



Breakdowns in internal controls in bank trading information systems: The case of the fraud at Société Générale

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ABSTRACT

The purpose of this paper is to examine the failure to detect breakdowns in internal controls in a major bank's trading information systems related to a fraud perpetrated by a mid-level derivatives trader. Specifically, this paper examines the events uncovered at Société Générale, a large French bank, in January 2008. The paper addresses the question whether the apparent breakdowns in internal controls were caused by the fraudulent activities of a single trader acting alone or whether there may have been a certain level of acceptance of these activities on the part of the bank hierarchy as long as the trader was making a profit. The conclusion of the paper is that bank management may have overlooked overrides of internal controls over bank trading information systems during periods when risky trading practices resulted in profits, but that management quickly took action to correct the internal control overrides when the trading practices led to losses, thus re-emphasizing the crucial importance of tone at the top in the internal control environment. The paper will also address current and future potential research which may have prevented the fraud at Société Générale.

1. Introduction

The purpose of this paper is to examine failures to detect breakdowns in internal controls in bank trading information systems which led to a massive fraud at Société Générale in January 2008 and to provide research opportunities and directions based upon these findings. Until the public announcement of the fraud, Société Générale (henceforth known as the “Bank” in this paper) was known internationally for its expertise in trading equity derivatives, which had become a highly profitable line of business for the Bank. In fact, in January 2008, *Risk Magazine* awarded Société Générale its Equity Derivatives House of the Year award (John, 2008). The Bank's systems for trading were considered to be some of the most complex in all of banking for handling equity derivatives. In response to the revelations of the fraud, high level officials of the Bank claimed that a single trader, Jérôme Kerviel had used his intimate knowledge of the Bank's trading information system to circumvent controls that would have prevented him from taking unauthorized trading positions. In addition they claimed that he made changes to the Bank's trading information system that enabled him to eliminate credit and trade-size controls, so that the Bank's risk managers were not aware of the unauthorized trades (Gauthier-Villars et al. 2008).

After the announcement of the fraud, Jérôme Kerviel was arrested by the French police and charged with several counts of fraud under French law. He was convicted by a Paris court in October 2010 and sentenced to three years in prison and ordered to pay 4.9

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billion euros (\$5.5 billion) as a fine to cover the losses that the Bank had incurred. Subsequent court rulings have eliminated the fine, but sustained the fraud conviction and prison term (Reuters, 2016). In June 2016, a different type of French court related to labor law, awarded Kerviel 400,000 euros on the basis that the Bank had fired Kerviel in an unfair manner because it was aware of his trading activities (Huffington Post, 2016). Separately, the French prosecutor rejected Kerviel's argument that the bank was aware of his activities, while considering a reduction or elimination of his prison sentence. Therefore at the time of this writing the case remains unresolved (Reuters, 2016).

This raises the question whether the apparent breakdown in internal controls in Société Générale's trading information systems were caused by the fraudulent activities of Kerviel acting alone or whether there was a certain level of acceptance of his activities on the part of the Bank's hierarchy. The overall purpose of the paper is to investigate this question and to discuss implications for research and practice. The remainder of the paper is organized as follows. Section 1 outlines the basic elements of the fraud perpetrated by Jérôme Kerviel in January 2008. Section 2 reviews the conclusions of a report prepared by the General Investigative Division (Internal Audit) of the Bank which outlines the details of the fraud and the internal control weaknesses that caused a failure to detect the fraud for several years. Section 3 summarizes a report prepared by PricewaterhouseCoopers at the request of the Board of Directors of Société Générale. Section 4 discusses the question posed in this paper and Section 5 offers some lessons regarding the fraud. Section 6 concludes the paper.

2. The fraud at Société Générale

2.1. Background of Société Générale

Société Générale was founded in 1864 during the reign of Napoleon III, the nephew of Napoleon Bonaparte. The Bank became an important source of capital for the rapidly growing French economy during the 19th and early 20th centuries. Just prior to World War II, Société Générale had 1,500 branches, including several branches in the United States and other countries. Following World War II, the left-leaning French government nationalized Société Générale. In 1987, the government returned the Bank to the private sector and by the end of the 20th century Société Générale had reestablished itself as one of the world's largest and most important financial institutions. By 2007, the Bank operated in almost ninety countries, had total assets of 1.1 trillion Euros, and had more than 130,000 employees worldwide (General Inspection Department, 2008).

2.2. Background of the fraud¹

In 2000, Jérôme Kerviel joined the back office (i.e. operations, compliance and internal audit) department of the *Global Equity and Securities Solutions* (GEDS) division of Société Générale after completing a master's degree in banking operations at a campus of the Université de Lyon (see Fig. 1 for an organizational chart of the bank). For four years, he was an internal auditor with the Bank where he reviewed trades in the GEDS division. In 2005, Kerviel transferred to the *Delta One Listed Products* (DLP) trading desk within the GEDS division where he became a junior trader (see Figs. 2 and 3). The DLP trading desk was only authorized to engage in low risk program trading. The primary purpose of the trading desk was to hedge the overall portfolio risk of the bank through managed trades. Kerviel's role was to take positions on major European stock indexes such as the Euro Stoxx 50, Germany's DAX Index and France's CAC-40 (Gauthier-Villars et al., 2008).

As of December 2007, GEDS had 1,365 employees divided into four main areas. The DLP trading desk, where Kerviel worked, was in the *Arbitrage trading* area, which means that the positions were intended to be fully hedged and therefore less risky (see Table 1 for list of the categories of products traded or sold by the GEDS division):

- *Structured product sales* (388 employees);
- *Financial engineering* (232 employees);
- *Cash equity sales and research* (360 employees)
- *Arbitrage trading* (385 employees); involving both proprietary trading (that is trading for the Bank's own account) and client related trading.

2.3. Elements of the fraud²

Beginning in 2005, Kerviel began making unauthorized trades and also exceeded the maximum transaction size that he had been assigned for individual trades. Because of his back office experience, Kerviel was familiar with the internal controls over the Bank's trading information systems and this familiarity allowed him to take unauthorized trading positions that were apparently not detected by the internal controls. The internal control system mainly relied upon supervision of the traders, which was lacking in the case of Kerviel, due to a failure to replace his supervisors. At one point, Kerviel created trading positions that exceeded the Bank's

¹ The section is derived from a Report prepared by the General Inspection Department (Internal Audit) of Société Générale issued in May 2008 (General Inspections Department, 2008).

² This section is based on contemporary accounts written just after the revelation of the Kerviel fraud and appearing in newspapers and blogs, including: Eyal (2008), Gatinois and Michel (2008), Gauthier-Villars et al. (2008), Hanes (2008), Jolly and Clark (2008), Kennedy (2008), Le Monde (2008), Peterson (2008), Routier (2008), Schwartz and Bennhold (2008a, b).

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