Risk Management in Context
One evening in the autumn of 1995, I flew into Boston to have dinner with Denis McCarthy, then the chief financial officer (CFO) of Fidelity Investments. McCarthy was the person to whom I would report if I accepted an offer to become the first chief risk officer for the corporation. I asked him what the main objective would be for this new position. His reply: “We want to operate in an environment in control, not a controlled environment.”

I took that job with the understanding that Fidelity wanted to improve its risk management practices, but not at the price of destroying the entrepreneurial spirit and product innovation that had made it the largest mutual fund company in the United States.

Fidelity was not alone then and is not alone now. Every business faces the parallel challenges of growing earnings and managing risks. A thriving business must identify and meet customer needs with quality services and products; recruit and retain talented people; and correctly make business and investment decisions that will lead to future profit opportunities. However, the pursuit of new profit opportunities means that a business must take on a variety of risks. All of these risks must be effectively measured and managed across the business enterprise.

Otherwise, today’s promising business ventures may end up being tomorrow’s financial disasters. As I am fond of telling audiences when speaking on the importance of risk management: “Over the longer term, the only alternative to risk management is crisis management—and crisis management is much more expensive, time consuming, and embarrassing.” The majority of such audiences have experienced one or more crises in their time, and so this is a message that rings true.

Every business decision involves an element of risk. There are risks involved in making investments, hedging with derivatives, or extending credit to a retail customer or business entity. There are also risks involved when developing and pricing new products, hiring and training new employees, aligning performance measurement and incentives with business objectives, and establishing a culture that balances revenue growth and risk management.
Over time, individual business decisions and risks collectively build up into a company’s overall risk portfolio, which will have a unique risk profile. This risk profile will determine the company’s earnings, and earnings volatility, over the business cycle. Some decisions will be winners and some will be losers. Some risks will offset each other, some risks will be unrelated to each other, and some will compound each other. In order to manage risk effectively, a business must address not only its underlying risks, but also the inter-relationships between them.

As we will see from the numerous case studies discussed in this book, ineffective risk management can lead to reduced earnings or even bankruptcy. However, risk management means different things to different people. In this book, risk management is defined in its broadest business sense. Risk management is not just about using derivatives to manage interest rate and foreign exchange exposures—it is about using a portfolio approach to manage the full range of risks faced by an enterprise. Nor is risk management only about establishing the right control systems and processes—it is also about having the right people and risk culture. And although the term has come to have some negative connotations, risk management is not only about reducing downside potential or the probability of pain, but also about increasing upside opportunity or the prospects for gain.

Individual investors managing their portfolios must be careful when it comes to the amount of risk that they take on. If they take on too much risk, perhaps by making aggressive investments, the losses could exceed their risk tolerance, or be too uncertain for comfort. On the other hand, if they fail to take on enough risk by making conservative investments, they may earn returns that are stable, but inadequate for achieving their financial objectives.

Striking an optimal balance between risk and return is not only important to the individual investor, it is also an imperative for business management. The concept of “no risk, no return” is widely accepted in the business world. A corollary to that concept is “higher risk, higher return”, a positive relationship illustrated in Figure 1.1. This is how many people think about the trade-off between risk and return, and it has the virtue of simplicity. However, it is certainly not valid if risk is put into its proper perspective.

A better way to think about risk and return is illustrated in Figure 1.2. The focus is no longer on the relationship between risk and absolute return, but about the relative or risk-adjusted return. A company in Zone 1 is not taking enough risk, and its capital is being underutilized. This company would be better off increasing risk through a growth or acquisition strategy, or reducing capital through higher dividends. In Zone 3, however, the company is taking too much risk. This company’s risk level is above and beyond its risk absorption capability in terms of capital and liquidity resources, and/or its risk management capability in terms of people and systems.
In Zone 2, the company has found the sweet spot that optimizes its risk/return profile. The problem is that most companies do not even have good information on enterprise-wide risk exposures (which is to say, where they are on the horizontal axis), let alone where they are on the risk-adjusted return curve. To make matters worse, the net present value (NPV) and economic value added (EVA) models frequently used in strategic planning naturally favor higher-risk investments unless proper adjustments are made.
to account for risk. Over time, investments guided by these unadjusted models may inadvertently lead a company to drift into Zone 3.

