

PRESS RELEASE

U. S. Senate Permanent Subcommittee on Investigations
HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS COMMITTEE



Carl Levin, Chairman
John McCain, Ranking Member

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**Opening Statement of Senator Carl Levin (D-Mich.)
U.S. Senate Permanent Subcommittee on Investigations Hearing on
JPMorgan Chase Whale Trades:
A Case History of Derivatives Risks and Abuses
March 15, 2013**

Good morning. Let me begin by extending a special welcome to a longtime friend, the new Ranking Member of the Subcommittee, Senator McCain. This is not the first time we have worked side-by-side. I deeply appreciate the energy and bipartisan spirit Senator McCain brings to our work together on the Armed Services Committee when he was Ranking Republican there and now here on this Subcommittee. Like the Armed Services Committee, this Subcommittee has a tradition of bipartisanship, and I very much look forward to continuing our partnership here.

In April 2012, Americans were confronted with a story of Wall Street excess and the derivatives disaster now known as the JPMorgan Chase whale trades. The largest U.S. banks today are deep into derivatives, complex financial instruments that derive their value from other assets. The derivatives behind the JPMorgan whale trades were part of a so-called "Synthetic Credit Portfolio" that essentially made outsized bets on whether particular financial instruments or entities were creditworthy or would default during specified time periods. The bets were made by traders in the London office of U.S. banking giant, JPMorgan Chase. Their trades – meaning their bets -- grew so large that they roiled the \$27 trillion credit derivatives market, singlehandedly affected global prices, and finally attracted a media storm aimed at finding out who was behind them.

That's when the media unmasked JPMorgan's Chief Investment Office (CIO) which, until then, had been known for making conservative investments with bank deposits. At first, JPMorgan's CEO Jamie Dimon claimed the April media reports about the whale trades were "a tempest in a teapot." But a month later, the bank admitted the truth: that their credit derivative bets had gone south, producing not only losses that eventually exceeded \$6 billion, but also exposing a litany of risk management problems at what had been considered one of America's safest banks.

JPMorgan Chase & Company is the largest financial holding company in the United States. It is also the largest derivatives dealer in the world and the largest single participant in world credit derivatives markets. It has consistently portrayed itself as a risk management expert with a “fortress balance sheet” that ensures taxpayers have nothing to fear from its extensive dealing in risky derivatives. But that reassuring portrayal of the bank was shattered when whale trade losses shocked the investing public, not only with the magnitude of the losses, but because the financial risk had been largely unknown to bank regulators.

The Subcommittee meets today after nine months of digging into the facts behind the whale trades. To learn what happened, the Subcommittee collected nearly 90,000 documents, conducted over 50 interviews and briefings, and has issued a 300-page bipartisan report. While the bank and its regulators have cooperated with our investigation, four key former JPMorgan employees directly involved in the derivatives trading declined to cooperate and, because they reside overseas, they remain beyond the Subcommittee’s subpoena authority.

Our findings open a window into the hidden world of high stakes derivatives trading by big banks. It exposes a derivatives trading culture at JPMorgan that piled on risk, hid losses, disregarded risk limits, manipulated risk models, dodged oversight, and misinformed the public.

Our investigation brought home one overarching fact: the U.S. financial system may have significant vulnerabilities attributable to major bank involvement with high risk derivatives trading. The four largest U.S. banks control 90 percent of U.S. derivatives markets, and their profitability is invested, in part, in their derivatives holdings, nowhere more so than at JPMorgan.

The whale trades demonstrate how credit derivatives, when purchased in massive quantities with complex components, can become a runaway train barreling through every risk limit. The whale trades also demonstrate how derivative valuation practices are easily manipulated to hide losses, and how risk controls are easily manipulated to circumvent limits, enabling traders to load up on risk in their quest for profits. Firing a few traders and their bosses won’t be enough to staunch Wall Street’s insatiable appetite for risky derivative bets or stop the excesses. More control is needed.

