

## SOCIETE GENERALE 2008: ROGUES IN THE TRADING ROOM, KNAVES IN THE BOARDROOM

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### INTRODUCTION

The term “rogue trader” has a certain flair to it, a dash of piracy and bad boy antics, but in reality “rogue traders” can create irreversible damage to a bank’s profits, reputation and credibility. 2008 has seen a spate of incidents, from Societe Generale, Credit Suisse, Lehman to Morgan Stanley with losses in the range of hundreds of millions to billions of dollars.

Rogue traders despite their aura of individual bravado are part of a system that allows these transactions to take place, due to negligence, complacency, lack of oversight or collusion. As banking historian Martin Mayer said in relation to the scandal that brought down Barings in 1995: “You have to worry about the guy who is making all the money”.

When fraudulent activity takes place over an extended period of time and despite outside warnings, can the culprit be held entirely responsible or are there “knaves” in the boardroom. As in so many banking scandals, losses and questionable activities, should CEOs be held ultimately accountable? In the United States from Chuck Prince at Citibank, to Stan O’Neil at Merrill to Jimmy Cayne at Bear Stearns, top managers have been forced out. In Europe and especially in France top management tends to close

ranks, play musical chairs by slight shifts in management and maintain institutional cohesion.

The saga of Societe Generale in 2008 has three parallel story lines. There is first the financial scandal and its implications; secondly institutional identity and history of the bank and its senior management; and last but not least the specific French characteristics of this sociocultural drama. Monetary, historical and cultural determinants interact in this “piece de theatre” with the same players, the same setting but three different scripts. In each case the denouement remains unclear and still to be decided .

So let’s lift the curtain and begin.

## I. THE FINANCIAL SCANDAL

January 24, 2008 a bombshell hit the financial news and media:

“Societe Generale said unauthorized bets on stock index futures by an unidentified employee caused a 4.9billion euro ( \$7.2bn) trading loss, the largest in banking history”.

The Bloomberg report stated that Societe Generale ( second largest bank in France after BNP-Paribas) plans to raise 5.5bn euros from investors and that the Bank of France is investigating. (Bloomberg report)

This seemed so sudden, so extreme and outrageous that the initial response was shock and disbelief “ at first this seemed like a joke” as SocGen “ was a leader in derivatives and considered one of the best risk managers in the world” (Bloomberg). The next response was horror at the lack of coordination between the Bank of France and the Fed. As it became quickly clear that nearly a week had elapsed between the discovery of the

fraud and the revelations, questions began as to when did they know and why did they wait?

The first official report presented to the Prime Minister in late February based on information provided to the Commission of Finances of the Senate and the Bank of France report set out the following timeline.

January 18, Friday evening, the Head of Corporate and Investments in the Paris home office, Mustier was told that a compliance officer uncovered 30bn euro trade on the German DAX. The trader Kerviel claimed he made a mistake- but when Deutsche Bank, the listed counter part was reached, it did not recognize the trade. ( Daniel Bouton, CEO of Societe Generale once notified his initial response was dismissive and disdainful: “ short lived rampage by rogue trader able to hack computers”).

All weekend, the trader is interrogated and it became clear that several transactions had fictitious accounts set up to cover trades.

By Sunday January 20, Daniel Bouton, convened the auditing committee to inform them of the extent of the losses and the decision is taken to try to unravel the loss position as soon as possible. The Governor of the Bank of France, Christian Noyer is notified and makes it clear that any account of 2007 results has to be put off till further clarification.

Monday, Jan 21, Martin Luthers King’s Birthday in the United States, markets reopen with weak activity as Paris tries to unravel position.

Tuesday January 22, representatives of the Commission Bancaire , equivalent of the SEC meet with the bank in order to get explanations on the “ disfunctionalities which allowed this to happen” (dysfonctionnements qui les auraient permis)”. After massive losses the

previous week the Fed lowered interest rates by 75 basis points. The Dow after initial losses of nearly 600 points stabilizes.

Jan 23, the Minister of Finance, Christine Lagarde is notified by Daniel Bouton. Finally the Bank of France notifies the FED, ECB and other EU banking officials. Japan and Asian markets stabilize. Unfortunately President Sarkozy was also only notified on January 23, creating a strong backlash from the Elysee: “Heads are likely to roll high in the French financial establishment after it emerged yesterday that President Sarkozy was kept in the dark for three days “( London Times site, January 26). Raymond Soubie, advisor on Social Affairs said: “There is perhaps a problem with the financial morality of capitalism beyond the specific case of Societe General.”