A principal message of this book is that a company should develop an integrated approach to measuring and managing all of its risks in order to optimize its risk/return profile. A key management requirement for risk/return optimization is to integrate risk management in the business processes of the company.

We’ve seen, then, that risk is an inescapable part of doing business and argued that a business should strive toward its optimal risk-return profile. However, there is another question that deserves examination: why manage risk? Indeed, why read this book?

A company could conceivably agree that it bears risks but feels it inappropriate to manage them, rather than simply live with them. Risk management may seem to be irrelevant, too costly, or not in accordance with the interests of the company’s stakeholders. Some academics have argued positions close to these, as we will see. Certainly, before a company invests money and other valuable resources into risk management (and before the reader spends any more time reading this book), the value proposition of risk management needs to be clearly established.

Perhaps the best way to answer the question “why manage risk?” is to borrow a popular technique used by diet and other self-improvement programs. That simple but effective technique is to paint a clear picture of the gain of action along with an equally clear picture of the pain of inaction. In the next section, we’ll paint the happy picture—the benefits of effective risk management in terms of the expected benefits and gains. In the section thereafter, we’ll paint the dire picture of the severe negative consequences—the pain—that may be suffered if effective risk management is not in place.

THE BENEFITS OF RISK MANAGEMENT

Numerous academic papers have established the theoretical basis for managing risk—arguing that it can reduce taxes, reduce transaction costs, and improve investment decisions. However, beyond the theory there are at least four practical reasons why risk management should be of paramount importance to the management of a firm. In this practical context, risk management should be defined more broadly to include internal controls as well as hedging.

Let’s now take a look at these four reasons in turn.

Reason #1: Managing Risk Is Management’s Job

One notion in modern finance theory is that managing risk, or more specifically hedging, is not necessary because an investor can reduce risk through a
diversified investment portfolio. Regardless of what some theoreticians may argue, you will never in the real world hear a fund manager or individual investor tell a company’s management: “Don’t worry about managing risk or bankrupting the company—I have a large diversified portfolio.”

Managing the risks of a business enterprise is the direct responsibility of its management, not its shareholders. While modern portfolio theory is a major contributor to the theory and practice of finance and risk management today, the argument that the investor can better manage or diversify risks does not ring true in the real world. The average individual investor probably spends more time buying a new car than addressing the risks of his or her investment portfolio. Even the professional fund manager is several degrees away from the insider knowledge required for effective risk management, which includes:

- Historical data on risk/return results, volatilities, and correlations;
- Current risk exposures and concentrations in the business; and
- Future business and investment plans that may alter the firm’s risk profile.

Given the complexity of the above information, as well as the lack of full transparency to outsiders, the shareholder cannot be expected to make optimal risk/return decisions. Measuring and managing enterprise-wide risks is a great challenge even for the enterprise’s management, who have superior access to information and support from risk management professionals. The most that shareholders can do is to elect an independent and risk-astute board that will represent their interests, and walk away with their investment dollars if they are not happy with management’s performance. In the meantime, it remains management’s job to ensure that the company achieves its business objectives and is not exposed to excessive risks.

**Reason #2: Managing Risk Can Reduce Earnings Volatility**

One of the key objectives of risk management is to reduce the sensitivity of a firm’s earnings and market value to external variables. For example, the stock prices of companies that are more active in, say, market risk management should exhibit lower sensitivity to market prices. This is borne out by the empirical evidence. For example, in a study published in 1998, Peter Tufano of the Harvard Business School ranked gold producers in terms of the intensity of their hedging activities. The conclusion was that the stock prices of those in the top quartile were about 23 percent less sensitive to gold price changes than those of the bottom quartile. A more recent study conducted in 2007 corroborates Tufano’s findings, and further reveals that the gold producers that hedge more tend to have larger asset values:
extensive hedgers, modest hedgers, and non-hedgers have, respectively, average asset values of $1,140 million, $614 million, and $200 million. This demonstrates how gold producers are aware of how the importance of risk management grows in direct proportion to the size of the company.

