

CSFI

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The Societe Generale affair: How could a bank's management/internal controls go so wrong? A CSFI round-table discussion with Anthony Belchambers (FOA), Gillian Tett (Financial Times), Pierre Briancon (Breakingviews) (Credit Suisse), Rudi Bogni and Brandon Davies (GARP) held on Thursday, March 20, 2008, from 12:30-2:15pm.

This discussion focused less on financial economics and more on concepts such as fear, greed, ethics, herding, common sense and class division, to name a few. One clear message was that the rogue trader is a well-established phenomenon that may require regulators to return to some old fashioned methods.

The first speaker was an advocate of common sense over brainpower and the need to balance potential risk with rewards to shareholders. Any discussion should remember three things: banks handle vastly amounts of money efficiently; given the size of the industry any default will carry a huge number; and new risks are old risks surrounded by more complexity and less transparency. There are many unanswered questions over SocGen. Were normal controls on Kerviel's activities lifted? Was management complicit in what he was doing? Was he able to conceal trades more easily through OTC rather than exchange traded transactions?

Traders tend to have a walk-on-water mentality, which means firms must keep a close eye on their star traders, and not be tempted to lift normal limits. The answer is to instil ethical values that should pervade the whole organisation and that can survive in the hothouse atmosphere created by the pressure to improve performance, the speaker said. Members pressed him on what this meant and how it could be instituted. He said it was about instilling values that traders could take from firm to firm. For employers it meant structuring bonuses that take account of market cycles and are based more on stock rather than cash.

For the second speaker social anthropology was the key. As a tribe, bankers had convinced themselves that money was simply a set of numbers on a screen not something with social and cultural significance. Because of the computer-based nature of banking they have become bad at spotting when humans have messed up what the computers were doing. They fail to put what they do in a human context. Fifty years ago most people including bankers would have seen money as akin to electricity – dull but necessary. Now most people would have the same view but bankers would see it as a route to making more money. Sadly 99.9% of the population does not have the training to understand what Kerviel was doing – and that includes politicians. As a result there is a risk of a political backlash. Lastly, most banks are so large that different sectors operate like Afghan tribes with the overlord not always knowing what is going on. The tribe doing best is untouchable. That used to be the securitisation department – now it is risk officers. What is the solution? The second speaker said there was a need for a simpler banking model, greater oversight and better financial education for politicians, consumers and the media.

The third speaker said people should not confuse SocGen with the credit crisis – it would probably be no more than a footnote to the history of 2008. No public money was used and SocGen has still posted a profit. But it is nevertheless a story of our times and lessons must be learned. It was rumoured that a fortnight before the news broke, SocGen's chairman Daniel Bouton said there were parts of the bank he didn't understand. Allegedly a middle manager quizzed Kerviel but let him carry on despite not understanding what he had told her. One member asked whether the class system – the fact that Kerviel did not come through the fast track system – played a role. The speaker doubted it did.

One member said Kerviel's activities argued for a return to narrow banking and a split between those and other institutions such as SocGen and Bear Stearns that should not receive public support. This would have been clearly exposed if Kerviel had brought down SocGen due to trades done in London. The first speaker said we needed a clear understanding of what lender of last resort means – who should be in the lifeboat?

The fourth speaker said rogue traders were a product of their environment, specifically a cultural divide between the blue suits and brown suits – star traders and back office folk; and secondly lax management. He asked why CEOs did not take the same interest in the qualifications of their traders as they did their chauffeurs. Efficient interviewing processes would be able to pick out the potential rogues. He said it was vital the City lauded the contribution an efficient financial system had made to strong growth and low inflation – something too valuable to lose in a regulatory backlash.

The fifth speaker said all traders were rogues –greedy with a high tolerance for risk. The real rogues were simply the ones who got out of control. He harked back to a bygone era when traders were East End barrow boys and inspection departments were stocked with ex-traders capable of taking over a trading desk and running the positions as part of their spot controls. The arrival of graduate traders, increasingly complex structured products and “irrelevant and incompetent” internal auditors means Firms no longer had much sanction over traders and were less likely to pick up the rogues. He said the recipe of rogue deals usually included the ability to hide trades in customer accounts; improperly kept counterparty credit limits; and complex products developed by the front office that the back office does not fully understand and for which there is no true market price. The answer? Use fear – larger and more effective police forces. One member said that there was one obvious candidate for that role who was currently unemployed – New York's former State Governor, Eliot Spitzer.