Beneath the ideological rhetoric, is SocGen’s leadership being accused of such arrogance that they had decided that even the president of France could be treated on a need to know basis. Or was it an issue that this President, also an outsider, a semi foreign lawyer could be treated in this fashion. Would Bouton have dared with Mitterrand, Chirac or certainly Valery d’Giscard d’Estaing?

Thursday January 24, the bank finally reveals the full extent of the losses: 4,9 bn euros (\$7.2bn) and announces an increase of capital of 5.5bn euros through JP Morgan and Morgan Stanley.

Jan 25, a committee from the Banking Commission opens a formal inquiry. The FT article referring to Daniel Bouton as the” golf mad boss of S-G who had fended off 1999 hostile bid by BNP” stresses that rumors are starting that the bank could again be a target for a takeover by Barclays, Santander, Unicredito or Credit Agricole.

There is talk of state intervention with the government pushing BNP and Credit Agricole to come in.

Jan 26 the Financial Times headline reads:“ The week that shook the world”.

Jan 27: News of Citicorp Chuck Prince forced out and Merrill Lynch Stan O’Neil, \$34bn losses in writeoffs directly related to 2007 subprime mortgage crisis.

Jan 28 New York Times article on “ French Style Capitalism” asks the question how did this type of trading go undeterred. It is discovered that Kerviel may have begun creating false transactions since 2005 undetected and undeterred!

Jan 29- Jerome Kerviel is arrested and “ held for falsifying documents and breach of trust”. Kerviel who earned 147,000euros ( a low end traders salary) claims he acted alone but that these procedures were commonplace. Apparently he did not seek personal gain, nor did he benefit from the gains, as there was no personal gain, nor did he embezzle, there was no actual fraud.

His job as “ arbitrageur was to use derivatives to exploit small price discrepancies in the value of different stock market indices. This involves buying futures contracts high and selling low ( hedging risk by simultaneously selling contracts to hedge he risk. The contracts are not settled on a daily basis, therefore he could pretend to trade with large institution (DB) in order to mask huge amounts at stake.”

The situation was further complicated as this sudden surge of activity occurred in a deeply volatile market, due to major losses in US markets all through January linked to the subprime mortgage crisis. As the CAC 40 had dipped to its lowest level since January 2007 on Jan 18, DAX and EUROSTOX also suffered significant losses. With very heavy

trading the impact of SocGen trading volume aggravated its own losses and impacted global exchanges.

The press begins to question whether SocGen's sudden huge position on January 21-23 destabilized the markets further and provoked the FED to act too rapidly. Where there global repercussions from the banks actions and lack of disclosure?

Jan 31 reveals that loyalty to the bank remains unscathed as the elite derivatives team stays in place. The Board and independent directors give Daniel Bouton a vote of confidence, declaring that any sudden changes in management would further erode the bank's ability to recuperate.

Feb 5: The Lagarde Report hits hard on lack of controls. Evidently in March 2007 Bouton had been alerted to tighten controls. Eurex clearing house had alerted Societe Generale of suspicious activity and had send warning on November 7, 20, 26 which were ignored. Dec 10<sup>th</sup>-SocGen finally replied but as it was close to Christmas the matter was dropped. This replicates the environment at Barings in December 1994, where despite warnings of suspicious trades, the holidays and upcoming bonuses overrode the need to investigate.

Feb 9<sup>th</sup>- There are references to a possible accomplice, Moussa Bakir, a futures broker at Newedge ( SOCGEN-CA joint brokerage firm), discovered through text messages.

In mid February the Financial Times reports that despite intense speculation of takeovers, Deutsche, Santander and Intesa Sanpaolo dismissed any interest. The bank refuted any rumors or insinuations of a breakup of assets ( following the model of the breakup of ABNAMro by a syndicate of Fortis, Santander) which would have allowed takeover of SocGen's retail business by the Italians, the investment arm by Credit

Agricole and the French retail network by its chief rival BNP. Although BNP had always remained interested, a hostile bid was ruled out. CALYON might have benefited, but French domestic consolidation had reached its limits and the EU would frown on further French mega bank mergers.

April 18- Under pressure from hostile shareholders, Daniel Bouton steps down as CEO but remains Chairman. He is replaced by Francois Oudea.

By late May at shareholders meeting there is a hostile response against Bouton, demanding further action and investigation.

Kerviel released from prison is hired by small French computer firm in Paris.

Daniel Bouton claims: “This individual acted alone, he had the brains to bypass all levels of internal control.”

