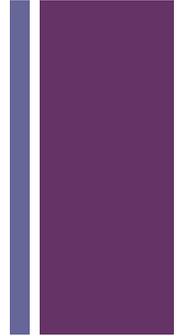


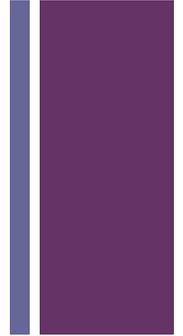
The story of JP Morgan  
Chase \$3B loss

# + What happened?



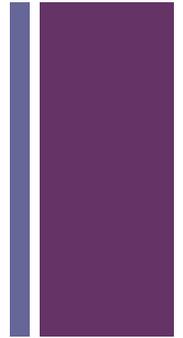
- Bank was investing in a benchmark for credit default swaps designed to mitigate bank's overall credit exposures, mainly higher interest rate and inflation.
- This was a series of 10 year Markit CDX North American Investment grade index "riskier, more volatile and less effective as an economic hedge than the firm previously believed."
- When prices diverged in unexpected way, JPM raised its bet but the expected turn around did not happen
- As rumors spread about the bets JPM was taking, others sought to take advantage of it
- JPM gave up at some point

# + What went wrong?



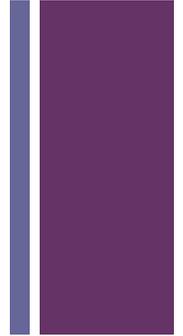
- Ina Drew the senior banker who saw the bank through the 2008 crisis was affected by Lyme disease ( a bacterial infection spread through the bite of the blacklegged tick)- She was spending less or no time on risk management
- Her absence allowed internal politics to come to the front
- Wrong notion that a hedge on credit exposures could reduce risk as well as earn lot of money
- Initial warnings were ignored.
  - Achilles Macris head of CIO failed to heed concerns as early as 2009 from the unit's own internal risk officer.

# + What went wrong? Contd.



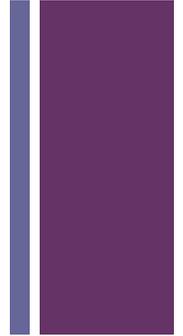
- The hedges earned them huge money in the past which possibly lulled them into complacency (when actually it should have raised warning)
  - CIO managed 17% of bank's assets and earned \$3.1B
- Bank's position was too big and it was moving the market
  - A \$650B book will obviously move markets-Mathew Streeter of FINCAD
  - In First quarter JPMorgan had a \$149 billion net bullish position in credit protection, net of bank's bearish positions-how much not known
  - **Also 'cut your losses' approach is difficult to follow when your bet is big**

## + What went wrong? contd.



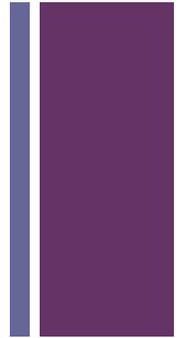
- The credit index bet introduced secondary risk exposures which the executives did not anticipate
- Bank relied too much on VaR
  - The bank also changed its VaR model which showed a loss of \$67M in first quarter; when they switched back to the old model, after the reported loss, it showed a VaR of \$129M!
- Model as well as data input could have been wrong

# + The fall out so far



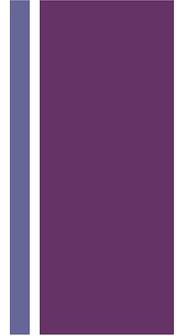
- Original loss estimated at \$2B
- Now they say it could be over \$3B
- Reputation of bank and Jamie Dimon in particular sullied
- Drew and Bruno Iksil (The London whale), the main trader - resigned
- Slide in stock price
- Shareholders ask for pay 'claw backs'
- Probes by
  - Justice department
  - SEC
  - FBI

# + Lessons



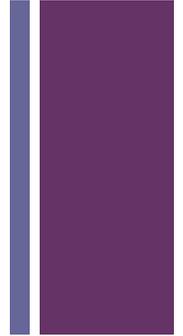
- Do not rely on any one measure of risk
  - Use wide range of risk measures like notional limits, stress tests, forward looking scenario analysis- not only VaR
    - Federal deposit insurance corp VC Thomas Hoenig
- When a hedge is huge a small movement in say interest rate could lead to a huge loss or profit –
  - in this case the initial interest movement is said to be just 25 basis points which led to a \$2B loss and it worsened after Jamie Dimon announced the loss
- The risk models and tools need to be constantly checked /validated.

## + Lessons contd.



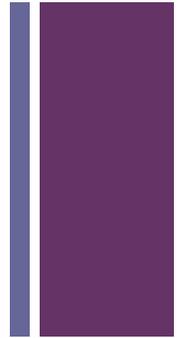
- When a key employee goes on leave or is sick, watch out! Is the back up there and working?
- Classic debate of whether Chairman and CEO posts should be separated- Jamie was both
- Probe huge profits to see if they could also lead to huge losses

## + Lessons contd.



- Abacus in Goldman Sachs, Repo 105 in Lehman, now this- do we really understand Derivatives? Are they really the 'financial weapons of mass destruction' as Warrant Buffet stated?
- Regulation of banks required?
  - Banks can perform some IB activities but should be prevented from making markets in derivatives or securities and trading activities or derivatives for their own account or a customers'
    - Federal deposit insurance corp VC Thomas Hoenig

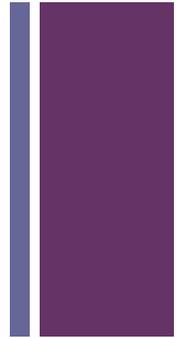
# + What were the regulators doing?



