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Thoughts on Risk Management for Financial Institution Undertaking Derivative Trade ------ A Comparative Analysis of Barings Bank Event and Societe Generale Event

Dacheng Qiu
School of Business Administration, Shenyang University, Shenyang 110044, China
E-mail: assdnylao2100@163.com

Yongli Jin
School of Business Administration, Shenyang University, Shenyang 110044, China
E-mail: jylsydx@163.com

Abstract

What causes Barings Bank event and Societe Generale event is a typical bank operational risk. It is the defects in internal management that lead to such a grave result. The Compliance and the Compliance Functioning Bank should be regarded as the guidance for internal risks management in financial institutions. What it emphasizes on is to make financial institutions pay more attentions on internal risks management and strict and effective executions for the sake of risks control. By designing more perfect management system, financial institutions can stop the emergence of operational risks. Besides, enhance the construction of compliance culture and devoting-to-work culture in financial institutions. Meanwhile, financial institutions should improve mutual cooperation and communication so that they can find out illegal affairs immediately.

Keywords: Financial risks supervision, Derivative trade, Compliance risks management

1. Introduction

On 24th, Jan. 2008, Societe Generale revealed its tremendous pre-tax loss of 4.9 billion Euro (about 51 billion RMB) caused by a trader for illegally betting on index futures. What investors concentrate on is whether it is another Barings Bank event or whether an excellent bank with a history of more than one hundred years collapses overnight. As time goes on, more details and development are displayed in various media. Although this event does not bring about a bankruptcy to Societe Generale, the tremendous loss and the similarities with Barings Bank event make people ponder over how to deal with the grave risks in financial derivative trade. In this paper, authors try to make a comparative analysis of the two events, probe into the reasons, and put forward personal ideas and suggestions for risks management in financial institutions.

2. The comparison between Barings Bank event and Societe Generale

	Barings Bank event	Societe Generale event
Time and background	On 18th, Jan. 1995, the Kobe Earthquake happened Japan. Then, Tokyo Nikkei stock index dropped dramatically in severally days.	All institutions perform poorly because of impacts of American sub-prime lending crisis. Stock market and futures market keep in falling.
Investment objects	Nikkei 225 Index Futures, Japan Government Bonds' short futures contract, Nikkei 225 Futures and Options trade	European stocks and futures index, Germany's DAX index, London Financial Times Ordinary Shares Index Futures
Company's response to the	Bank of England makes liquidation for bankruptcy of Barings Bank.	From 21st to 23rd, Jan. hedge more than 50 billion Euro long position in three

event		times and inform it to the media immediately.
Realized direct loss	Till 2nd, Mar. 1995, the loss of Barings Bank reached 916 million UK pounds (about 1.4 billion dollars).	Societe Generale lost 4.9 billion Euro (about 7.1 billion dollars).
Consequence	On 5th, Mar. International Netherlands Groups N.V. took Barings Bank's all assets and liabilities, purchasing it completely by agreement.	Realize re-financing 5.5 billion Euro by seasoned equity offering.
Supervision institutions concerned	Barings Bank's internal supervision department, Singapore International Monetary Exchange, Singapore financial supervision authority, England financial supervision authority.	Societe Generale's internal supervision department
Impacts on neighbor market	Other stock markets are impacted to different degrees. Exchange rate of UK pounds drops drastically and UK pound – Mark exchange rate falls to the lowest in history.	On 21st, Jan. European Stock drops by 7%. On the second day, US Federal Reserve cuts rate by 75 point.

3. By comparing and analyzing the two events, find out reasons for this kind of event.

Financial derivatives satisfy investment bank institutions' needs for interests. Undertaking financial derivatives trade can produce satisfying profits for investors but also huge risks of investments. Financial risks are caused by capital raise and application in economic operation. In other words, financial risks are possibilities of causing losses by uncertainties in financing. Traders collect a large sum of capitals by illegal ways and invest them in stock market and futures market for speculations and arbitrages with the hope of winning more profits. These operations are illegal and dangerous in nature. Once the market betrays the prediction of traders and then relevant supervision departments do not interfere with their struggle with the market, the loss will be a disaster.

From the table above, we conclude several reasons for this kind of events as follow:

(1) Both Barings Bank event and Societe Generale event are exposed to the public as stock market and futures market fluctuate abnormally so that even traders make gambling speculations, can not they hedge the loss. Traders in both events make speculations on derivatives with high correlation degrees. Therefore, once risks in market become greater, speculations based on amounts of capitals are nothing but desperate gambling. Once the market does not follows their predictions, former investments are far from repairing realized losses. And then the two traders tempt to affect the market trend by investing more in market. As these illegal operations are exposed to the public, what they get is nothing but tremendous losses and juridical punishments. In a sense, it is the rise of market risks that improves possibilities of this kind of events.

(2) Companies' responses affect final losses directly.

