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MULTIBILLION DOLLAR “LONDON WHALE” TRADING LOSSES AT JPMORGAN CHASE HIGHLIGHT SHORTCOMINGS OF DODD-FRANK ACT AND NEED FOR STRONGER BANKING REFORM, NEW LEVY STUDY SAYS

ANNANDALE-ON-HUDSON, N.Y.— A recent report by the Senate Permanent Subcommittee on Investigations blasts JPMorgan Chase, specifically its Chief Investment Office (CIO) and Synthetic Credit Portfolio (SCP) traders, for misleading regulators and shareholders regarding the $6.2 billion “London Whale” trading loss. While the report suggests that the company and management acted in bad faith or worse in their representation of events, a new report from the Economics Institute of Bard College argues instead that a more probable explanation for the misinformation is that the bank had grown in size and complexity to such a degree that management had no idea of the operations of the SCP unit, and the larger implication of the “London Whale” episode is that JPMorgan Chase had grown too big to regulate, despite the new Dodd-Frank financial reforms.

In his new Public Policy Brief, More Swimming Lessons from the London Whale, Levy Senior Scholar Jan Kregel takes issue with several findings of the Senate report, including that the CIO operated without a clear mandate and that hedging activities (and, by implication, the use of derivatives) were inappropriate for a financial institution. Kregel says that both assertions are incorrect. He contends that the CIO, at its creation, had a clear mandate, one that it met successfully until 2010, when, in response to changing market conditions, its activities were expanded to include making profits from short credit hedges. At that time, the author maintains, the CIO faced incompatible goals: to create profits from short hedges, to adjust to improving credit conditions by limiting short hedges, and to reduce the gross positions of the portfolio to lower the CIO’s risk-weighted capital charges. When the SCP elected to resolve this conflict by expanding its notional portfolio of long and short CDS (credit default swap) index positions, it created a Ponzi financing scheme that ultimately led to substantial losses. Kregel adds that mark-to-market accounting also created

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significant problems for the CIO’s trading strategy, and contends that the problem with the CIO’s mandate was the 2010 injunction to create profit—a problem compounded by a remuneration policy driven by unit profitability. “A hedging unit is expected to incur losses most of the time if the bank’s operating strategy and credit assessments are well run; it will only generate profits in periods of crisis,” he writes. “It was thus totally inappropriate to remunerate CIO operations on the basis of profitability.”

Kregel asserts that JPMorgan Chase created the equivalent of a shadow bank to fund the SCP’s short positions using a Ponzi scheme. Further, he argues that the underlying problem was not, as has been argued, proprietary trading per se, but a financial system that allows banks to operate across all aspects of finance and creates the necessity for macro hedging. He concludes that the “London Whale” episode makes it clear that systemic risk remains in the financial system and that policymakers must address banks that are too big to fail, manage, or regulate. “It should be clear that it is not the proprietary trading as such” that caused JPMorgan Chase’s difficulties, Kregel writes. “The problem is the failure to accept that such activity comes at a cost and therefore cannot be a profit center, nor can it be funded from either customer deposits or an internal shadow bank. However, the solution is not to prevent such hedging, but rather to have reporting and supervision to justify the level and type of hedging as appropriate—or, alternatively, the repeal of the 1999 Financial Services Modernization Act, which allows banks to operate across all aspects of finance and thus makes such macro hedging via derivatives necessary.”

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