As such, companies exposed to interest rates, foreign exchange rates, energy prices, and other market variables can better manage earnings volatility through risk management. Managing earnings volatility today is more important than ever given that the stock market severely punishes stocks that fail to meet earnings expectations. At the same time, the Securities Exchange Commission (SEC) and other regulatory bodies are cracking down on earnings management practices that use accounting techniques to smooth out earnings. In this business environment, management must pay more attention to managing the underlying risks of the business.

Reason #3: Managing Risk Can Maximize Shareholder Value

In addition to managing earnings volatility, risk management can help a business enterprise to achieve its business objectives and maximize shareholder value. Companies that undertake a risk-based program for shareholder value management typically identify opportunities for risk management and business optimization that can add 20 to 30 percent or more to shareholder value. Such improvements can be achieved by ensuring that:

- Target investment returns and product pricing are established at levels that reflect the underlying risks;
- Capital is allocated to projects and businesses with the most attractive risk-adjusted returns, and risk transfer strategies are executed to optimize portfolio risk and return;
- The company has the appropriate skills to manage all of its risks in order to protect against large financial losses or damage to its reputation or brand;
- Performance metrics and incentives, at both the individual and business unit levels, are in congruence with the enterprise’s business and risk objectives; and
- Key management decisions, such as mergers & acquisitions and business planning, explicitly incorporate the element of risk.

Strategies for achieving these objectives, and case studies of how they work in practice, will be discussed in the main sections of the book.

In a 2009 study, Massimo Mancini of the Kellogg School of Management has supported the notion that active risk management contributes to shareholder value. Using hedging as a proxy to define active risk management,
Mancini studied the fuel hedging practices of airlines: he noted that hedgers were rewarded with 15 to 16 percent more economic value than non-hedgers. Risk management adds value not only to individual companies, but also supports overall economic growth by lowering the cost of capital and reducing the uncertainty of commercial activities.

**Reason #4: Risk Management Promotes Job and Financial Security**

On an individual level, perhaps the most compelling benefit of risk management is that it promotes job and financial security, especially for senior managers. In the aftermath of the 2008 turmoil in financial markets, a significant number of CEOs, COOs, chief risk officers (CROs), and business group heads of financial institutions lost their jobs because of poor risk management performance. Senior executives in other industries have faced similar fates in the wake of risk management problems. More recently, senior executives involved in corporate frauds and accounting scandals have appeared on national TV being led away in handcuffs and face the potential of severe criminal sentences.

In addition to career risks, senior executives with a significant portion of their wealth tied up in company stocks and options have a direct financial interest in the success and survival of the firm. These incentives, if structured appropriately, work to put the skin in the game for managers, resulting in a strong alignment between management and shareholder interests. Risk management provides managers with a higher degree of job security and protects their financial interests in their firm.

**Integration Adds Value**

Risks faced by companies are highly interdependent. Consider these risks in the form of a Venn diagram (Figure 1.3). Next, realize that key interdependencies exist between financial risk and business risk, business risk and operational risk, and operational risk and financial risk. Now further examine the fact that each of these major categories of risk is comprised of more granular risks. For example, financial risk, as demonstrated in Figure 1.3, can be broken down into market risk, credit risk, and liquidity risk. These financial risks in turn have their own interdependencies. Let’s examine loan documentation as a practical example of a key interdependency between operational risk and financial risk (i.e., specifically credit risk).

As a business process, the quality of loan documentation is usually considered an operational risk. However, if a specific loan is performing (i.e., the
borrower is making timely loan payments), the quality of that specific loan document has no real economic impact. On the other hand, if that loan is in default, the quality of the loan documentation can have significant impact on loss severity, with respect to collateral and bankruptcy rights. Interestingly, loss analyses conducted by James Lam & Associates at lending institutions revealed that up to one-third of “credit losses” were associated with operational risks.

