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Société Générale scandal: 'A suspicion that this was inevitable'

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PARIS: The first e-mail message arrived in Société Générale's offices on Nov. 7. The surveillance office at Eurex, one of the biggest European exchanges, alerted a compliance officer at the bank that for seven months a trader named Jérôme Kerviel had engaged in not just one but "several transactions" that had raised red flags.

Société Générale, taking its time, responded on Nov. 20, when another risk-control expert at the bank replied that there was nothing irregular. "The recent volatility increase on the U.S. and European stock markets explains our new need for after-hours trading," the bank official wrote about Kerviel's trades, according to e-mail messages reviewed by the International Herald Tribune and The New York Times.

A second e-mail message from Eurex came on Nov. 26. Not satisfied by the bank's explanation, the bourse demanded more details. Société Générale provided them on Dec. 10 □ and both Eurex and the bank's own risk managers let the matter of Kerviel's trades drop.

By the time Kerviel set off another alarm, on Jan 18, five weeks later, it was too late. Though he had a profit on his surreptitious trading of roughly $2 billion by late December, his gain quickly went south. It would balloon into a loss of more than $7 billion as the bank frantically unwound Kerviel's financial positions on Jan. 21-22.

A spokeswoman for Société Générale declined to comment on the contents of the warning from Eurex or the bank's response, citing an internal inquiry by a special committee of independent directors now under way.

Overlooking the warnings by Eurex about Kerviel was only one of a series of missteps by Société Générale that led to his staggering loss.

The 144-year-old bank allowed a culture of risk to flourish, creating major flaws in its operations that enabled the rogue trader's activities to go undetected, according to bank officials, investigators and traders who worked with Kerviel.

Far from being discouraged from placing big bets, Société Générale traders were rewarded for making risky investments with the bank's money. It was not uncommon for traders to briefly exceed limits imposed on their trading before pulling back, despite controls meant to prohibit this.

"I have a suspicion that this was inevitable, given the way things were engineered," said Yves-Marie Laulan, a former chief economist at Société Générale and a longtime Paris banker. "It's a necessary warning that these things are so complicated that they are hard to control."

While management depicts the 31-year-old Kerviel as a lone operator who spiraled out of control, interviews with current and former Société Générale employees suggest that he was also the product of an environment where risk taking was embraced, as long as it made money for the bank.

"If this scam had been uncovered in November, when he was still up, he would have been fired but I suspect we would have heard very little about it," said a French financial official who insisted on anonymity because of his role in the investigation.

The damage wrought by Kerviel comes in the wake of two trends that reshaped Société Générale: the explosive growth of its derivatives business and its use of its own money to make bets on the market, known as proprietary trading.

Throughout Société Générale's sprawling derivatives business, said one current employee who used to work with Kerviel, traders were encouraged to make proprietary bets, even on desks that specialized in what top executives called "plain vanilla products," like the team where Kerviel worked, Delta One.

"You must take positions, even if you are not a proprietary trader," said this employee, who insisted on anonymity because he was not authorized to talk to the press. "During appraisals by bosses, they made it clear you were judged by how well you did your basic job, as well as how much money you made on prop trades."

Kerviel told French prosecutors as much. Asked if his superiors knew of his activities, he said, "at the beginning, just as at the end of my maneuvers, they didn't want to intervene," adding, "They know the machinery."

Kinner Lakhani, an analyst with ABN Amro in London: said, "Unlike some of their peers, Socgen was not shy about taking proprietary trading risks. Perhaps such businesses grew faster than risk management could cope."

Within Société Générale's corporate and investment bank, according to Lakhani, the percentage of revenue from market-making and proprietary trading rose to about 35 percent by mid-2007 from 29 percent in 2004.

The derivatives group started in the 1980s as a small team of highly trained and highly regarded engineers and mathematicians from the best schools. They quickly became known as "les moines-soldats," the soldier-monks. And as their importance inside the bank grew, their confidence, even arrogance, grew with it.

Like the devout and disciplined fighters they were named for □ the monks who fought in the Crusades □ the soldier-monks of Société Générale prided themselves on rising above the passions that moved the masses.

Similarly, Société Générale's soldier-monks believed that they could manage both the risk inherent in betting on the markets □ through complex computer models □ and the ardor of their regular traders, through controls.

Their hubris was having too much faith in their power to do either.

But they were dedicated to making Société Générale a world-class power in derivatives and, like the knights of old, they were fiercely competitive, both on and off the trading floor.

"We considered it a mission," recalled Antoine Paille, who recruited Jean-Pierre Mustier, now the head of Société Générale's corporate and investment bank. It was Mustier who ultimately confronted Kerviel after his fraud was discovered on Jan. 18.

While based in the United States in the 1990s, Mustier and another derivatives executive, Luc François, organized a sailing competition with other banks and steered the Société Générale boat to victory. François eventually rose to head the derivatives business but reportedly left last month after the revelation of Kerviel's trades.

