

IFRI 's TUESDAYS in Brussels



A Professional Look at the Financial Crisis

Pr. Eric de KEULENEER

Executive Director of Credibe and of the Fondation Universitaire

Lunch debate, February 12th 2008

The Story of a Basic Trader

According to Eric de Keuleneer, the huge scandal around the Société générale and the major losses caused by one of its traders, Jérôme Kerviel, is the case of a trader that contrary to the first information from the Société générale was not a Machiavellian genius but a basic trader in a rather minor position hoping to get a bonus of just €300.000.

His area of expertise was not speculation but arbitrage of indexes. He would take an arbitrage position between the indexes and the components of indexes with a simple computer model. He would buy components and sell indexes without taking big risks because in the end the value of components equals the one of indexes. From 2005 though he has started putting some delay between the buying and the selling of components and indexes and in the meantime he has done transactions that were fully covered. He has taken advantage of the different interest rates and values between two transactions and has made some money. He now claims that these speculation activities were obvious and that the Société générale could not ignore them but accepted them because he was making money. The Société générale discovered his activities on the 18th January, after he lost more than a billion euros because of a bail on the German stock market index.

A Dreadfully Poor Control

This scandal gives a bad impression of banking activities. To Professor de Keuleneer, it is frightening to discover that such a leading bank (the Société générale is known as the most important bank in equity derivatives) has such a poor control over its own activities. The risk control procedures of all banks are being investigated today.

Lesson 1: Something is wrong in Banks

The first lesson to draw from this case is that remuneration schemes in trading rules are pervert. Every trader aims to make money at the end of the month to get a bonus. Hence they take risks in order to make enough money. Nowadays there is a real incentive to take risks, without even being sanctioned for it if things go wrong.

Lesson 2: A Problem of Understanding of Risks and Control of Risks

The second message is that most of boards of directors of banks do not even know what risks are taken in their own bank. Banks have a problem of understanding and controlling risks. A lesson drawn from the subprimes crisis is that many banks (commercial banks mostly, and investment banks at a lesser level, for some investment banks very little)

are losing a lot of money in subprimes transactions, whereas hedge funds seem to come out of this debacle without major problems. In a hedge fund people do know what they are doing, which is not the case in big banks. An investment bank such as Goldman Sachs understands the importance of risks control: last year the best paid managing partner was actually the manager in charge of risks, who was paid more than the chairman. Risk control management has to be taken more seriously in banks.

To conclude, Eric de Keuleneer highlighted another problem that many banks have encountered over the last weeks: the unwinding of bridge financing. Many commercial banks have served as last-resort players and have leveraged lending transactions on private equity funds. They were supposed to be refinanced by long-term securities, or long term financing by other banks (a bridge financing). But now they discover that there are no long term financing available on the other side. Those transactions are worth many hundred billion dollars and banks that lent money for acquisitions will have to reduce the value of these loans.