

# The \$72 Billion Arriviste

*How did Jérôme Kerviel manage to lose so much of his bank's funds in so little time with so little oversight?*

BY IRWIN M. STELZER

“A gile brain,” “shone in the public sector,” a “reputation for odds-defying leadership,” “bright and arrogant.” The financial press’s description of the rogue trader who cost Société Générale (SocGen), France’s second largest bank, \$7.1 billion? Actually, no. That’s the reputation of Daniel Bouton, the chairman and CEO of SocGen, and the man ultimately responsible for making certain that no trader can circumvent the risk-avoidance systems of his bank. Jérôme Kerviel, the 31-year-old rogue trader who didn’t find Bouton’s system very difficult to circumvent, is a man of “mediocre abilities” according to the *Independent* and “not really a star” according to the *Times* of London.

Kerviel graduated from the University of Lyon, an undistinguished school to which France’s low flyers are consigned. Valérie Buthion, director of the university’s finance department, said, “People who want to be golden boys or clever in the market don’t come here.” “I was held in lower regard than others because of my educational and professional background,” Kerviel complained to prosecutors about SocGen.

The École Nationale d’Administration, from which Bouton emerged to become the youngest-ever member of

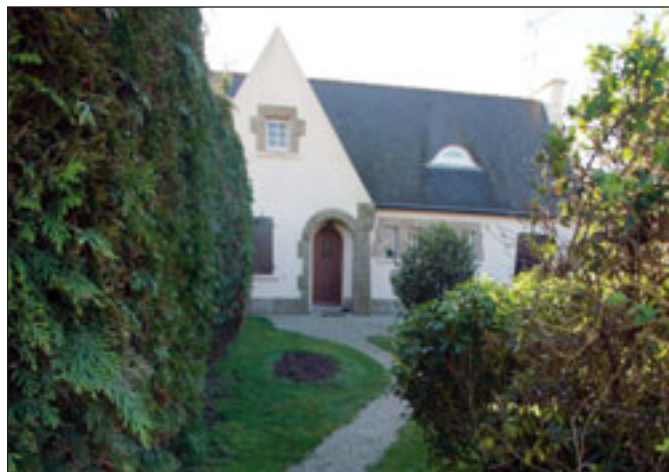
the elite branch of the French civil service, before becoming CEO of SocGen in 1993, exists in an elite and elevated world known only by reputation in places such as the University of Lyon. So it is no surprise that Bouton’s earnings are in the millions, while Kerviel was paid a mere \$150,000 per year plus a tiny bonus (on the order of \$2,000), extraordinarily modest by the standards of the business—which might say something about the salary scales at investment banks, but that’s a topic for another day.

Experts and auditors are scrambling to figure out how

Kerviel managed to dig such a deep hole for his employer, apparently in only two weeks of trading. For one thing, shortly before the debacle, several “anomalies” had been uncovered in his accounts, but the bank was content with his explanation that these were mere arithmetic errors. For another, the bank should have known to be on its guard: The press had given sensational coverage to Nick Leeson, an equally low-

level employee at Britain’s once august Barings Bank, when he wiped it out in 1995 with similar fraudulent, unwise bets on the very securities that Kerviel traded.

Here’s how he did it, if indeed he was acting alone, as some informed members of the banking community increasingly doubt. When Kerviel was promoted from the back-office of SocGen, where he dealt with the bank’s security systems, to become a trader, he took with him the codes used by controllers in the bowels of the firm to prevent traders, who do not know those codes, from taking large unhedged risks. It seems not to have occurred



*The Kerviel family home in western France*

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to anyone that Kerviel's promotion put the back-office, front-office separation at risk—again despite the fact that his career path was paralleling that of Leeson, who moved from processing and settling trades in Barings's back office, to the actual trading floor. The sleepy SocGen monitors finally awoke from their slumber when Kerviel entered a trade with a bank that had been put on credit restriction by SocGen and could not therefore have been involved.

No one thought that this handsome, always elegantly dressed young man—described by his mother as “a reserved, serious child,” a loner with a mere 11 friends on Facebook—would decide that he could predict market movements and bet the bank, and more, on his judgment, rather than hedge his bets, as the bank's risk-averse procedures require.