Among the most troubling aspects of the whale trades case history is that JPMorgan traders, who were required to book the value of their derivative holdings every business day, used internal profit-loss reports to hide more than half a billion dollars in losses in just three months. Eventually, those misreported values forced JPMorgan to restate its earnings for the first quarter of 2012. But to this day, JPMorgan maintains that the mismarked values did not, on their face, violate bank policy or generally accepted accounting principles. But if derivative books can be cooked as blatantly as they were in this case without breaking the rules, then the rules need to be revamped. And given how much major U.S. bank profits remain bound up with the value of their derivatives, derivative valuations that can’t be trusted are a serious threat to our economic stability.

The whale trades also demonstrate how easily a Wall Street bank can manipulate and avoid risk controls. The financial industry assures us that it can prudently manage high risk activities, because they are measured, monitored, and limited. But as the Subcommittee report demonstrates in detail, JPMorgan executives ignored a series of alarms that went off as the

bank's Chief Investment Office breached one risk limit after another. Rather than ratchet back the risk, JPMorgan personnel challenged and re-engineered the risk controls to silence the alarms. It is difficult to imagine how the American people can trust major Wall Street banks to prudently manage derivatives risk when bank personnel can readily game or ignore the risk controls meant to prevent financial disaster and taxpayer bailouts.

The whale trades also provide another example of a major Wall Street bank's misstatements and concealment. Our investigation found that the bank failed to fully disclose the Synthetic Credit Portfolio to regulators for years, even when it tripled in size in the first three months of 2012, and even when traders went on a buying spree, acquiring \$40 billion of new credit derivatives in March, "doubling down," in the words of the OCC, on an already losing trading strategy. In fact, in January 2012, the bank told the OCC, inaccurately, that the portfolio was decreasing in size, when it wasn't. Most troubling of all, when the media spotlight hit, senior bank executives mischaracterized to investors and the public the nature of the whale trades and the extent of risk management and regulatory oversight, gambling apparently that the portfolio's bad bets would recover before anyone took a closer look.

Well, we took that closer look, and it isn't pretty. A massive derivatives portfolio riddled with risk. A runaway train of derivatives trading blowing through risk limits. Hidden losses. Bank executives downplaying the bad bets. Regulators who failed to act.

Together, the facts are a reminder of what occurred in the recent financial crisis: we can't rely on a major bank to resist risky bets, honestly report derivative losses, or disclose bad news, without a strong regulator looking over its shoulder, backed by laws that require transparency, risk limits, capital buffers against losses, and consequences for misconduct.

That's the big picture. Here are some of the detailed findings from the Subcommittee's investigation.

1) JPMorgan's Chief Investment Office rapidly amassed a huge portfolio of synthetic credit derivatives, in part using federally insured depositor funds, in a series of risky, short-term trades, disclosing the extent of the portfolio only after intense media exposure.

In just a few months during 2011, as shown in Chart 1, the Chief Investment Office's Synthetic Credit Portfolio grew from a net notional size of \$4 billion to \$51 billion, and then tripled in the first quarter of 2012 to \$157 billion. That exponential growth in holdings and risk occurred with virtually no regulatory oversight.

2) Once the whale trades were exposed, JPMorgan claimed to regulators, investors and the public, that the trades were designed to hedge credit risk. But internal bank documents failed to identify the assets being hedged, how they lowered risk, or why the supposed credit derivative hedges were treated differently from other hedges in the Chief Investment Office. If these trades were, as JPMorgan maintains, hedges gone astray, it remains a mystery how the bank determined the nature, size, or effectiveness of the so-called hedges, and how, if at all, they reduced risk.

3) The Chief Investment Office internally concealed massive losses in the first several months of 2012 by overstating the value of its synthetic credit derivatives. It got away with

overstating those values within the bank, even in the face of disputes with counterparties and two internal bank reviews.