Kerviel was never viewed as soldier-monk material. He was a provincial from decidedly middle-class stock □ the son of a hairdresser and a metal- shop teacher □ but he possessed an advantage that his better-bred superiors did not.

In his five years toiling in the back office before being promoted to Delta One in 2005, he had become expertly familiar with the proprietary system Société Générale used to book trades, known as Eliot inside the bank. While the risk-control department did monitor the bank's overall positions very closely, it did not verify the data Kerviel entered into Eliot. And Kerviel knew the timing of the nightly reconciliation of the day's trades by Eliot, so he was able to expertly delete and then re-enter his unauthorized transactions without being caught.

Kerviel's method of entering trades was one red flag cited by Eurex in its initial warning, along with questions about two "large" positions □ one net short position in DAX futures and one net long position in Euro Stoxx 50 futures. In the same letter, they asked what his investment strategy was and why these transactions were often entered through a London-based Société Générale subsidiary called Fimat Futures Limited. Eurex even inquired whether Kerviel had entered the transaction automatically or manually.

"Please explain the background for this procedure," two Eurex officials wrote to Xavier de la Maisonneuve, a compliance officer at Société Générale who has been questioned by investigators.

Vincent Duclos, another compliance officer in the equity derivatives division, not yet questioned by the police, provided the Nov. 20 and Dec. 10 responses to Eurex. His replies in part were based on accounts provided by Kerviel and his supervisor, as well as a compliance officer at Fimat, said Jean Veil, a lawyer for Société Générale. Kerviel's "supervisor had signaled that there was no anomaly whatsoever," Veil said.

De la Maisonneuve, who received the initial query on Nov. 7, said the bank gets 15 to 20 queries from different exchanges each year, many of them from Eurex.

He said by telephone Monday that his team had been in telephone contact with Eurex after their two letters in November to ensure it would fully answer their queries.

"Their questions were based purely on strategy and procedure," he said. "At no moment of these conversations was there any mention of abnormal volumes. They considered our second written response adequate and satisfying."

He added that Eurex did not take up Société Générale's offer of a conference call to further discuss the matter after the Dec. 10 letter.

A top official at Société Générale, who insisted on anonymity because of the sensitivity of the matter, said that in the weeks after the Eurex warning, Kerviel was shaken, and took additional steps to cover his tracks. He tried to manipulate areas of the internal risk-control system he was unfamiliar with, which ultimately led to the discovery of his suspected fraud in mid-January.

In his testimony to the police, however, Kerviel identified two members of the Delta One team he said were familiar with his activities going back to last April. These colleagues, according to lawyers familiar with the case, were Martial Rouyère, head of the Delta One trading desk, and his deputy, Eric Cordelle. Rouyère has since been questioned by the French authorities. Veil said he expected Kerviel's "entire hierarchy," including Mustier, to eventually be questioned by the police.

Given that Kerviel was able to exceed trading limits and evade detection for so long, as well as Société Générale's handling of Eurex's November warnings, "we can easily infer that the internal controls were either inadequately designed or have not been operating effectively and efficiently," said Francis Hounnongandji, a corporate governance expert who is also president of the French chapter of the Association of Certified Fraud Examiners.

That conclusion is being echoed at the highest levels of the French government. On Monday, Finance Minister Christine Lagarde said, "Very clearly, certain mechanisms of internal controls of Société Générale did not function, and those that functioned were not always followed by appropriate modifications."

In meetings with investors in recent days, Société Générale's chief executive, Daniel Bouton, has admitted his bank's internal systems did not keep up with the pace of growth in the derivatives business. "He told them while our derivatives business was going 130 miles an hour, risk control was only going 80," according to one analyst who covers Société Générale but insisted on anonymity.

He added that with traders making so much money, the analyst added, "they were untouchable; they had the power."

Pascal Decque, an analyst who covers Société Générale in Paris for Natxis, agreed that the bank was more willing to take risks than any of its French rivals, including BNP Paribas, which is rumored to be considering a bid for Société Générale.

As an example, he cited Société Générale's loss of □2 billion, or $2.96 billion, stemming from subprime-related investments □ twice the size of the hit BNP Paribas took, even though BNP is larger.

The U.S. Securities and Exchange Commission is investigating whether Robert Day, an American Société Générale board member, violated insider trading rules by selling shares worth □45 million before the bank's audit committee was informed of the subprime loss.

Société Générale and a spokesman for Day said last week that the share sales by Day and his family's trusts occurred in several transactions from December 2007 to Jan. 18, during a predetermined window when directors were allowed to exercise options. Both statements said all required disclosures were made, and "no inside information was used in any way" with respect to these sales.

As for Société Générale, the price of its hubris is still to be tallied. Like many observers, Decque believes it likely that the bank will eventually lose its independence as a result of Kerviel's losses, most likely via an acquisition by another French bank.

"Socgen was brilliant in their achievement, they were the world leader in derivatives," Decque said. "Maybe when you are that good, you think you will never fail."

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