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The JP Morgan "Whale" Report and the Ghosts of the Financial Crisis

By: Ben W. Heineman, Jr.

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The apparition of 2008 returns once more. Two recently released JP Morgan Chase (JPM) reports on the causes of the "London Whale" trading losses raise important questions about whether financial service firms can exorcise the spectral issues which were so central to the financial crisis. They read as if JPM and a key headquarters unit — the Chief Investment Office — had not learned a single lesson from the meltdown four years ago. And unfortunately, they suggest that, in our huge, complex financial institutions, major failures of organizational discipline and major losses are likely to recur, despite greater attention to risk management.

These reports — one from a company task force and a second from a review committee of the board — were overshadowed by two items announced the same day: the related news that the bank board had slashed CEO Jamie Dimon's annual compensation in half — from $23 million in 2011 to $11.5 million in 2012 — because of his "Whale-related" failures, and that JPM had posted a record 2012 net income of $21.3 billion.

But the 129-page internal task force report is significant. It analyzes in some depth the personal and institutional reasons for the more than $6 billion loss in a credit derivatives portfolio traded, paradoxically, by the London branch of JPM's Chief Investment Office, a unit supposed to invest a pool of funds conservatively in order have liquidity to offset losses elsewhere. Led by Michael Cavanagh, co-Chief Executive Officer of the Corporate and Investment, the task force outlines a series of failures that echo those that beset financial sector creation of interconnected toxic assets in the past. And almost no one has focused on the relationship between JPM's problems, the past failings in the financial sector and the issues for the sector in the future.

These are not failures associated with well-considered and well-bounded risk taking. Everyone understands this kind of risk taking is core to any business (financial or industrial or consumer) and obviously will not always be crowned with success. Rather, they are blameworthy actions, involving culpability stemming from negligence or worse, and requiring, at the least, private sanctions (firings, demotions, clawbacks, pay cuts) and system remedies. Here is a brief summary of the findings:

London Office. The traders — Bruno Iksil ("the Whale"), Javier Martin-Artajo and Achilles Macris (the boss) — did not understand the complex trades, did not monitor them, doubled down when initial results were poor, did not listen to questions from the risk function and did not communicate the full extent of trading losses.

Headquarters of Chief Investment Office (CIO). Ina Drew, the head of the CIO, failed to review or monitor the trading strategy; failed to ensure that the risk and finance functions were providing appropriate oversight and control of the portfolio in question; did not appreciate the size, complexity, risk and magnitude of the issue in the first quarter of 2012 as conditions worsened; and as a result, gave misleadingly optimistic reports to JPM senior management until problems surfaced dramatically in April-May, 2012. The risk limits set were too vague and broad. And, the Value at Risk (VaR) model was badly flawed, understating risk.

Firm-Wide Functions and Leaders. Generally speaking, firm management did not ensure proper controls and oversight at CIO as its trades became more complex and risky. The company Chief Risk Officer (Barry Zubrow, until January 2012) and the CFO (Doug Braunstein, since replaced) bore significant responsibility for the inadequacies of the risk and finance functions inside CIO — and for the failures of firm-wide risk and finance to spot trouble. CEO Dimon was criticized for failure to understand warning signs in a unit reporting directly to him (calling the trades "a tempest in a teapot" in an April analysts' call). Dimon himself ultimately said that "[t]hese were egregious mistakes.They were self-inflicted..." In short, there was not robust debate with the right facts at the right level about the portfolio risk.

The Board and the Risk Policy Committee. The board review committee exonerates the board and the Risk Policy committee from any culpability because "the information communicated to the Risk Policy Committee...did not suggest any significant problems in the CIO" until the issue began to break open in April, 2012." This conclusion is silly on its face because the review committee's report makes a number of recommendations of changed processes which are so basic that those proposals should be read as criticisms for past failures of the board and the Risk Committee. For example, the review committee says that the Risk Committee should: insist on better context when risk issues are presented; ensure that risk leaders are asked about what really bothers them; assess adequacy of risk resources in all units; conduct regular reviews — and spend more personal time — on the firm's compliance with risk protocols; ensure that the chief risk officers are truly independent and can challenge business decisions; and define more clearly the lines between the Risk and Audit Committees. Well, no duh.

Virtually every "cause" of the significant trading losses delineated by the internal JPM task force would have been found in earlier internal and independent reports about the sources of problems at many financial institutions during the credit crisis. In addition, the JPM task force does not address other key questions: Why did Dimon let the Chief Investment Office — with the normal role of conservative capital management to offset losses elsewhere — start this kind of speculative trading in the first place? Why were red flags ignored by senior managers in CIO and in the firm? How credible is the

report's conclusion, without published analysis, that "the Firm's compensation did not unduly incentivize the trading activity that led to the losses"?

Moreover, JP Morgan Chase still has unfinished business with the regulators here and abroad on the trading fiasco. For example, the bank recently entered into a cease and desist order with the Federal Reserve and the Comptroller of the Currency (COC) to work out new regulator-approved processes relating to the issues about the board's role, risk management, finance and audit identified in the internal Task Force report. And questions of fraud in the London office and inadequate SEC disclosure by JPM are also being pursued by government investigators.

The crucial question raised by the Whale incident — and by the delineation of causes in the internal report — is whether these types of blameworthy acts, with significant consequences, are likely to recur in huge financial institutions because they simply cannot control important corporate or business units with significant capital at risk.

Are these acts likely to recur regardless of internal systems and process, and regardless of regulatory oversight?

The question has special salience because it happened at JP Morgan Chase, which had a reputation for careful risk management; because it happened right under the nose of Jamie Dimon, JPM's so-called "chief risk officer"; because it happened in a unit reporting directly to Dimon which was supposed to trade conservatively in order to have funds to offset poor bets elsewhere. The bank deserves credit for facing the trading problem forthrightly once it emerged unmistakably as a major issue: Dimon took blame; the company made public a reasonably critical internal report (even if key issues were not addressed); it set a good standard of accountability in using clawbacks and Dimon's comp reduction for those responsible (see my earlier blog posts); and it has set forth paper remedies for the specific problems which will be refined with the Fed and the COC.

But, the fact remains: the Whale incident's replay of these fundamental, blameworthy acts — which characterized the financial melt-down — suggests a basic failing that may defy an effective remedy. This is why the Whale has significance beyond the particular losses and poses an enigma which business and government must ponder.

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http://blogs.hbr.org/cs/2013/01/the_jp_morgan_whale_report_and.html