With such a complex, interlocking system of company-wide risks, it is obvious that a silo-based risk management strategy is inferior to the integrated framework of ERM. Having separate organizational units or individuals address specific risks requires that these risks be segmented and then isolated in different parts of a company. Because risks are highly interdependent, this distribution cannot be efficient or effective. Targeting individual risks as silos will not account for the interdependencies between them, meaning associated risks may not be captured and the big picture may be completely overlooked. Gaps and redundancies will result in an inefficient system. In addition to the critical issue of interdependencies, another key weakness of a silo-based risk management approach is the challenge of aggregating risk exposures across the organization. For example, if business units use different methodologies and systems to track counterparty risk, then it would be difficult to quantify the aggregate exposure for a single counterparty. While the individual exposures at each business unit might be acceptable, the total counterparty exposure for the organization may be too great.
Enterprise risk management (ERM) provides integrated analyses, integrated strategies, and integrated reporting with respect to an organization’s key risks, which address their interdependencies and aggregate exposures. In addition, an integrated ERM framework supports the alignment of oversight functions such as risk, audit, and compliance. Such an alignment would rationalize risk assessment, risk mitigation and reporting activities. Moreover, an integrated ERM framework would consider how macroeconomic factors can impact the organization’s risk/return profile, such as interest rates, energy prices, economic growth, inflation, and unemployment rate.

More examples that demonstrate how integration adds value can be found in other areas of business management and technology. In business management, I believe that the integration of strategy and risk is the next frontier in ERM. A number of studies—James Lam & Associates (2004), Deloitte Research (2005), and The Corporate Executive Board (2005) have found that strategic risks represented approximately 60 percent of the root causes when publicly traded companies suffered significant market value declines, followed by operational risks (approximately 30 percent) and financial risks (approximately 10 percent). The integration of strategy and risk allows a company’s board and management to better understand and challenge the underlying assumptions and risks associated with the business strategy.

In technology, system integration also brings many benefits, since such integration allows for enterprise-level data management, robust business and data analytics, straight-through transaction processing, and more effective reporting and information sharing.

Further examples where integration adds value can also be found outside of business, such as in exercise and martial arts. In fitness programs, cross-training is recognized by fitness experts as having many benefits. By integrating cardio with strength training, flexibility training, and endurance training, athletes can prevent injuries, rehabilitate injuries, enhance strength and power, and improve the functional strength of their bodies.

In the world of mixed martial arts, which has developed in the past 20 years, the integration of various styles has demonstrated that it can add value to centuries old practices and beliefs. Traditionally, it was believed that a silo-based approach to martial arts was superior and that a martial artist should be dedicated to one specific style. Single style martial artists would argue about which style was the most superior. However, the emergence of mixed martial arts has changed that attitude. A mixed martial artist combines karate, kung fu, jujitsu, tae kwon do, wrestling, and multiple other fighting styles, allowing them to adapt to any situation; this gives them a significant advantage when in combat with a fighter trained in a single style.

The key point here is that integration adds value, whether it is in the practice of ERM or many other aspects of business and life.
Ultimately, the arguments above may not sway skeptical managers. Arguments based on the potential gains of improved risk management can be supported by those that point out the potential pain of ineffective risk management. However, these are very often rebutted by the sentiment that “it couldn’t happen here” or “if it ain’t broke, why fix it?” In these cases, it is worth reminding the skeptics that history has repeatedly demonstrated how bad things can and do happen to good companies.

If anyone ever doubts that risk management is a critical issue for any business enterprise, they should take a hard look at Figure 1.4. The wheel of misfortune illustrates that risk management disasters can come in many different forms, and can strike any company within any industry. Beyond purely financial losses, the mismanagement of risks can result in damage to the reputation of the individual companies, or a setback for the careers of individual executives. The damage can quickly escalate until a previously healthy firm suddenly faces bankruptcy; indeed, the cumulative losses suffered by U.S. thrifts in the mid-1980s bankrupted not just individual companies, but the entire industry.

A close examination of these disasters serves two purposes. First, it underlines the importance of risk management. Second, it offers an insight into the prime tenets of a new, advanced approach to risk management—the approach called enterprise risk management, with which this book is primarily concerned. We’ll develop these tenets in the next few chapters.