As late as January 2012, the CIO had valued its credit derivatives by using the midpoint in the daily range of “bids” and “asks” offered in the marketplace. That’s the typical way to value derivatives. But beginning in late January, the traders stopped using midpoint prices and started using prices at the extreme edges of the daily price range to hide escalating losses. In recorded phone conversations, one trader described these marks as “idiotic.”

At one point, traders used a spreadsheet to track just how large their deception had grown by recording the valuation differences between using midpoint and more favorable prices. In just five days in March, according to the traders’ own spreadsheet, the hidden losses exceeded \$400 million. The difference eventually exceeded \$600 million. Counterparties to the derivative trades began disputing the CIO’s booked values involving hundreds of millions of dollars in March and April.

Despite the obvious value manipulation, on May 10 – the same day JPMorgan announced that the whale trades had lost \$2 billion – the bank’s controller concluded a special review and signed off on the CIO’s derivative pricing practices as “consistent with industry practices.” JPMorgan leadership has continued to argue that the values assigned by its traders to the Synthetic Credit Portfolio were defensible under accounting rules.

Yet in July 2012, the bank reluctantly restated its first-quarter earnings. It did so only after an internal investigation listened to phone conversations, routinely recorded by the bank, in which its traders mocked their own valuation practices.

Their mismarked values weren’t wrong simply because the traders intended to understate losses; they were wrong because they changed their pricing practices after losses began piling up, stopped using the midpoint prices they had used up until January, and began using aggressive prices that consistently made the bank’s reports look better. Until JPMorgan and others stop their personnel from playing those kinds of games, derivative values will remain an imprecise, malleable, and untrustworthy set of figures that call into question the derivative profits and losses reported by our largest financial institutions.

4) When the CIO’s Synthetic Credit Portfolio breached five key risk limits, rather than reduce the risky trading activities, JPMorgan either increased the limits, changed the risk models that calculated risk, or turned a blind eye to the breaches.

As early as January 2012, the rapid growth of the Synthetic Credit Portfolio breached one common measure of risk, called “Value-at-Risk” or VaR, causing a breach, not just at the CIO, but for the entire bank. That four-day breach was reported to top bank officials, including CEO Jamie Dimon, who personally approved a temporary limit increase, and voila, the breach was ended. CIO employees then hurriedly pushed through approval of a new VaR model that, overnight, dropped the CIO’s purported risk by 50 percent. Regulators were told about that remarkable reduction in the CIO’s purported risk, but raised no objection to the new model at the time.

The credit derivatives portfolio breached other risk limits as well. In one case, it exceeded established limits on one measure, known as Credit Spread 01, by 1,000 percent for months running. When regulators asked about the breach, JPMorgan risk managers responded that it wasn't a "sensible" limit and allowed the breach to continue. When still another risk metric, called Comprehensive Risk Measure, projected that the Synthetic Credit Portfolio could lose \$6.3 billion in a year, a senior CIO risk manager dismissed the result as "garbage." It wasn't garbage; that projection was 100 percent accurate, but the derivatives traders thought they knew better. Downplaying risk, ignoring one risk warning after another, and pushing to reengineer risk controls to artificially lower risk results, flatly contradict JPMorgan's claim to prudent risk management.

5) At the same time the portfolio was losing money and breaching risk limits, JPMorgan dodged OCC oversight. It omitted CIO data from its reports to the OCC; failed to disclose the growing size, risk, and losses of the Synthetic Credit Portfolio; and delayed or tinkered with OCC requests for information by giving the regulator inaccurate or unresponsive information. In fact, when the whale trades first became public, the bank offered such blanket reassurances that the OCC initially considered the matter closed. It was only when the losses exploded that the OCC took another look.

6) The failure of regulators to act sooner can't be excused by the bank's behavior. The OCC also fell down on the job. It failed to investigate multiple, sustained risk limit breaches; tolerated incomplete and missing reports from JPMorgan; failed to question the bank's new "value at risk" model that dramatically lowered the CIO's risk rating; and accepted JPMorgan's protests that the media reports about the portfolio were overblown. It was not until May 2012, after a new Comptroller of the Currency took the reins at the agency, that OCC officials instituted their first intensive inquiry into the Synthetic Credit Portfolio.