Kerviel claims: “ I will not be the scapegoat for Societe Generale”

The official report which came out in February was highly critical of the decision and asks why was the government not informed before the 23. Such communication in these cases would and should be instantaneous. The bank claimed that in order to avoid panic, it needed to maintain total secrecy. The decision to act was justified in order to avoid contagion if the situation became public too soon, while the bank was trying to assuage losses and bring in new capital. The bank needed to be accountable, but full disclosure could have put in cause the stability of the French and international exchanges.

Did Societe Generale assume that it could cover its losses, unravel the position and only declare the problem after the fact? In a 24/7 technological market, this seems improbable naïve and arrogant.

How was one trader able to conduct this operation ? The report which does not name Kerviel explains that actual positions were hidden through fictitious accounts and fake positions, by switching dates and names, the culprit managed to stay ahead of internal verifications. He would label operations pending, falsify pre-confirmations on future trades which avoided immediate red flags from back office and internal controls. The bank claimed that the culprit could do this as he had worked in the back and middle offices, knew all control procedures including computer systems.

But as the official report confirmed there was a serious breakdown in the internal chain of command. The facts are known , but answers to the following questions remain opaque:

Why was this trader allowed to assume huge positions with any outside control on a case by case basis?

Once the investigation began, it was discovered that fictitious trades had been on the books since 2005, for small amounts. Through 2007 the amounts surged, reaching close to 30bn euros in unaccounted for activity, when Eurex notified the bank, through November 2007 why were these warning ignored?

Why was he allowed to continue acting with positions as high as 50bn Euros if there had been prior warnings in January 2008?

Why was he allowed to plead to mistakes, cancel these transactions and not be put under supervision?

How secure were the computer systems, pass words and access codes?

Why, when the bank had been the subject of 17 inspections by the auditing committee of the commission of finances in 2006-2007 and comments were made on security concerns, were these concerns ignored.?

Why was a trader allowed to move from back office like Nick Leeson without any additional vetting or supervision and basically function independently with huge amounts of the bank's money? In 2008 why was the fire wall between back office and trading floor ignored after the lessons of Barings had become common knowledge and practice for all trading rooms?

There are clear parallels with Barings, the venerable British bank created in 1763, which was once considered the pillar of European banking, key partner of American investment houses throughout the 19th century and previously bailed out by the Bank of England in 1890. Barings also sought "to merge old style banking with a free wheeling security business"(FT, March 1995). Nick Leeson in charge of back office and handling trades in the Singapore office single handedly lost \$1.4bn of the bank's money by taking long positions on the Japanese Nikkei futures Index. Peter Barings, last of the original Barings on the Board blamed the "rogue trader". But the real failure occurred in the London offices inability to control and maintain oversight. Matrix management in reality meant decentralization to the point in which Singapore branch went unsupervised. London management did not understand the instruments nor the methodology. Between 1991-1995 Asian operations grew from 15 to 1000, without additional monitoring. Leeson cooked the books, creating fake account 8888 in back office. In January 1995 the Bank of England within hours of being informed of the magnitude of the problem decided that contagion in the City was unlikely as the issue was solvency not liquidity. The response

occurred in a global crisis environment barely a year after the Spanish bailout of Banesto which had to be folded into Santander, the ongoing losses at Credit Lyonnais and the Peso crisis full force with Mexico threatening to default and potential international meltdown. Barings was sold to ING, for 1 pound. ING the global Dutch bank absorbed its 660million pound loss. In 2000 “ Barings, the oldest name in London investment banking is set to disappear in a rebranding exercise. ING, its Dutch owner intends to phase out the local identities of subsidiaries worldwide” ((FT, October 25, 2000).

Leeson a fugitive was quickly caught, jailed , suffered cancer, and is now a paid consultant on financial crisis.

Historically major losses rarely occur in the home office. The Barings loss of \$1.4bn occurred in Singapore where Leeson took charge of back office while trading for numerous accounts : BaringsSecurity Japan, Barings Futures Singapore, Barings Securities HK. John Rusnak, lost Allied Irish \$691 million in Atlanta in 2002; Sumitomo’s Hamanaka “ Mr. Cooper” was discovered in1996 to have lost \$2.6 in fake trades in copper over 11 years in the New York office; Daiwa’s, chief government bond trader , Igushi lost \$1.1bn in 1997 in New York. In fall 2007 at CALYON a rogue trader lost 250 million euros on an unauthorized trade in New York. The excuse in each of these cases has included the lack of supervision in branch offices and the lack of vetting and communication with home office. Societe Generale losses took place in the main offices of the bank in Paris on the trading floor. Therefore the question of lapse of control, supervision and in house monitoring is all the more flagrant. Who was responsible in this chain of command: immediate supervisor, head of Delta One unit, head of asset

management, internal auditors, compliance officers? French organizational charts are far more vertical than horizontal especially in the Paris office. Was the head of section Mustier totally unaware? He has been neither charged , nor dismissed.

