Levy Economics Institute of Bard College

June 5, 2013

One–Pager | No.38

Financial Reform and the London Whale

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The recent report by the Senate Permanent Subcommittee on Investigations on the operations of JPMorgan Chase's Synthetic Credit Portfolio (SCP) unit, also known as the London Whale, has brought renewed attention to the risks of proprietary trading for insured banks. The report provides little information beyond that available in initial reports of the episode (for an analysis, see Policy Note 2012/6), but the presentation of the detailed communications between bank management, regulators, and the unit's traders provides depth to the larger risks inherent in the financial system after Dodd-Frank. A recent Levy Institute policy brief reviews the findings of the new report and expands on the lessons that we can draw from the evolution of the London Whale episode, and concludes that much remains to be done to prevent a repetition of the activities that produced the recent crisis.

While the Senate report suggests that the company and management acted in bad faith or worse in their misrepresentations of the events leading up to the closure of the unit, a more probable explanation is that the size and complexity of the bank were such that it had become too big for management to have a clear idea of the real conditions in the SCP. This also suggests, a fortiori, that the bank was too large to be regulated effectively.

The report further suggests that the Chief Investment Office (CIO), the parent entity of the SCP unit, operated without a clear mandate from top management. However, it is clear that JPMorgan Chase anticipated that the CIO would undertake overall hedging of the bank's credit risk as well as exploit connections between credit derivatives, risk-weighted assets, and bank capital. The changing mandate of the CIO was in part a response to the changed economic and policy environment that emerged after the 2007–08 financial crisis, including new international risk standards issued by the Basel Committee on Bank Supervision. A review of the CIO's performance suggests that until 2009 it had successfully implemented management's priorities, as evidenced by the fact that the bank was not driven to insolvency by the crisis.

As the CIO mandate was expanded to meet the changing conditions as markets recovered, it eventually was faced with incompatible goals—to create profits from short credit hedges, adjust to improving credit conditions by reducing short hedges, and reduce the gross positions of the portfolio to reduce risk-weighted capital charges of the CIO. The SCP elected to resolve this conflict by expanding its notional portfolio of long and short CDS index positions. But in doing so, the SCP created a Ponzi financing scheme, and because of the large size of the position, counterparties soon took up an opposing Ponzi strategy. It was at this point that the strategy produced losses that neither the traders nor management could explain, thus leading to the decision to cut losses by disbanding the unit.

The Senate report also criticizes the CIO's remuneration policy as part of what drove its choices. However, a much larger concern is that the CIO, a hedging unit, was remunerated on the basis of profitability. A hedging operation should not necessarily be profitable; it is expected to offset unexpected losses. Mark-to-market accounting also created significant problems for the trading strategy and is arguably the most important failure of JPMorgan Chase's management.

Finally, the Senate report points to "broad systemic problems" in a number of areas. Specifically, it claims that the CIO operated without a clear mandate and that hedging activities (and, by implication, the use of derivatives) were not appropriate for a financial institution. Both assertions are incorrect. The problem arose when JPMorgan Chase created the equivalent of a shadow bank that funded the SCP's short positions through what was in effect a Ponzi scheme. Further, while proprietary trading was involved in the losses, the real problem was that the bank was allowed to operate across all aspects of finance and the difficulties that this creates for efficient macro hedging. If we are to reduce systemic risk, not only must banks provide regulators with more detailed information on their balance sheet hedging, but it is also necessary to rethink the 1999 Financial Services Modernization Act, as it has led to banks that are too big to fail, manage, or regulate.

Events such as the London Whale episode can easily distract us from the larger risks inherent in the current financial system. Financial reform is urgently needed to ensure the proper regulation of financial institutions and to discourage banks from investing in the wrong kind of risks. Dodd-Frank remains a flawed approach to reforming the financial system. It has done little to return banks to their proper role: financing capital investment that produces income and employment growth.

A more detailed discussion of these issues can be found at www.levyinstitute.org/publications/?docid=1812.

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