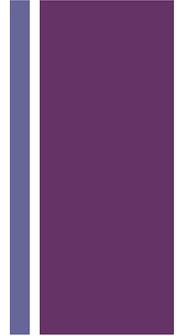
- Embeds/on site supervisors of Regulators in JPMC:
  - Federal reserve bank of NY: 40
  - Federal deposit insurance corp.: 4
  - Office of Comptroller of the currency: 70 (in 3 Offices in USA)
  - **None knew what was happening.**
  - Possible reasons:
    - None at JPM Chief investment office at London
    - It was not clear whose role it was to check
    - What was to be checked also not clear- was the regulator's role to monitor risk management? Did they have the information and tools to do it?

# + Can regulators control such trades in future?

- Trading and market making are high frequency activities that can take place between regulator exams with little evidence they ever occurred.
- Monitoring trading on 'high-frequency basis ' would be costly for both banks and regulators.
- Also what exactly is 'proprietary trading' is not clear to frame rules like the Volcker rule.



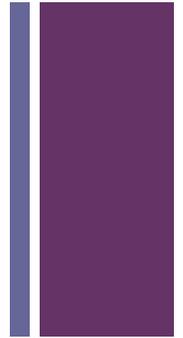
# + A parallel from the past –the Long term capital management case



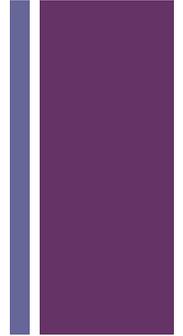
- This one is similar to the Long term Capital Management (LCM) crisis of 1998?
- LCM bet in what it considered to be a sure bet- new 30 year Treasury bonds and its value divergence as compared to 30 year bonds issued 3 months earlier
- Eventually values of these should converge
- But so many took the bet and the divergence grew
- LCM bet more ...
- The margins got very big and LCM ran out of capital!
- JPM is big and hence can take this loss.

## + Jamie Dimon speaks ..Before

- On Volcker rule: “if you want to be trading, you have to have a lawyer and a psychiatrist sitting next to you determining what was your intent every time you did something.”
- On initial reports that surfaced about the chief investment office in early April, a “complete tempest in a teapot.”

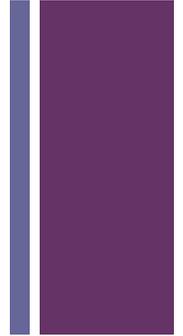


# + Jamie Dimon speaks...after



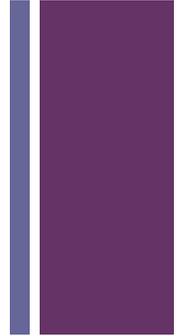
- After he knew the quantum of loss and the gory details:
  - "what the hedge morphed into violates our own principles"
  - "We made a terrible, egregious mistake and there's almost no excuse for it"; the bank was "sloppy" and "stupid."
  - "(The hedges were ) flawed, complex, poorly reviewed, poorly executed, and poorly monitored."
  - wounds "self-inflicted."
  - "We're going to manage it to maximize economic value for shareholders; We're willing to hold as long as necessary."
  - bank has "egg on its face," and "plays right into the hands of a whole bunch of pundits out there."
  - "the type of trading that led to the loss would not be banned by the so-called Volcker rule"

## + What others say



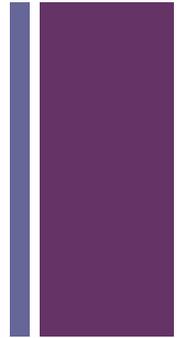
- "How much banks should be allowed to rely on Value-at-risk (VaR) models i.e estimates of losses that could occur on a particular trade or portfolio of trades...."
  - Sheila Bair ex-chairman of Federal Deposit Insurance corp.
- "The enormous loss JPMorgan announced today is just the latest evidence that what banks call 'hedges' are often risky bets that so-called 'too big to fail' banks have no business making. Today's announcement is a stark reminder of the need for regulators to establish tough, effective standards."
  - Senator Carl Levin, Michigan Democrat

## + What others say contd..



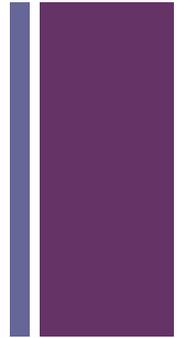
- “JPMorgan Chase C.E.O. Jamie Dimon has been a relentless critic of financial reform; “The surprise loss proves him wrong.”
  - Dennis Kelleher, president of Better Markets
- “JPMorgan violated the cardinal rule of risk: **Don’t become the market.**”
  - A senior Wall street executive

# + Sources



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- JP Morgan Hedge Exposed the Bank to More Risk –CFO mag
- Discord at Key JPMorgan Unit Is Faulted in Loss – NY Times
- ‘London Whale’ Said to Be Leaving JPMorgan – NY Times
- F.B.I. Inquiry Adds to JPMorgan’s Woes –NY Times
- JPMorgan's Trading Loss Is Said to Rise at Least 50% - NY Times
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