Jerome Kerviel, and Nick Leeson were both cases of extravagant positions taken, vast amounts of the banks money made available to junior traders, collusion between the back office and the trading floor, creation of fictitious accounts and benign complicity on the part of management. But where Barings failed or turned a blind eye to the doings of profitable traders in their Singapore office, Societe Generale'a lack of oversight which is still in the early stages of investigation and evaluation was also part of a larger cultural and historical hierarchy in which Jerome Kerviel was the culprit as well as the scapegoat. Once caught, grilled and threatened he made it clear that in this business model of derivative trading : "It is impossible to generate that much profit with small positions, which leads me to say that so long as I was in profit, the superiors closed their eyes to the way I did it and the amounts I took on. From day to day , in the normal course of trading and taking normal sized positions, no trader can generate that much money. As long as we were earning and it wasn't too visible, it was fine and nobody said anything"(Financial Times, March 2008)

This is a powerful argument and probably why Kerviel was never charged and is free. As in the Barings case, as long as the bottom line seemed to be in the black all was well. Despite warnings in the fall of 1994 to the London head office, like Eurotext warnings throughout 2007, senior management choose to ignore rather than investigate.

In an interview in Les Echos, Daniel Bouton vigorously refuted all allegations of collusion: “I want to categorically kill all these fantastical scenarios in which we sought out a scapegoat for I don’t know what purpose.” (“un bouc émissaire pour marquer je ne sais quoi, Les Echos, February 25)

Who was Kerviel? Like Nick Leeson, Jerome Kerviel was outside the social hierarchy which has dominated large European investment banks for the last 200 years.

But where Leeson was a high school dropout, Kerviel was educated in math and computers. Where Leeson had been relegated to the “colonies”, rather than London, Kerviel hired in 2000 at the Paris office as middle office support staff at a salary of 35,000 euros was smart enough to be promoted to the floor in 2005 as part of the elite, high power Delta One trading team. With degrees from “second tier universities” in Nantes and Lyon, “far removed from mathematicians” he was ambitious, hardworking and a loner. In order to prove himself he immediately began taking large unauthorized positions and won big on some bets.

For eight months prior he never took a holiday (just 14 days in August) and on weekends often went back to his hometown to see his mother. His only drinking buddies at the bar next to the office were the guys from the back office.

A computer whiz, he knew how to enter false contracts under different names, create false emails to confirm accounts and knew that computer passwords were not changed on a regular basis. When caught he “admitted inventing the false trades and said that he thought he had discovered a “martingale” an 18<sup>th</sup> century betting system based on doubling a bet after every loss”. But as bettors realized, martingales works only with

unlimited funds”. His head of division Mustier claimed he was “mythomane”. Bouton was “shocked” refusing to meet Kerviel and called him a “terrorist”.

Is Jerome Kerviel a real life incarnation of a very important myth in French collective conscience since the post Napoleonic era? Is he Julien Sorel, Rastignac, or Frederic Moreau the classic young man from the provinces in the novels of Stendhal, Balzac and Flaubert who comes to Paris where he encounters corruption, temptation and hypocrisy. Jerome Kerviel, son of a seaside hairdresser and metal work shop teacher, respectable, hard working lower middle class was “desperate to prove that he was the equal of the highly educated members of Parisian elite who dominated SocGen’s senior ranks”.

In his little town of Pont l’Abbe (pop8000) within a few weeks he became a local hero, a cult figure of everyman: “In keeping with the country’s deep rooted suspicion of capitalism, he is viewed as a little guy who has struck a blow against the fat cats of the global financial system”. A devoted son and average guy his has become a story of societal dichotomies and age old antagonisms.

The deputy mayor said : “It is Paris or the big people ganging up on the small Breton, we don’t like it”. (New York Times, February 17, 2008)

## II. INSTITUTIONAL HISTORY AND IDENTITY

Societe Generale, the last of the three grand old ladies of French banking to have kept her name and institutional identity intact was chartered on May 4<sup>th</sup> 1864, nearly a year after the opening of Credit Lyonnais in Lyon. 1864 was a very good year for France, French finance and French power. Paris was awash in money, urban construction

projects, lavish, vulgar displays of wealth in the parties of the super rich, the powerful and the antics of its courtesans. The franc was so strong and stable that in 1865 Napoleon III would set up the Latin Monetary Union as counterweight to the power of the omnipotent British pound.

September 28, 1864, in London, Karl Marx helped organize the First International. These two events emblematic of the era's social and political polarization are relevant to the events of 2008.

