suggested has, in our view, little bearing on the situation as the above controls should have operated irrespective and would make us believe that his colleagues did not track their own positions. This is highly unlikely.

Doubtlessly we will find out more with time about any control lapses within the bank. However, if our first assessment is correct, even if our Risk Surveys are short and sharp we would like to think that we would have picked up one if not more of the basic control weaknesses highlighted above.

Lastly, it is interesting to speculate as to where such an “incident” leaves us in terms of possible standard insurance covers (i.e. excluding bespoke captive policies). Over and above direct losses, there is also a risk that Soc Gen will be sued by interested third parties, notably shareholders, some of whom have already lodged criminal charges with the police. Certain types of cover obviously stand out:

- **Bankers Blanket Bond (BBB)** or fraud cover, including computer crime. Whilst such policies sometimes exclude illegal or fraudulent trading, when they do provide cover there is usually the requirement that the perpetrator has the *intent or has obtained an undue financial gain for himself*. The same is true for computer crime sections that are mainly geared to external fraud. Although Soc Gen apparently finally pressed charges against Kerviel for falsification and fraudulent

misuse of bank records and computer fraud, a number of statements quoted reflect the fact that Kerviel apparently made no personal gain from his misdeeds, other than possible bonus. The question as to possible accomplices is still unanswered but appears unlikely.

- **Bankers Professional Indemnity** or errors and omissions may be available if third parties sue the bank for damages over the incident. However for this cover to apply such third parties (Soc Gen shareholders) would have to prove negligence on the part of Soc Gen and a direct link between this and their loss, which may not be easy despite the possible lapses highlighted above. Further, although taking excessive trading risk is not a criminal offence per se, if fraud has been committed by Kerviel, (malicious intent or undue enrichment for himself or others) this automatically invalidates the BPI policy as a standard exclusion.
- **Directors and Officers (D&O)**. Normally any such incident that adversely affects the performance of a company gives rise to a claim against the directors personally to the extent that they may have failed in their duties. Here again any third party investors would have to prove negligence on the part of the directors and a direct link between this and their loss. This could be made easier if there is proof that directors were aware of problems but did nothing to rectify matters in a timely manner. However it is doubtful that the fact that Soc Gen's management closed out Kerviel's positions and crystallised the loss would be sufficient grounds for such a claim as it was essentially a prudent move.
- **Unauthorised Trading (UAT)**. Such policies exist and normally cover named traders for losses where they intentionally exceed bank imposed trading limits *where the bank is trading for its own account only*. Unfortunately, such policies vary in wording and scope, which makes it difficult to assess possible coverage with the facts at our disposal. However, all things being equal such a policy would seem to provide an element of cover. Having said this, it should be understood that available market capacity for such UAT policies is very limited.

To close, when all is said and done the real question is perhaps whether Kerviel is solely to blame and in how many other banks could this happen ? Also, it does rather make a mockery of the avowed objectives of Basle II and Sarbanes-Oxley.

PATRICK MAUGHAN
FLUX RISK SERVICES
JANUARY 2008