SUMMARY

Société Générale is a French bank founded in 1864 as a result of the Industrial Revolution. After the Industrial Revolution, steel mills and railroad companies financed their expansion through bank loans. The bank was among the first to establish foreign branches, opening its first in London in 1870. This was the main reason for Société Générale to start up. Since the start, the bank was fast growing and in the 1990s Société Générale became France’s leading bank. The bank has since then grown to be a company represented in over 75 countries all over the world. With its 33 million customers and 60,000 employees, the bank is ranked as the 8th biggest bank in Europe.

What happened?

In the end of January 2008, Société Générale Chief Executive Officer (CEO), Daniel Bouton announced that under the duration of just three days, the bank had made losses of €4.9 billion due to a string of unlawful securities trades. According to Bouton a “rogue trader” who had used his knowledge to bypass the bank’s internal control structure made these trades. This “rogue trader” was none other but Jerome Kerviel. In no less than two cases after Daniel Bouton’s announcement, Jerome Kerviel was arrested. The young Parisian had pulled off one of the biggest frauds in the history of the banking industry. Kerviel’s job during the time at Société Générale involved making “plain vanilla” hedges in the European stock-indexed options within the equity derivatives division, the bank’s most profitable operating unit.

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1. What concepts in this chapter are illustrated in this case?

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3. What should be held responsible for Société Générale’s trading losses? What role did management play?

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3. Explain the concept of the bank’s internal control structure. What were the weaknesses in this internal control structure? How could the bank have prevented these losses in the first place?

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3. What are the controlling mechanisms that are in place in the bank's trading operations? What roles do they play in the trading operations of Société Générale? How effective are these mechanisms in detecting and preventing unauthorized trading activities?
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Société Générale (A): The Rogue Trader

SUMMARY

Société Générale is a French bank founded in 1864 as a result of the industrial revolution. After the industrial revolution steelmakers and railroad companies in France needed funding and this was the main reason for Société Générale to start up. Already from the start the bank was fast growing and in the 1920s Société Générale became France’s leading bank. The bank has since the start grown to be a company represented in over 75 countries all over the world. With its 33 million customers and 160000 employees the bank is ranked as

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What happened?
In the end of January 2008, Société General’s Chief Executive Officer (CEO), Daniel Buton announced that under the duration of just three days, the bank had made losses of €4.9 billion due to a sequence of unlawful securities trades. According to Buton a “rogue trader” who had used his knowledge to bypass the bank’s internal control structure made these trades. This “rogue trader” was no one else but Jerome Kerviel. In no less than two days after Daniel Buton’s announcement, Jerome Kerviel was arrested. The young Parisian had pulled off one of the absolute largest frauds in the history of the banking industry. Kerviel’s job during the time at Société General involved making “plain vanilla hedges on European stock-market indices” within the equity derivatives division, the bank’s most profitable operating unit.
A plain vanilla security is the opposite of more exotic products, e.g. a standard type of option. Starting from 2005, Jerome Kerviel began exceeding the maximum transaction size and began engaging in other unauthorized transactions. He learned several different ways to circumvent the internal controls, which sometimes meant creating fake emails from managers authorizing his transactions, preparing false documents, intercepting warning messages etc. To conceal his enormous risk-taking, he did also record fictitious transactions that appeared to be hedges, offsetting the risk taken in the first place. For example, if he had gone long in a block of securities, he did a short fictitious trade in the same assets, to make it look like the bank only suffered a small loss, at worst.

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Kerviel used this approach repeatedly to bypass the Basel II & Basel III minimum capital requirement ratio. At one point, Kerviel had outstanding positions far exceeding the stockholders’ equity of €33 billion, this mainly in near-term moves that he predicted the market would take.