Let’s take a deeper look now, going beyond the immediate headlines to assess the underlying causes and find some more durable truths. An entire book, if not several, could undoubtedly be written about notorious business disasters of the twentieth and twenty-first centuries, but we will review six actual cases here:

1. Bausch & Lomb, a consumer products company;
2. Kidder, Peabody, an investment bank;
3. Metallgesellschaft, an energy company;
4. Morgan Grenfell, an asset management company;
5. Société Générale, a global bank; and
6. MF Global, a commodity trading firm.

The Shortsightedness of Bausch & Lomb

In 1993, the optical manufacturer Bausch & Lomb (B&L) was a world leader in contact lenses and sunglasses. B&L was a company run very much according to the numbers, with failure to reach sales targets regarded as
inexcusable. According to the *CPA Journal* (1 September 1998), the company’s contact lens division (CLD) had met or exceeded expectations for no less than 48 consecutive months, but in fall 1993 it was becoming apparent that it was not going to make its numbers.

The CLD made back some ground by offering distributors heavily discounted prices and extended payments. This promotion produced sales that surpassed third-quarter forecasts, but had the considerable drawback that the glut of contact lenses now in the market would depress fourth-quarter sales even more than they had been in the third quarter. If the CLD were to meet its fourth-quarter earnings expectations, it would have to resort to still more extreme measures.

It did. The CLD told its distributors that their relationships with B&L would only be maintained if between them they took on its remaining inventory. Most accepted, although this meant accepting ridiculously huge...
volumes of product—some ended up with as much as two years’ worth of inventory. At the same time, the CLD also fell foul of its retail customers after Business Week alleged that it had been selling the same lenses as disposables (priced as low as $7.50) and as traditional lenses (priced at $70). More than 1.5 million buyers of the expensive lenses sued; the claim was ultimately settled in 1996 for a reported $68 million.

The CLD’s actions—which, when uncovered, led to an SEC investigation and a $22 million charge against earnings—might have been considered an isolated aberration, had it not been for the fact that another B&L division was also employing dubious practices to shift product at around the same time. The Asian Pacific Division (APD) sold half a million pairs of sunglasses that were shipped to a warehouse in Hong Kong rather than to their putative buyers. This meant that the APD’s accounts receivable balance rose rapidly; but rather than raise provisions against bad debts, it conducted exchange transactions so that the customers in question received credits to their accounts and then repurchased the goods.

The APD generated another $20 million of misreported revenue; together, the two rogue divisions led to a $17.6 million overstatement of net income. The company corrected its financial statements in 1996 and paid $42 million to settle a class-action suit brought by shareholders in 1997. The damage was done, however. B&L’s share price grew only sluggishly as U.S. equity markets boomed during the 1990s, despite healthy revenues—perhaps the ultimate irony for a company that had valued performance above all else.

The Curtains Close on Kidder, Peabody

At the beginning of 1994, business at General Electric appeared to be going swimmingly. Under the direction of Jack Welch, considered by many to be one of the world’s top CEOs, it had reported 51 consecutive quarters of earnings and was widely regarded as one of the few truly successful conglomerates. All that was about to change.

Trouble was brewing at Kidder, Peabody, the investment bank in which GE held an 80 percent stake. Kidder had already caused GE embarrassment in 1987—the year after it was acquired—when it was fined $25.3 million by the SEC for insider trading. This time the problem was much more complex and controversial. Kidder was about to take a $210 million charge after taxes against first quarter earnings for 1994, resulting in a first-quarter loss of $140 million.

Kidder alleged that the loss was due to bogus profits recorded by Joseph Jett, the 36-year-old managing director of the government-trading desk. Jett’s basic strategy was to enter into forward contracts that involved the exchange of strips (interest-only government paper) for bonds. His employer
claimed, however, that when the date of the exchange came, Jett would roll the loss-making contracts forward and log fictitious profits (as reported in *The Wall Street Journal*, 18 April 1994).

Jett recorded $350 million in profits in 1993—enough to earn him a $9 million bonus. His $10 million compensation exceeded even that of Jack Welch. But according to Kidder, the profits were phony; Jett had allegedly concealed a $9.5 million loss in 1992, $45 million in 1993, and $29 million in the first few months of 1994. Jett claimed that he was made a scapegoat for Kidder’s underperformance.