Kerviel's operation was simplicity itself. He thought that European shares would move up and took large bullish positions on the Dow Jones Euro Stoxx 50 Index and the German DAX. He seemed to balance those bets with others that assumed share prices would fall, standard procedure at the bank. Except that the latter trades never happened: He used fictitious accounts created with stolen IDs and passwords and his knowledge of the bank's security systems. When monitors questioned a few of his trades, he satisfied them by producing fake emails showing that the positions had been properly hedged. And when computer monitoring threatened to uncover his scheme, he temporarily removed the trades from the system, returning them only when the computer sweeps had been completed.

All of which would have made a great story, but in the end one of more interest to SocGen's shareholders than to the rest of the world, if the discovery of the fraud had not been followed by two, perhaps three world-shaking events. The first was the worldwide collapse of share prices on January 21, wiping some \$1 trillion off the value of the world's assets. No wonder, say some of those studying just how such a cataclysm could overtake world markets on a day when there was no news of disaster in any of the major economies: That was the day a shocked SocGen started to unwind its unwanted positions, which involved dumping

about \$73 billion worth of bad bets (roughly equal to the GDP of Slovakia and more than the total market value of SocGen) onto a market that was already edgy, taking a loss of \$7.1 billion in the process.

Bouton decided that it was unfair to his stockholders, who included many of his partners, to leave the bank exposed to further drops in the market. So rather than devise a strategy for an orderly unwinding—if, indeed, such a strategy could be devised in today's markets—he decided to sell, sell, sell. The process of unwinding remains shrouded in secrecy, but it seems that most of the selling was on the Frankfurt exchange. Experts are split on whether it was this unloading of positions that triggered the collapse of share prices on January 21, but they

do agree that the volume of selling on the Frankfurt and other exchanges on that and subsequent days was unusually high. We will never know: Bouton says he held to the promise he made to France's regulators to limit the scale of the sell-off on any market so as not to destabilize it, and both the *Autorité des Marchés*, the stock market regulator, and the *Banque de France* seem satisfied with his explanation. (They are less certain that the decision of a top SocGen executive to dump millions of dollars worth of shares in advance of the announcement of the fraud will escape being classified as insider trading when investigations are completed.)

What makes it uncertain that SocGen's selling triggered the worldwide share-price collapse is the fact that the Australian and Japanese markets had crashed on Sunday night, Paris

time, long before SocGen began unloading its positions, and the FTSE 100 (an index of shares in leading British companies) lost 4 percent in the first few minutes of Monday trading, before SocGen's trades hit the market. Still, there were rumors of a large overhang of selling. In the end, David Wyss, chief economist at Standard & Poor's, put it best: “How much did the market decline in Europe have to do with unwinding those positions? It's hard to know . . . but it certainly looks suspicious. It is probably not the sole cause, but I am certainly not ruling it out as a significant factor.”



*SocGen's headquarters in Paris*

Ambiguity is not something that sells papers or produces television ratings. So it has been more convenient for reporters to conclude that Kerviel indeed caused a worldwide collapse in share prices by attempting to devise a foolproof system for beating the markets. Better still, a second possible world-shaking consequence of Kerviel's trades came along. Federal Reserve Board chairman Ben Bernanke and his colleagues on the very next day cut interest rates by a massive three-quarters of a percentage point. Surely, this was the Fed's panicked response to the SocGen sell-off. After all, the U.S. markets were closed on January 21 in honor of Martin Luther King Jr., there was no news that the American economy or the U.S. stock markets were in any new trouble, and therefore no reason to cut rates in advance of the regular meeting of the monetary policy committee, only a few days away. So it must have been Kerviel.

Possible, but not likely. Bernanke has been increasingly sensitive to criticism that the Fed is behind the curve, and just doesn't understand the gravity of the situation in U.S. financial markets and the economy. With one massive heave he hoped to get ahead of the so-called curve—never easy to do, given the propensity of investment bankers and related institutions to want bigger and bigger bailouts from situations they have created for themselves. Even last week's additional cut of 50 basis points seems unlikely to satisfy the Wall Street set.