In 1987 Societe Generale, first of the big three state run banks to be privatized in the initial Mitterrand Chirac co-habitation, was judged the soundest in productivity and risk coverage, compared to Credit Lyonnais and BNP. Under pre EU French banking regulation the state could carry a 51% stake till 1999 and gradual reduction to under 10% as applied in the privatization of Credit Lyonnais. BNP (created in 1966 from BNCI and Comptoir National d'Escompte) was privatized in 1993 under the Balladur co-habitation. In 1998 one year before the proposed merger of Societe Generale and Paribas (encouraged by the Bank of France) SocGen's shareholders included Accor, AGF, Alcatel, Schneider, Vivendi, Axa. Under the leadership of Marc Vienot from 1987-1998 the bank specialized in commodity financing and investment banking. Bouton became CEO and Vienot chairman in 1997. Bouton fended off the hostile bid by BNP led by Pebereau in 1999 to derail the Societe Generale-Paribas merger. He retained the banks independence, despite American style pressure and tactics from BNP and warded off potential takeovers in the next decade. Its pool of qualified mathematicians and engineering specialists allowed it "a natural advantage in the complex field of equity derivatives. Instead of focusing on more traditional cash equities business and advisory

mandates as lead banks for M&As, Societe Generale focused on equity derivatives, quickly gaining a reputation as sole experts in EU markets; SocGen was an early pioneer of exchange traded funds in Europe- tax efficient, low fee investment funds that are traded on stock exchanges.

The bank combined two diametrically opposed sets of values: cautious, disciplined, risk adverse yet in order to earn huge profits in a hyper competitive environment, innovative, risk taking and creative. Elie Cohen of Centre National de la Recherche Scientifique wrote: "S-G is a pioneer, so it is not surprising that the most creative fraud would take place within the bank's most creative activity". S-G was ranked first or second since 2003 among equity derivative firms" according to Risk Magazine. In 2007, it received the award for 'Equity Derivatives House of the Year' from The Banker."

In 2008 Societe Generale has 120,000 employees in 77 countries and 22 million retail banking customers. A global player, it is the lead French bank in former CEE countries with a presence in Poland, Serbia, Rumania, Moldova, Bulgaria, Croatia, Czech Republic, Slovenia as well as Morocco, Ghana, Brazil and with a stake in Rosbank, Russia's second largest retail bank. It retains successful, highly profitable operations in the United States and in Asia.

On June 18<sup>th</sup> the Financial Times announced that Societe Generale and Rockefeller&Co, US wealth management firm "have formed a private banking alliance". Societe Generale acquired a 37% stake in Rockefeller Financial Services. This is the first major transaction for Societe Generale "since January's rogue trading scandal rocked the bank. Daniel Bouton made the deal by reassuring Rockefeller and Co that "it was a one time problem and did not reflect systemic weakness". As wealthy clients of private bank are increasing

in the United States this move allows Societe Generale to penetrate the private banking market segment in the United States. At the news SocGen shares rose 3.2 % to 60 euros.

Alls well that ends well...

European top banks and corporations carry long historical traditions. In 1999, nearly 40% and in 2008 French nearly one third of CAC 40 were created before 1914, including Societe Generale, BNP/Paribas, Credit Agricole, Lafarge, Vivendi-Veolia, (former Compagnie Generale des Eaux), Schneider, Suez, Michelin, Sanofi-Aventis ( former Rhone Poulence-Hoechst), Dexia, AXA and Saint Gobain, created under Colbert in 1665. On the German DAX most corporations, dismantled, divested and totally reconstituted after 1957, nearly half of the 30 were incorporated before 1914: Allianz, Bayer, BASF Commerzbank, Continental AG, Daimler, Deutsche, Post bank, Henkel, Siemens. Munich Re, Thyssen-Kruppp. On the London FTSE (FOOTSIE)100, among the top 25 in market capitalization over half were established in the 18<sup>th</sup> and 19<sup>th</sup> century, many as part of the British Empire including Royal Dutch Shell, Standard Chartered, AngloAmerican, Royal Bank of Scotland, Rio Tinto Group, HSBC,BP, British American Tobacco, Barclays, Lloyds, Royal Bank of Scotland. But where the UK could be brutally pragmatic and allow the dissolution of Barings, French and German governments and finance work in unison to maintain national and institutional integrity whenever possible. Mergers and consolidation remains in-country and adversarial to foreign bidders.