What really happened may never be known. Although the SEC subsequently found Jett guilty of books and records violations, no criminal charges were ever filed and the National Association of Securities Dealers (NASD) cleared him of fraud. But the aftermath was nonetheless devastating. Jett was only the first to go, followed either through dismissal or resignation by at least five former colleagues including the CEO and the head of brokerage. Kidder itself was sold later that year to a rival brokerage, Paine Webber, for a knockdown price of just $90 million.

Although the Jett affair was more opaque than many later trading fiascoes, many of its root causes—inadequate oversight of traders and understanding of trading strategies—have been repeated. Most notable was Barings, the venerable UK merchant bank which collapsed in 1995 after more than $1 billion of trading losses run up by rogue trader Nick Leeson. Kidder’s tale, and the others like it, suggest that companies should not be so dazzled by the golden geese that they stop looking for the rotten eggs.

**Meltdown at Metallgesellschaft**

One of the most celebrated financial disasters of the 1990s was the massive loss racked up in crude oil trading by Metallgesellschaft Refining and Marketing (MGRM), an American subsidiary of the international trading, engineering, and chemicals conglomerate Metallgesellschaft (MG).

In 1992, MGRM implemented an apparently lucrative marketing strategy. The company agreed to sell specified amounts of petroleum products every month for up to 10 years, at pre-agreed prices above the current market price. The company then used a stack hedging strategy, under which it purchased a succession of short-term energy futures to hedge its long-term commitments. The assumption was that if oil prices dropped, the futures position would lose money, while the fixed-rate position would increase in value. If the oil price rose, on the other hand, the futures gains would offset the losses from the fixed-rate position.

This neat solution turned out to be badly flawed. Under MGRM’s strategy, the company would gain over a long period of time if the oil price
dropped, as it sold oil month-by-month at the pre-arranged higher rate. However, it would be exposed to losses made on the energy futures immediately, as margin calls came in. In addition, there was no stable relationship between the long-term forward commitments and the short-term energy futures—another major risk for the company. Thus, when oil prices actually dropped, the company faced a cash flow crisis and ultimately a funding crisis that reached all the way back to the parent company. In December 1993, MG was forced to bail out MGRM and cash in its positions at a loss totaling more than $1 billion.

Academics have been arguing about whether MG did the right thing ever since. Theoreticians such as the Nobel prize-winning economist Merton Miller and his colleague Christopher Culp maintain that had MG been able to persevere, in the long term it would have made a profit, recouping the losses on the futures through profits on the sale of petroleum. Others have pointed out that this is irrelevant, given that the company could not have done so in practice, while some have cast doubt on the size of the potential long-term gains. An auditors’ report, commissioned by MG shareholders, maintains that 59 million barrels’ worth of the long-term contracts had a negative value of about $12 million, so the value of these contracts could never have offset the losses, even in the long term.

The MG episode illustrates a concept that can be referred to as funding risk—the risk that positions may be profitable in the long run, but bankrupt a company in the short run. This is a risk that arises if negative cash flows are mismatched with positive cash flows, with the emphasis jointly placed on cash and flows. It is not enough just to think about how much money a strategy will bring in; risk managers must also think about when that money will come in.

**Morgan Grenfell’s Asset Mismanagement**

Morgan Grenfell Asset Management (MGAM) was doing well in 1994. Pension assets managed by the company’s Investment Services division had grown from $7.6 billion to $10 billion during 1994. The firm was fast developing a reputation for being knowledgeable and effective.

In 1995, however, one of its employees embarked on a course of action that would culminate in a media spectacle big enough to overshadow those successes. Sometime during that year, fund manager Peter Young began making covert purchases of large quantities of stock in companies that could charitably be described as little known. What Young saw in these companies was known only to himself; some of them were very unlikely to have been endorsed by MGAM’s investment guidelines.

One example was Solv-Ex, a company described by *Barron’s* as having “a rather checkered past and nothing more tangible than ambitious
plans for exploiting Canada’s Athabasca tar sands for oil and minerals” (4 November 1996). Young bought $30 million of stock in this gem—not at a discount, as might be expected for an extremely risky bulk purchase, but at a $2-a-share premium.