In Barings Bank event, as the trader Leeson asks the headquarters in London to remit 10 million UK pounds for paying supplemental deposit to the exchange, the headquarters do not check the trade done by Leeson carefully, which leads to the collapse of Barings at last. However, in Societe Generale event, as things go public, the bank reports to the supervision agency and shows attentive cooperation. At the same time, it completes the hedge of more than 50 billion Euro long position in three days and fixes the loss at 4.9 billion Euro in the poor performance of market. Without such immediate responses, as what was said by Bouton, the bank's administrative executive "the loss might be ten times larger than present", which will make Societe Generale copy the collapse of Barings Bank.

The inherent high risks of derivatives indicate that events similar to Barings Bank event and Societe Generale event can not be avoid thoroughly under present laws and regulations. After all, derivates trade is a capital game in nature. Where there are losers, there are winners. Profits attract more investors. In the capital gamble market, most investors undertake hedge operations. Only few but necessary hedgers and speculators drive the gamble. For institution investors undertaking hedges and investments, to win or lose is common. But losses should be remained at an acceptable level. Once losses are beyond the level, institutions can make their losses fixed and quit by hedging. Combating with the market by increasing investments can do nothing but worsen the condition.

(3) Poor risks supervision increases probabilities of this kind of events and degrees of losses. After several decades of years' development, financial risks management has been equipped with a set of complete theories. Many countries have already issued laws and regulations about risks supervision. Therefore, only if the trade follows laws and regulations, can the tremendous loss be avoided. The key lies in the powerful supervision of supervision subjects over

trading activities.

Barings Bank, with 233 years history, had abundant capitals and a well-known fame. Societe Generale was named as one of most excellent banks in risks management field in 2007. Their risks management systems were widely accepted. However, it is the poor execution of risks management system that causes losses. In fact, traders can manipulate certain amount of capitals for derivatives trade. However, the two traders easily escaped from banks' internal checks by some popular tricks and appropriate a large sum of capitals for bet in capital market, in a sense, what was under the acquiescence of banks' top executives who hoped for great profits from these star traders. In front of profits, all laws and risks management regulations become meaningless, not mention the compliance management and compliance culture.

4. New suggestions for risks management development in financial institutions

In Sep. 1998, the *Framework for Internal Control Systems in Banking Organizations* listed "validity and compliance" as one of important elements for banking internal control framework. On 29th, Apr. 2005, Basel Committee on Banking Supervision amended and issued the directions for *Compliance and the Compliance Functioning Bank*, which pointed out clearly: Compliance risks management is an important and independent risks management function. Compliance means banking activities must be in accord with proper laws, supervision regulations, rules, principles made by self-disciplined organizations, and norms for banking operations. Compliance risks management is a dynamic process in which financial institutions identify, monitor, evaluate, and report compliance risks, amend compliance management systems continuously, adopt corrective methods and impose proper punishments initiatively, try to avoid all illegal activities, and manage compliance risks all the time by constructing a set of effective compliance risks management mechanism.

Financial institutions face three sorts of risks: credit risk, market risk, and operational risk. Thereof, credit risk and market risk are hard to be excluded internally for financial institutions. The Barings Banks event and Societe Generale event are caused by typical banking operational risks derived from defects in internal management. The directions for *Compliance and the Compliance Functioning Bank* should be taken as a guided file for financial institutions' internal risks management, which reflects more attentions on internal risks management in financial institutions and more effective executions for the sake of risks control. In specific, we can improve internal risks control and risks management from following aspects:

(1) Put an end to these operational risks by designing more perfect management system. Financial institutions should organize the compliance departments considering the coherence of self risks management strategies and organizational structures. Put the internal audit and compliance control department right down the board of directors and appoint the CFO to the chief at the same time. Also, at the bottom level, apply the job rotation system and compulsory vocation system to some important positions, what can help to find out abnormal things in time. Financial institutions should constitute the compliance performance evaluation system, compliance accountability system, and credit report system that are the three backbone systems for compliance risks management. The implementation of these systems is completely controlled by the compliance department who reports to the board of directors periodically.

(2) Enhance the construction of compliance culture and devoting-to-work culture. Ensure legal implementation of compliance management by designing perfect management system. Only by building up compliance culture and devoting-to-work culture, can clients in financial institutions think much of risks management, accept boring compliance checks from compliance management department, and cooperate together to probe into and find out defects and risks in internal management system. So long as the corporate culture is to take honesty and integrity as the moral principles and the board of directors and the top management level serve as the example, the compliance will be most effective.

(3) Financial institutions should enhance mutual cooperation and communication in order to find out risky activities in time. On one hand, perfect the construction of information trade authorizing system, prevent against stealing accounts and codes, set up more precise risks pre-warning system, and realize information share in the financial institution in order to make more clients supervise potential risks. On the other hand, financial institutions should warn one another against doubtful large amounts of capital transfer by timely information exchange. Meanwhile, financial institutions must know their position and risk levels by communicating with the exchange.

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