Socio historical and cultural guidelines for French banks and corporations were first established in the symbiotic relationship between the state, Treasury and industry in the name of the monarchy under Colbert, Louis XIV Minister of Finance. This paternalistic

model of industrial policy, revived and adapted to the tenets of post Napoleonic France were part of Auguste Comte's and Saint Simon's philosophy of oligarchic social capitalism which dictated French market ideology through the Second Empire and Third Republic. The state in close collaboration with industry would choose which sectors and which institutions best served the interests of France and then encourage these sectors to aggressively pursue their market share. Credit Lyonnais, founded in 1863 as the first deposit bank, independent of the monopoly of the Bank of France as well as Societe Generale in 1864 became part of this larger cultural framework which maintains and respects strong centralized dirigiste policies internally and externally.

.Henri Germain, founder of Credit Lyonnais ( who presided over the bank from its inception in 1863 to his death in 1905) and Eugene Scheider who spearheaded Societe Generale were conservative, moderate republicans, disciples of Saint Simon who viewed their banks as engines of France's economic expansion and a means of devoting finances to public works and public good. When Sarkozy or Villepin spoke of economic patriotism, they are part of this long tradition in which the prestige of the state and its economic well being are intrinsically linked.

Despite Napoleon III's pro market and pro business approach, banking was still regarded with suspicion and both of these institutions had to overcome inherent fears and insecurities bred into the French mindset since the Law debacle of 1720. The balance of deposits in French banks between 1840 and 1863 was 50 times less than in England.

Wealth was hoarded in gold and in land investment. French merchants, newly wealthy middle class and aristocrats still traumatized by the souvenir of the Revolution had to be coaxed and persuaded to trust deposit banks. Fundamentally Societe Generale, Comptoir

d'Escompte and Credit Lyonnais represented solid, cautious, disciplined and almost provincial values. Adrian Mazaret, influential businessman and director of Credit Lyonnais wrote in a letter in 1865 :

“For a bank the first quality is wariness: it is necessary to be systematically wary of every person, every deal. It is necessary to always question what is the motive, what is the reason and if one is not totally satisfied, to not hesitate to abstain.... The resistance of the banker must be proportionally equal to the insistence of the client”. The legislature passed a new law on May 5, 1863 on SARL, Joint Stock Limited Partnership which allowed companies to start up with only an initial capital of 20 million. Credit Lyonnais started with 40,000 shares. In 1864 Societe Generale's initial offering included 3000 shares held by Credit Lyonnais top shareholders. By 1865 the banks began to open branches, trying not to step on each others territory. Following the credit crisis of 1866, there was a surge of investments and placement abroad. Both banks begin to seek out foreign markets in the first wave of global financial operations.

Although there were withdrawals after the financial crisis of 1866, the war in 1871, 1873 and the panic of 1882, overall depositors were given guarantees that the bank always maintained sufficient reserves to cover any losses and especially to avert a run on the bank. Societe Generale in Paris and Credit Lyonnais in Lyon transformed French banking from elitist private banking and limited credit facilities monopolized by the Bank of France, the Rothschilds and Banque Laffitte into a modern sector, capable of competing with the global British banks like Barings, Barclays and Lloyds. These banks were different in name, concept and public. Called credit, caisse, comptoir and societe they extended credit facilities to “newer capitalists”, were ready to engage in merchant and

investment transactions and offered crossover between traditional activities of the “haute banque” and banque d’affaires”, investment and commercial banking. As early as 1865 Societe Generale and Credit Lyonnais were in direct competition with Bank of France, able to attract private capital by offering advantageous conditions, better levels of interest and willingness to work “at any price and at all prices”. Arles Dufour wrote in 1863: “The monopoly of the Banque de France and especially the way in which it is exercised, is so detrimental to commerce that I applaud anyone who can beat them at their own game”.

These banks proved their political clout during and in the aftermath of the Franco-Prussian War, first by the transfer of large groups of assets to London and gold reserves to Geneva and in 1872 by actively participating in the war reparation bond issues. Credit Lyonnais led with Rothschild and Bank of France, followed in 1872 by the participation of Societe Generale, Credit Foncier and the newly founded Banque de Paris et des Pays Bas.

In competition and occasionally in syndicated deals the banks funded huge municipal works projects, urban infrastructure and reconstruction. Maintaining close contacts with newly founded insurance companies, often under the auspices of the major banks Societe Generale was considered more adventuresome in some operations. Directors of banks were also members of industry boards and could assume government positions. In 1879 an article in *Economiste francais* refers to 400 members of Parliament who are Board members and directors of top companies and banks. France went through a new wave of intense risk taking and speculation in the 1879-1882 boom years till the crash of 1882

causing critics to question the objectivity of banks concerning the corporations they represented.