Young also managed to circumvent a Securities and Investment Board regulation forbidding a fund from owning more than 10 percent of any company. He did this by establishing a system of companies, apparently through a Swiss law firm. These companies were paired, so that each owned some 90 to 95 percent of its partner company, while Young purchased the other 5 to 10 percent for the funds under his control.

In September 1996, the London regulators began investigating the valuation of assets in MGAM’s three largest European funds. Trading on the funds shut down for three days and resumed only after Deutsche Bank, the parent company, replaced the questionable assets in the fund with $300 million in cash. Nonetheless, about 30 percent of investors left the funds within the next few weeks, taking $400 million with them.

The turmoil in the wake of this scandal was enormous. MGAM had to compensate more than 80,000 investors and was fined by the City of London regulators. Establishing the value of the compensation required two teams, each with 100 members, from two major accounting firms. Questions about how Young had been allowed to get away with his eccentric trading for so long—especially given reports that he had been cautioned about breaching investment guidelines months before the suspension—continued to haunt MGAM.

Young, meanwhile, briefly returned to the limelight a few months later, when he made his first court appearance wearing a dress and full make-up. Whatever the motivation behind this switch in gender polarity, it served as a suitably surreal coda to an affair that had been as perplexing as it had been expensive.

**Société Générale Blindsided**

The financial world was shaken to its core in early 2008 when Société Générale, then counted amongst the most esteemed financial institutions in the world, announced that a single trader, Jérôme Kerviel, had caused the bank a net loss of 4.9 billion euros. The bank’s top officers were left reeling, caught completely by surprise—how could they have been blindsided by such blatant and flagrant violations of company policy?

In the immediate aftermath of the incident, many critics pointed the finger at Kerviel, hurling accusations of personal greed and ambition—he was labeled a rogue trader and blamed entirely for the fiasco. However, when police raided Kerviel’s home, they found none of the evidence that would condemn
him as an unstable individual with uncontrollable, reckless urges—his apart-
ment was simple, with no luxurious extravagances, and he did not even own
a car. As James B. Stewart writes in The New Yorker, “how could one person
have amassed an exposure, as Kerviel had, of fifty billion euros without his
superiors at the bank knowing?” He goes on to note that Kerviel quickly
gained the sympathy of the public, with 50 percent of respondents in a Le
Figaro poll blaming Société Générale itself for what happened.

As the months rolled by and investigators painstakingly unraveled the
mystery around the relationship between the trader and the bank, it became
evident that this was more complex than a simple case of rogue trading—
and the story that the bank’s top level executives had no idea what was
going on became less and less credible. For example, internal and external
audits of the bank uncovered the fact that around 74 alerts about Kerviel’s
unusual trading activities slipped under the radar of the bank’s risk systems.
There is now also substantial evidence that highlights the ineffective super-
vision of Kerviel’s direct superiors, who rarely checked on the transactions
of individual traders.

It is also important to consider the highly complex nature of the deriv-
atives that Kerviel was trading in—due to their, as implied by the nomen-
clature, derived value, derivatives can fall and rise significantly in value
in response to comparatively smaller changes in the market. Since there
is an unavoidable element of unpredictability to markets, a trader can
find himself abruptly deserted by his golden touch when the markets shift
unfavorably.

Kerviel discovered that he could avoid this by performing intra-day
trades, which would not show up on the bank’s daily records—he could
offset any losses with false trades to cover his own tracks. He was encour-
aged by his initial successes, and was even praised by his superiors for a job
well done—Kerviel says that while his superiors reprimanded him for his
trading activities, he did not take it seriously, because he was not punished.
Eventually, his supervisors appeared to grant him free rein, exempting his
computer from the company’s system of alerts.

This demonstrates that while it is evident there was some form of ERM
in place at Société Générale, top executives did not implement it in the
face of such potentially high profits—greed overpowered caution. Kerviel
believed his superiors approved of his strong performance, regardless of
the methods he used, which seems a reasonable statement, considering he
was given a bonus of three hundred thousand euros in 2007 for his trading
performance. Kerviel was aware that his illicit trading was constantly setting
off the bank’s internal trading risk management system—information that
was most definitely accessible to his superiors—but since no one actually
brought it up with him, he did not stop.
However, as the number of false trades built up, the bank could no longer turn a blind eye to Kerviel’s actions—correspondence with Deutsche Bank, one of the firms that Kerviel had forged trades with, revealed that it had no knowledge of Kerviel’s contracts. Kerviel’s house of cards came tumbling down in a matter of days, when further investigation of his hidden trades yielded losses of around fifty billion euros that more than cancelled his previous stellar gains.