Again, with the lessons of the 2008 financial crisis so painfully fresh, it is deeply worrisome that a major bank should seek to cloak its risky trading activities from regulators, and doubly worrisome that it was able to succeed so easily for so long.

And finally:

7) When the whale trades went public, JPMorgan misinformed regulators and the public about the Synthetic Credit Portfolio. JPMorgan's first public response to the April news reports about the whale trades was when its spokesperson, using prepared talking points approved by senior executives, told reporters on April 10, that the whale trades were risk-reducing hedges known to regulators. A more detailed description came in a conference call held on April 13 with investment analysts. During that call, Chief Financial Officer Douglas Braunstein made a series of inaccurate statements about the whale trades as shown in Chart 2: He said the trades had been put on by bank risk managers and were fully transparent to regulators; he said the trades were made on a very long-term basis; he said the trades were essentially a hedge; and he said the bank believed the trades were consistent with the Volcker Rule which prohibits high risk proprietary trading by banks. Those public statements on April 13 were not true. As late as May 10, bank CEO Jamie Dimon repeatedly described the synthetic credit trades as hedges made to offset risk, despite information showing the portfolio was not functioning as a hedge. The bank also neglected to tell investors the bad news that the derivatives portfolio had broken through

multiple risk limits, losses had piled up, and the head of the portfolio had put management of the portfolio into “crisis mode.”

It was recently reported that the eight biggest U.S. banks have hit a five-year low in the percentage of deposits used to make loans. Their collective average loan-to-deposit ratio has fallen to 84 percent in 2012, down from 87 percent a year earlier, and 101 percent in 2007. JPMorgan has the lowest loan-to-deposit ratio of the big banks, lending just 61 percent of its deposits out in loans. Apparently, it was too busy betting on derivatives to issue the loans needed to speed economic recovery.

Based on its investigation into the JPMorgan whale trades, our report makes the following recommendations.

- 1) When it comes to high-risk derivatives, federal regulators need to know what major banks are up to. We should require those banks to identify all internal investment portfolios that include derivatives over a specified size, require periodic reporting on derivative performance, and conduct regular reviews to detect undisclosed derivatives trading.
- 2) When banks claim they are trading derivatives to hedge risks, we should require them to identify the assets being hedged, how the derivatives trade reduces the risk associated with those assets, and how the bank tested the effectiveness of its hedging strategy in reducing risk.
- 3) We need to strengthen how derivatives are valued to stop inflated values. Regulators should encourage banks to use independent pricing services to stop the games; require disclosure of valuation disputes with counterparties; and require disclosure and justification when, as occurred at JPMorgan, derivative values deviate from midpoint prices.
- 4) When risk alarms go off, banks and their regulators should investigate the breaches and take action to reduce risky activities.
- 5) Federal regulators should require disclosure of any newly implemented risk model or metric which, when implemented, materially lowers purported risk, and investigate the changes for evidence of model manipulation.
- 6) Three years ago, Congress enacted the Merkley-Levin provisions of the Dodd-Frank Act, also known as the Volcker Rule, to end high risk proprietary betting using federally insured deposits. Financial regulators ought to finalize the long-delayed implementing regulations.
- 7) At major banks that trade derivatives, regulators should ensure the banks can withstand any losses by imposing adequate capital charges for derivatives trading. It is way past time to finalize the rules implementing stronger capital standards.

The derivatives trading that produced the whale trades damaged a single bank. But the whale trades expose problems that reach far beyond one London trading desk or one Wall Street

office tower. The American people have already suffered one devastating economic assault rooted largely in Wall Street excess, and they cannot afford another. When Wall Street plays with fire, American families get burned. The task of federal regulators, and of this Congress, is to take away the matches. The whale trades demonstrate that task is far from complete.