Throughout the 19<sup>th</sup> and 20<sup>th</sup> century Societe Generale's rivals are Credit Lyonnais, Bank of France, Comptoir d'escompte. At the height of colonial expansion, French banks were global institutions and seen as "bankers to the universe" with offices across Europe, the Middle East, North Africa, IndoChina and Russia. Societe Generale and Credit Lyonnais are competitors in all areas with SocGen judged by the Bank of France as somewhat more aggressive in deals according to a 21 May 1878, Banque de France inspection report.

Taking on a lower profile, closing ranks and focusing on domestic networks, the major banks withstood the turmoil of 1924-1926 and the disastrous war years. However in 1946, DeGaulle understood that in order to restore credibility in the currency and the major banks the state had to intervene to set up one unified system. Societe Generale, Credit Lyonnais as well as the Bank of France were nationalized in 1946.

The banks remained in status quo till the Mitterrand years when the complex marriage of socialism and capitalism led to privatization and reforms.

### III. SPECIFIC FRENCH SOCIO-CULTURAL CHARACTERISTICS

A New York Times Feb 17 article: "Where the Heads no longer roll" describes the closed elite circle of the Club of 100, created in France as a gastronomy society of wealthy Parisian businessmen in 1912. This group which included Daniel Bouton, Claude Bebear, founder and CEO of AXA, who just retired (and who remarked in an interview on Feb 17 "The CEO of a French company is more of a monarch than in the US ( "monarque

eclairé”), Fourtou, head of Vivendi, Michel Pebereau of BNP. This club is “a close knit brotherhood-its nearly all male- that shares school ties, board memberships and rituals like hunting and wine tasting”. Bebear, often called “godfather of French capitalism” was replaced in 2000 at AXA by Henri de Castries, also graduate of ENA. De Castries’ ancestor was naval minister under Louis XVI, his grandfather US ambassador under DeGaulle. Over half of France’s CAC 40 are run by graduates of ENA and /or Polytechnique. Like Bouton, the new head of Societe Generale is Francois Oudea, graduate of ENA and Polytechnique whose prior positions between 1987-1995 were at the Ministry of Finance, Economy and Budget. Mustier, head of Corporate Investment and Kerviel’s superior is 47, ENA/ Poly; the banks’s CFO is from Poly, formerly with Indosuez and Dresdner. In France as in Germany many bankers at major institutions have life long careers; many have second or third generation or by marriage affiliations. It is part of a French tradition since the Restauration and July Monarchy of 1830 that top officials move between positions in industry, high finance and government , often maintaining government positions simultaneously with board memberships in each of these sectors.

The independent directors who throughout the spring continued to express vote of confidence in Bouton even as President Sarkozy suggested he should step down are Antoine Jeancourt Galignani- former head of AGF and Banque Indosuez, Folz of Peugeot and Azema from Vivendi. What these interconnections prove is that by contact, rank, birth right and career path the inner sanctum of French corporate structure is closed and fundamentally has not changed in nearly 150 yeas.

Chirac in his first term 1995-2002 was ineffective in combating this inbred system, alienating rather than integrating the business community which put him in power. He tried half heartedly and failed to undo what an article in the Banker in January 1996 described as : “ A system of crossshareholdings, interlocking boards and shareholder pacts that permits them to exert control, even though in the minority at the expense of profitability”. The insiders waltz or “ Pantouflage” continues. The term refers to the word for slipper, a metonym for cozy, familial arrangements. In 2008 the term accountability can replace profitability, but the message remains the same.

The premise set out in 1984 by Jane Kramer in her analysis of the Paribas scandal (evading Mitterand’s nationalization ( called”la recuperation du patrimoine”) by moving assets to Switzerland)has again to be questioned:

“It is part of the folklore here that land and Catholicism have left the French unfit for capitalism” (New Yorker, August 6, 1984)

In 2008, France has proven that it can respond efficiently and aggressively to the demands of the market. But the conundrum remains, in order to be fit , it has to define it’s own version of capitalism , which respects elitist, oligarchic, dirigisme in the name of French competitiveness and prestige.

It is a form of capitalism which rewards innovation, creativity and risk taking, but within a tightly structured societal and intellectual framework

In part, France has always regarded its finances and banking sector as a part of the civil service, a government function or a function protected by the government depending on the status of the institutions.

The rapid industrial and financial transformation of France from the 1850s to the 1880s established in the cultural sphere an economic typology, a mythic universe with a new theogony within the capitalist pantheon. By the 1830s, popular culture, literature and the arts had become obsessed with monetary, transactional, commercial issues.

