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The Loss Where No One Looked

How Low-Level Trader Cost Société Générale

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Jérôme Kerviel, the Société Générale employee who sparked the world's biggest-ever trading loss, was so low on the bank's totem pole that some didn't consider him a trader at all.

That may have been what allowed him to pull it off.

According to preliminary inquiries into the trading fraud that cost Société Générale €4.9 billion (\$7.2 billion), Mr. Kerviel allegedly placed hundreds of thousands of unhedged real trades on stock-index futures markets. ([Read the bank's statement](#)¹.)

For months, Mr. Kerviel avoided detection because -- even as he allegedly built up massive positions -- he always managed to square his books as a low-level trader in the "Delta One" desk: never make a big profit or loss. When one trade caught the attention of a supervisor last week, and the system collapsed, myriad small losses compounded into a huge financial hole for the bank.

A prosecutor is due to decide today whether to put Mr. Kerviel, who was questioned by police this weekend, under formal investigation. Through his attorneys, Mr. Kerviel has denied wrongdoing.

Had Mr. Kerviel been one of the A-league traders in Société Générale's most prestigious perch -- the desks that handle complex equity derivatives -- his actions likely would have drawn more attention.

To run that section of its business, Société Générale spends a fortune luring talent from France's elite engineering schools to nab people who can develop "exotic" derivative products, using sophisticated computer models.

But the Delta One desk on the seventh floor of the bank's headquarters in western Paris deals with the boring corner of the equities derivatives market: It's a low-risk division where Société Générale and its clients can place basic bets on whether a stock market index will rise or fall. Profits are generated through the sheer volume of transactions.


"We all lived in fear that something within the exotic products would blow up in our face. It never came to our mind that we might have a problem with Delta One," said a top Société Générale official.

Arrival at Delta One

Though even within Société Générale, traders held little regard for the Delta One desk, for Mr. Kerviel, just getting there had been an achievement. For his first five years at the bank, beginning in 2000, he toiled away at a back office of the prestigious equity-derivatives desk, a place that other traders derisively refer to as "the mine."

In 2005, Mr. Kerviel was promoted to the Delta One desk. There, his job was to invest in portfolios

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that took opposite bets on the direction of the markets. The bets essentially were supposed to offset each other in what is typically a low-risk way to make a small profit.


Mr. Kerviel was given an annual target: earn between €10 million and €15 million for the bank. And he was given a small margin to play with: the net value of his almost perfectly balanced portfolio of bets should be kept roughly under €500,000.

The Ghost Trader


Jérôme Kerviel's job at Société Générale was to take minimal risk: His mission was to balance out positions on his book. But Société Générale says flaws in its control system allowed the trader to leave the bank with a €50 billion exposure.




ROUTINE
On a normal day, Mr. Kerviel would balance a bet that a stock-market index would rise with a contract on a futures exchange or another bet that the index would drop.




FICTITIOUS
For almost a year, Mr. Kerviel allegedly made real bets one way and fictitious bets in the other direction. His supervisors would see a balanced book when, in fact, the bank was exposed to hefty, real risk.



DROPS IN OCEAN
Though Mr. Kerviel's positions exceeded his authorized limit, they were scattered on different balance sheets and drawn within the bank's massive volume of daily operations on futures exchanges.



BALANCING TRAILS
Mr. Kerviel allegedly would enter fictitious "forward" contracts, which—unlike contracts with futures exchanges—don't necessarily generate money flow until the contracts reach maturity.



ELUSIVE ACTION
Mr. Kerviel allegedly knew the calendar of in-house controls, during which supervisors would scan his book. To elude controls, the trader erased fictitious positions right before the scan and re-created new ones immediately after to keep his book balanced out. The temporary misbalance didn't trigger an alert.

Sources: Société Générale; WSJ reporting

But while there, Mr. Kerviel found a way to rack up a potential liability of €50 billion via a simple scheme: Making bold trades in one portfolio and then covering up those positions with a fictitious, second portfolio. That led to a neutral trading account that wouldn't draw attention.

Scattered Trades

In addition, the trades were scattered on several separate balance sheets, and drawn into the massive flow of daily transactions, so the bank never realized Mr. Kerviel was vastly exceeding his risk limit.

The fake trades in the second portfolio were fake trades with actual banks or clients. Rather than betting on futures with an exchange -- a move that would trigger money flow and would have left trails -- Mr. Kerviel used forward transactions, which often don't require actual cash to exchange hands.

With this type of over-the-counter transaction, clients didn't know that they had been used to make a fake trade.

Books Check Out

When the bank checked Mr. Kerviel's books, the real and fictitious trades balanced out within the trader's risk limit and everything looked normal.

Several times, Mr. Kerviel's supervisors spotted mistakes in the trader's books. But Mr. Kerviel would claim it was a mistake and fix it, said Jean-Pierre Mustier, head of Société Générale's investment-banking arm.

"Société Générale got caught just like someone who would have installed a highly sophisticated alarm ... and gets robbed because he forgot to shut the window," said the Société Générale manager.

Much of Mr. Kerviel's real trading was in making bets on the future prices of big European indexes, including the Dow Jones Euro Stoxx 50, the DAX index in Germany and the CAC-40 in France.

Total Exposure

As of Jan. 18 -- the day Mr. Kerviel's ruse went astray -- Société Générale had €18 billion of exposure

to the DAX, €30 billion exposure to the DJ Euro Stoxx 50 and €2 billion to the FTSE 100 Index in London, according to Mr. Mustier. All of these exposures were established this year in a short period of time, he said.

As he traded, Mr. Kerviel had to circumvent rules on how much one portfolio gain or loss could exceed a mirroring set of trades. For example, if Mr. Kerviel hypothetically bet that an index would rise in value €10, he would need to make a counter trade to cover that amount.

To balance the books, Mr. Kerviel began using the fake trades in a second portfolio, bank officials say.

For example, in his real trade, Mr. Kerviel was betting that indexes would rise at a certain point in the future. To offset that real risk, Mr. Kerviel made fake trades to show he had taken positions for a drop in the indexes, bank officials say. He forged trade documents on these trades, they add.

Covering Tracks

Once Mr. Kerviel had offset his real trading positions with fake ones, he still needed to cover his tracks. So he would erase his fake trades just before his books were checked, bank officials say. Once the threat had passed, he quickly would re-enter the trades to balance his positions. The temporary imbalance, apparent for just a few minutes, failed to set off alarms.

Mr. Kerviel also had to cancel the fake trades before confirmations of those trades were sent to the alleged counterparties such as banks. Bank officials say he used computer access codes to enter the bank's system and cancel the trades. He then created more fake trades to keep his books balanced. Mr. Kerviel's trading in 2007 essentially was flat in terms of profits and losses. But his 2008 trading yielded actual losses and trades.

The juggling act ended Friday, Jan. 18 when a counterparty trade exceeded a certain financial threshold. That then led to the discovery of a suspicious trade confirmation email.

At 10 p.m. that Friday, Mr. Mustier received a phone call that something had gone wrong.

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