It is important to know that Kerviel did not only lose money on his bets. In 2007, he earned more than a billion euro to Société Générale. However, in the beginning of 2008, things took a downturn. The whole thing started with a vast miscalculation that the market would be sharply higher in late January. Instead, the market declined and Kerviel had a loss of €1 billion in his hands. On Friday, the 18th of January, Kerviel's trades were discovered. During the weekend, Société Générale's CEO Daniel Buton took a decision that all positions should be closed down to avoid potentially catastrophic losses. However, over the three day period it took to sell all securities, the European market fell sharply, resulting in total losses of €4.9 billion. This is a figure equivalent to approximately 20% of the bank’s former equity capital as well as the size of the GDP in Kosovo 2011. The announcement which Société Générale made after closing Kerviel's open positions made stock prices fall all around the globe, and even provoked Nicolas Sarkozy to officially demand a stop to the current financial system.
1. What concepts in this chapter are illustrated in this case?

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- **System vulnerabilities:**
  - Computer crime: using computers as instruments of crime to defraud the bank, customers, and other financial institutions
  - Internal threats from employees: Kerviel has access to privileged information; he was able to run through the organization’s system without leaving a trace

- **Business value of security and control:**
  - Organizations can be held liable for needless risk and harm created if the organization fails to take appropriate protective action to prevent loss of confidential information, data, corruption, or breach of privacy
  - Had Kerviel committed his actions in the U.S. he would have violated the Sarbanes-Oxley Act. Organizational executives could have been held criminally liable.
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**Information system controls:**
- General controls: govern the design, security, and use of computer programs and the security of data files in general throughout the organization’s information technology infrastructure
- Application controls: automated and manual procedures that ensure that only authorized data are completely and accurately processed by that application
• **Risk assessment:** determines the level of risk to the firm if a specific activity or process is not properly controlled
• **Security policy:** drives policies determining acceptable use of the firm’s information resources and which members of the company have access to its information assets
• **The role of auditing:** an MIS audit examines the firm’s overall security environment as well as controls governing individual information systems

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2. **Describe the control weaknesses at SocGen. What management, organization, and technology factors contributed to those weaknesses?**

One former SocGen risk auditor, Maxime Legrand, called the control procedures used to monitor the activity of its traders a sham and that the management “pretend(s) to have an inspection to please the banking commission.”

**Management:** Kerviel’s supervisors saw a balanced book when in fact he was exposing the bank to substantial risk because of the way he entered the transactions. Kerviel worked late into the night long after other traders had gone home and took only four vacation days over the course of 2007 to prevent his activities from being detected. Managers did not enforce vacation policies that would have allowed them to scrutinize his work while he was gone. Supposedly he used his manager’s computer to execute several of his fraudulent trades while the manager watched him. Kerviel’s defense lawyers argue that he acted with the tacit approval of his superiors during his more successful initial period of fraudulent activity.

**Organization:** Kerviel gained familiarity with many of the company’s security procedures and back-office systems. He was then moved to another job in the company in which he could use
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**Organization:** Kerviel gained familiarity with many of the company’s security procedures and back-office systems. He was then moved to another job in the company in which he could use that knowledge. He knew the schedule of SocGen’s internal controls which allowed him to eliminate his fake trades from the system just minutes prior to the scheduled checks and re-enter them soon after. The temporary imbalance did not trigger an alert. The bank ignored many warning signs that Kerviel was capable of the level of fraud that he committed. The bank failed to follow up on 75 warnings on Kerviel’s positions over the course of several years.

**Technology:** Kerviel was able to use other employees’ access codes and user information to enter fake trades. The system failed to detect that Kerviel performed legitimate transaction in one direction, but falsified the hedges that were supposed to ‘offset’ the legitimate ones. He entered false transactions in a separate portfolio, distinct from the one containing his real trades. No system detection software was installed to detect these transactions. SocGen’s controls were capable of detecting more complicated errors and fraudulent transaction than the simple ones that Kerviel allegedly committed.

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- Stronger auditing procedures should have been in place and enforced. Auditors can trace the flow of sample transactions through the system and perform tests, using automated audit software.