The Bourse dominates theater, novels caricatures, articles and pamphlets. Prudhon in his *Manuel du speculateur a la Bourse*, 1854, followed by Jules Valles, *L'Argent par un home de letters devenu home de Bourse*, in 1857 under the guise of vicious satire become part of a tradition attacking the principles, lures and pitfalls of speculation.

The Stock exchange in 1826 had about 30 listed shares. In 1850 the number rises to 118, by 1869= 407(298 French, largely railroads, banks, insurance) and 109 foreign. The stereotype of the unscrupulous speculator Robert Macaire and the naïf shareholder M. Gogo (characters created in the Frederick Le Maitre play: *L'Auberge des adrets*), caricatured by Philippon and then by Daumier is ingrained in popular imagination.

Both left and right were deeply ambivalent toward monetary and especially speculative activities. On moral grounds the basic paradox was that speculation, even short term stock speculation on gold against paper shares “agiotage” so bitterly attacked in the 18<sup>th</sup> century was an essential part of market activity which moved forward industrial, commercial infrastructure urban expansion across France. During the Second Empire the banker is brought out of the shadows into the limelight. Rothschild, Laffitte, Casmir-Perrier, Achille Fould, all had interests in commerce, international trade and banking to expand and facilitate their transactions. In unison with a state eager for reform and growth, they represented the motors for French economic development in a period which Alain Plessis rightly called “the railroad revolution, the banking revolution, the creation

of business” ( la revolution ferroviere, la revolution banquiere.... Le bourgeoonnement d’entreprises” which takes off after the laws of 1863 and 1867 which allow SARLS, societes anonyms.)

This surge of activity is however in reality limited to a fraction of the population, Alain Plessis quotes a study in 1861 that about 150,000 Frenchmen have listed shares in their portfolio . France still remains and will remain a nation of landowners, tangible assets, gold and bank notes.

The definition of capitalism in France is an ongoing process. Can republican meritocracy be reconciled with elitist oligarchic management? Sartre in his biography of Flaubert made the essential distinction of Flaubert’s inability to reconcile having and earning money, the contempt for the act of acquiring versus the respect for the act of having, inherited wealth.

In France and Germany in the last decade there has been slow dismantling of 19<sup>th</sup> century corporate governance, closed doors, incestuous boards, arcane accounting, opaque supervisory mechanisms, a slow acceptance of the role and voice of shareholders. Large multinational corporations have accepted cultural shifts ( use of English in the boardroom), however the assumption remains that structural changes should be brought about by the government not the private sector, therefore the schism

But now this privatized financial and corporate sector is no longer accountable to the government as owner and majority shareholder, therefore when the government requires it to implement policies or politics, it can and has refused. Profit is a motive for the French corporate class, but social responsibility remains a subtext in the political and corporate discourse.

While Sarkozy understood this paradox, it has hindered his ability to implement radical reforms. The electorate, suffers from a social malaise, growing unemployment to nearly 10% and as high as 40% in immigrant communities, ineffective stagnant labor markets entrenched by social policies remain geared to a state run economy. In a recessionary global environment, growth is predicted at 1.5 – 2% top for 2008-2009. The population at large has never crossed over from the sense that the government is still the creator and guarantor of their jobs and security: an emotional lender of last resort. In the last decade despite an almost totally privatized corporate, financial and media sector France remains highly ambivalent on the Anglo-American model of non state intervention.

A survey in April 2006 at University of Maryland showed that only 36% of French are in favor of “ free enterprise and market economy as the best system for the future”. Of twenty countries surveyed : US=71%, Germany=65%, China=74%., Spain=63%, UK=67%, Russia=43%, France has the lowest score in overall faith in the system.

This is not a new paradox, nor a new battle, the lines in many ways have been drawn since the early 19<sup>th</sup> century, a constant push and pull between the revolution and “nostalgie de la monarchie” which still dominates French political, social and economic life. This is an ongoing issue and the scandal at Societe Generale will merit an ongoing investigation. Will heads roll? Not very likely. There will be more controls, more scrutiny and more care taken on risk management issues and procedures, but overall, once the losses absorbed and the markets fully calmed, the culture will remain the same. Societe Generale will continue to hire the best and the brightest globally. The derivatives game may have lost its charm , for now and certainly derivatives in the name of arcane

mortgage instruments have been tainted. But as we learn through history, there is always another scandal, another fraud and another particularly right, ambitious young man hoping to strike gold.

The great irony is that it was not Kerviel but Societe Generale and Bouton who succeeded at the “martingale”. Keep on betting in order to recoup your losses, do not lose your nerve , nor your flair and know that you do have a limitless amount of resources, not only reserves in the narrow liquidity sense of the term, but profound historical, institutional, national reserves which will not let you fail.