So Kerviel only *might* have triggered the massive January 21 sell-off and the almost unprecedented cut in the Fed funds rate. But he certainly created uncertainty as to the future of SocGen. For one thing, French president Nicolas Sarkozy is livid: He was not told of the bank's problems until four days after they were discovered. Sarkozy is in the midst of a drive to reassert France's significance as a

global player—selling nuclear plants in the Middle East, establishing a French version of the BBC, making France a force in financial markets. The ability of a single, rather undistinguished trader to make over \$73 billion in unau-

thorized bets from the desk of one of the nation's leading financial institutions is not welcome news at the Élysée. And even though SocGen is a private-sector bank, the close interlocking of business and government that characterizes French capitalism makes it likely that Sarkozy, impatient not only in matters of the heart, will not confine himself to a Gallic shrug. "When there is an event of this nature, it cannot remain without consequences as far as responsibilities are concerned," a very annoyed French president told the press. Lest that message be misunderstood, French finance minister Christine Lagarde urged SocGen's board to "consider whether the person in place is the best to steer the ship when she is pitching, or whether the captain should be changed."

Sarkozy wants Bouton's head, but the SocGen board is so far backing Bouton, the man they see as best able to fend off a hostile takeover. Sarkozy, however, is passing word that it might just

be best if SocGen were taken over by a rival. But only a French rival: "The government is intent on preserving it as a large French Bank," announced François Fillon, Sarkozy's prime minister. Foreign money is welcome in the U.S. banking sector, but France protects its "national champions" in what it considers one of its many "strategic sectors." The no-foreigners-welcome sign remains in place. There are, after all, limits to Sarkozy's pledge to reform and open the French economy. But BNP Paribas, France's largest bank, has hinted it would make a bid if the government reversed its earlier opposition, which was



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based on the belief that France deserves two large banks. American observers of the government's involvement in a private-sector matter are as shocked, shocked as was Captain Renault when he discovered gambling in Rick's Café Américain.

Meanwhile, Kerviel awaits his fate, which will include seven years in prison if prosecutor Jean-Claude Marin has his way—although the magistrate refused to charge Kerviel with fraud, settling for the lesser charges of abuse of trust and forgery. Bouton probably considers such a stint trivial compared with his own fall from grace. He has “temporarily renounced his salary,” according to reports in the *Financial Times*, but in the long run that is unlikely to appease the shareholders who have had to pony up the billions needed to shore up the bank's balance sheet; or those who bought shares in SocGen early in the week of January 21 when Bouton knew of but had not announced the fraud; or investigators who wonder whether the bank's decision to charge the loss against last year's earnings, rather than against 2008 performance, means there is more than fraud hidden in the \$7.1 billion write-down. The latter suspicions have

been fanned by reports that on the very day that SocGen announced its belated discovery of Kerviel's attempt to join the ranks of macho traders, the bank also reported a \$3 billion write-down due to losses in the subprime market. Even more encouraging of suspicions: At one point Kerviel had locked in well over \$2 billion in profits, a third of the bank's net. He contends that his superiors had to know from those results that he was taking big risks, but were content to allow him to do so—until the markets turned against him. Not implausible.

Kerviel, according to his mother, a retired hairdresser,

“didn't pocket a centime.” He “is not a robber; he is a good man,” contend his defense lawyers. Perhaps. But during the time when his trades were producing profits, which they were during 2007, Kerviel racked up some

\$81 million in cash for the bank, which, had his luck not turned, would have generated a \$300,000 bonus. And had his \$2 billion-plus in paper profits not been wiped out early in 2008, he might even have been invited to dinner at Bouton's house, although that is not certain, distinctions being what they are in the world of French industry and finance.

Kerviel might not be the man who broke the bank at Monte Carlo. But he is the man who almost broke the bank at Paris. He will not, as the old song goes, be “a mass of money, linen, silk and starch [and] . . . hear the girls declare, ‘He must be a millionaire.’” Saddest of all, this shy, introverted young man, who failed in his effort to attain a black belt in karate and failed to win enough votes to obtain a seat on his hometown's municipal council, will never be able to sing, “I've such lots of money, I'm a gent.”

All is not lost, however. He's being hailed as “Robin Hood” and the “Che Gue-

vara of France.” The London *Observer* reports that the French Communist party is calling Kerviel a latter-day Alfred Dreyfus, accused merely for taking on the establishment. He is a hero to the ladies in the hair salon his mother sold two years ago, and millions of his countrymen are hailing him for bringing down the “bosses” who are trying to replace the French social model with the red-in-tooth-and-claw Anglo-Saxon-style finance capitalism. Surely, a starring role in “The \$7 Billion Man,” or more likely “The €5 Billion Man,” is in the handsome Kerviel's future. ♦



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