In the end, Société Générale decided to liquidate Kerviel’s trades instead of hoping for a miracle in the markets that would turn the tides in their favor, which likely swelled the already enormous amount of loss; the bank also had to borrow heavily from Morgan Stanley and J.P. Morgan to avoid bankruptcy. All Société Générale trading was temporarily halted, which resulted in a four percent drop in share prices, while Kerviel was taken to court and immediately sent to jail.

In a nutshell, as Kerviel’s psychologist succinctly summarizes, “the combination of the financial and personal success derived from his hidden trading, plus the lax supervision by his superiors . . . had a strong effect in the reinforcement” of Kerviel’s trading practices. Kerviel says that he was not, by any means, the only Société Générale trader who performed illicit trades for the sake of higher profit margins, which speaks to the extent to which profit was emphasized over risk management within Société Générale.

As such, it seems that it was not the case that Société Générale did not have established risk management procedures—it was simply that its employees chose not to follow them for the sake of higher profits, which speaks to the importance of fully implementing ERM. While Jérôme Kerviel certainly made rash decisions, he was ultimately just one weak link in an entire chain that was faulty and vulnerable to breakage.

**MF Global Goes Under**

Following a series of illegal transactions that moved customer funds for corporate purpose, MF Global filed for what would become “the eight-largest bankruptcy in U.S. history” on October 31, 2011.

Jon Corzine, CEO of MF Global, put the company under suspicion when he vehemently voted against a Commodities Futures Trading Commission proposal that would enforce greater control on how companies like MF Global could invest clients’ money. Corzine’s aversion to risk management during his reign at MF Global is a continuation of his reputation for making big market bets at Goldman Sachs, where he previously served as the head of its fixed-income division.

Further investigation revealed that MF Global had deliberately tried to cover up its enormous debt risks by tapering short-term borrowing “at the
ends of its fiscal quarters” so that it was much lower than the “average and peak levels for the full quarters” by a full 16 to 24 percent.8

MF Global defended itself vigorously in this regard, insisting that this pattern occurred organically, as a result of natural market conditions and client activities. Of course, as Charles Mulford, a professor at the Georgia Institute of Technology, wryly puts it, “I’m left to wonder why client needs are always reduced at the end of the quarter.”9

In financial lingo, this is called *window dressing*. Window dressing is not illegal, and by no means was MF Global the only financial institution that practiced this. However, Corzine’s usage of clients’ money to make up for the bank’s crippled financial assets in the wake of the European debt crisis *was* in direct violation of the law. Under Corzine’s guidance, MF Global invested 6.3 billion on European debt. This amounted to more than 500 percent of its tangible common equity. Inevitably, when the European economies collapsed, MF Global found itself sinking. In terms of risk management, it seems unbelievable that such a concentrated risk position was allowed to take place—evidence of the weaknesses of a top-down hierarchy system.

In a desperate last-ditch attempt to save the ship, MF Global’s top executives decided to use their clients’ money to pay off short-term debts. For example, on October 28, 2011, Edith O’Brien, former assistant treasurer at MF Global, was ordered to transfer $175 million from clients’ accounts to pay off an overdraft at J.P. Morgan Chase.

Corzine tried to calm the markets: mere days before MF Global filed for bankruptcy, he told investors that “the firm was taking steps to reduce its market exposure,” while in reality, the company only continued to take on more risk as it shifted more assets around to try and save itself.10 When it failed to do so, it had to throw the towel in. Unlike Goldman Sachs, MF Global was *not* too big to fail, and so it was left to drown.

Bausch & Lomb, Kidder Peabody, Metallgesellschaft, MGAM, Société Générale, and MF Global: six very different companies. But it should already be apparent that there are common themes that can be drawn from these and other headline-grabbing incidents. We’ll explore these in the next chapter.