France: Trader accuses Société Générale of using him as a "smokescreen"

Andre Damon
29 January 2008

Lawyers for Jérôme Kerviel, the 31-year-old securities trader accused of being responsible for €5.3 billion in losses by Société Générale (SocGen), accused the bank Monday of seeking to use his transactions to hide its own losses. Elisabeth Mayer and Christian Charrière-Bournazel, Kerviel's lawyers, said that SocGen sought to use him to create a "smokescreen that would distract the public's attention from far more substantial losses that it had made in recent months, notably the unbelievable subprime affair."

The lawyers accused the Société Générale executive board of creating the bulk of the losses attributed to Kerviel when they dumped his positions into a plunging European equities market, and that this decision "itself provoked losses of €4.5 billion." They also claimed that Kerviel's portfolio was profitable by about €1.5bn at the end of last year.

The bank declined to comment on the lawyers' statement and is apparently standing by its original assessment of the losses, which it attributed to "exceptional fraud." Kerviel stands accused of "breach of trust" and "unauthorized computer activity." The prosecution dropped two of the heavier charges it had originally pursued, including attempted fraud and forgery. The bank continues to allege that Kerviel falsified documents in order to cover his tracks, but that charge has had its credibility lessened after the Paris prosecutor dropped the charge of fraud.

Mayer told the press Monday, "In my view, he was thrown to the lions before being able to explain himself." She continued, "It's a lynching." The allegations carry up to seven years in prison if Kerviel is convicted. Kerviel presented himself to police Saturday. He was held at the police station for the next two nights, speaking to financial investigators, and saw a judge on Monday morning.

Meanwhile, Frederik Canoy, a lawyer for a group SocGen minority shareholders, announced that a legal complaint had been filed against the bank requesting that investigators look into possible cases of insider trading. The complaint followed a notice by a French market watchdog that Robert A. Day, a member of the company's board, sold some €70.89 million worth of bank shares on Jan 9, over a week before the bank began its major investigation of Kerviel's positions. Two foundations linked to Day also sold some €9.59 million worth of shares the next day.

Investigators also reported that Kerviel's positions had come under investigation by Eurex, the international derivatives exchange. He was able to avoid further investigation by claiming he had properly covered his positions.

Kerviel was employed as a junior-level trader at the Société Générale, making about €100,000 per year, including his bonus. According to the bank, his portfolio included over €50 billion worth of securities and was valued at a loss of €1.5 billion on Monday. It will, of course, be wondered how a junior-level trader was able to manipulate such huge sums, which amounted to more than the company's market capitalization. Frank Partnoy, a law professor at UC San Diego, told the press that SocGen (like most other banks) assesses risks "on a net basis." This means that traders can take out positions of virtually any size, provided that they paired with other positions that appeared to cancel out the risk.

Partnoy notes that these hedging positions are by no means transparent, especially since they are often very complex and based on analysis of past performance that may not hold true in periods of extraordinary readjustment, as is currently the case. What is exceptional in the case of Kerviel is the extent to which the boundary between "exceptional fraud" and normal functioning of financial markets has become blurred.

The bank published a document, entitled "Explanatory

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note about the exceptional fraud," attempting to explain how Kerviel was able to generate such massive losses. The bank claims that the futures portfolio managed by Kerviel, which amounted to over €50 billion, was not abnormally large, as it was in the nature of his position to buy and sell such huge blocks of stock for comparatively small returns.

The bank concludes that "the financial instruments in the portfolio, which were genuine and consistent with the volumes traded by a large investment bank, were subject to daily controls and in particular margin calls with the main clearing houses." In other words, the €50 billion portfolio managed by Kerviel, which placed heavy bets on the rise of European equities indexes, was supposedly in no way extraordinary.

Kerviel's alleged fraud was, according to the bank statement, confined to the way he hedged his main portfolio. The bank document states that the Kerviel was required to take counterpositions for all of holdings. These hedges would pay out in the event of a stock market decline, and lose value in the event of an upswing. Kerviel allegedly created fictional transactions to skew his hedges so that they would not fully cover a market decline, and would allow for large speculative gains in the event of an upswing.

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The stock upsurge Kerviel was betting on never materialized, and on Friday, January 18, as European equities began to tumble, the bank claims it realized that the trader's hedges would not cover the losses incurred by his main portfolio. An investigation followed during the weekend, and the bank decided Monday to fully unwind all of Kerviel's positions during the next three days. The selloff corresponded with the worst drop in world equities markets since 2001. The bank then proceeded to announce its losses on Thursday.

The account published by the Société Générale has encountered significant criticisms. The head of equity derivatives at one of the bank's rivals told the *Financial Times*: "As the business has developed, the liquidity and the volumes have grown so much, you get used to it and as arbitrage has become more difficult, you do it in bigger sizes. But if it was one person with a €50bn position, that would be strange." Another banker told the newspaper: "It's a high-volume, low-margin business. But a position that size is not something you would give to a junior trader. You only need a fat-fingered moment and you've tripped the market."

What could have motivated Kerviel to systematically violate accepted — at least on paper — bank procedures? The Paris Prosecutor, Jean-Claude Marin, acknowledged that Kerviel did not stand to individually make any money from his transactions. But if his positions turned out successful, he would stand to make hundreds of thousands on his holiday bonus. Earlier this year, he expected to take home a bonus of some €300,000 as a direct result of gains on his speculative positions. As Marin, put it, "He wanted to seem like an exceptional trader and anticipator of the market and wanted to get a higher bonus." Moreover, "Little by little, he started taking positions of pure speculation, and it must be recognized that many of these operations generated profit for his employer."

While the bank's executive board may feign righteous outrage over the behavior of this one "rogue" trader, one can hardly say his actions are that much different from those of "respectable" bankers. After all, the current credit crisis is largely the immediate result of funds managers attempting to hide risk by buying up mystery-meat subprime securities. Instead of speculating on Stocks, as Kerviel was doing, they speculated on the US housing bubble. When the bubble began to deflate, the subprime-related bank sectors began to report massive write-offs. As one analyst put it, "5 percent of the banking sector is responsible for 95 percent of the losses."

Moreover, it is worthwhile noting that the disclosure of losses attributed to Kerviel immediately overshadowed the bank's loss of €2.05bn in sub-prime based securities. As Partnoy puts it, "A proper ranking of the losses SocGen announced would go: first, trading losses by management; second, CDOs; third, Mr Kerviel. The leading rogue trader in history was a distant third on SocGen's list of bad news that day."

He continues, "Many other banks, including Merrill Lynch, Citigroup, Morgan Stanley and others have disclosed even bigger losses from subprime-related derivatives and CDOs. As was the case at SocGen, these banks' risk management systems did not alert managers, directors, or shareholders to the risk that a handful of people could bring them to their knees. The fact that the SocGen scandal involves one person and a more brazen scheme makes it different in degree only, not in kind."

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