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**Written Testimony for the Senate Permanent Subcommittee on Investigations**  
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**I. Introduction**

Good morning Chairman Levin, Ranking Member McCain, and Members of the Subcommittee. My name is Michael Cavanagh, and I serve as the Co-Chief Executive Officer of the Corporate and Investment Bank at JPMorgan Chase & Co. (“JPMorgan” or the “Firm”). I also led the JPMorgan Management Task Force’s review of losses incurred in 2012 by the Firm’s Chief Investment Office (“CIO”). I appreciate the opportunity to participate in today’s hearing on matters relating to those losses, and will answer as best I can any questions you might have.<sup>1</sup>

We have worked closely with the Subcommittee’s staff during the course of its inquiry regarding the 2012 CIO losses, and have cooperated as completely as possible to help provide a full picture of what happened and how it happened, as well as JPMorgan’s response. We appreciate the courtesies the staff has extended throughout the course of this inquiry and thank them for their professionalism.

You have requested that we address in this testimony a range of topics, including the findings of the Task Force, oversight of CIO and the Synthetic Credit Portfolio (including trading strategies, risk management, hedging, valuation, and modeling), and communications with third parties, including investors and regulators, regarding the Synthetic Credit Portfolio. I address each of these topics below. Before turning to them, however, and on behalf of our entire

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<sup>1</sup> My testimony today is intended to reflect the Task Force’s view of the facts. Others, including regulators conducting their own investigations, may have a different view of the facts, or may focus on facts not described in the Task Force Report, and may also draw different conclusions regarding the facts and issues. The Task Force’s mandate did not include drawing any legal conclusion, and accordingly, by my testimony today, neither I nor the Task Force purport to do so.

management team, I want to repeat what we have said before: that we let down our shareholders and failed to meet the high standard we set for ourselves. We have learned valuable lessons from our experience, and have taken and are continuing to take a number of significant remedial actions that we believe will make us an even stronger company going forward.

## **II. The Task Force**

Over the past nine months, the Task Force and its advisors conducted a thorough review of the CIO losses. The Task Force's work – which included interviews of many current and former JPMorgan employees, an examination of millions of documents, and review of tens of thousands of audio files – was overseen by an independent Review Committee of the Board of Directors, which conducted its own investigation and with whom the Task Force also shared and discussed its findings. The Task Force also shared and discussed its findings with the entire Board, and as you know, made its findings public on January 16, 2013.

The Task Force made five key observations, which are described briefly below. These observations reflect the Task Force's view that direct and principal responsibility for the losses lies with the traders who designed and implemented the flawed trading strategy. However, they also reflect the Task Force's view that responsibility for the flaws that *allowed* the losses to occur lies primarily with CIO management but also with senior Firm management.

The Firm's views on responsibility for these losses have had direct and concrete results. The Firm has terminated the employment of those most responsible and clawed back their compensation; it has accepted the resignations of other relevant employees; and it has reduced the compensation of other personnel both within CIO and elsewhere, including the Chief Executive Officer. Beyond these employment actions, the Firm has undertaken a significant effort, across the entire Firm, to re-examine its risk management practices, and has worked to

take all necessary steps to ensure that the Firm is employing best practices and is well-positioned to prevent similar incidents in the future.

**A. The Findings of the Task Force**

1. Key Observations

The Task Force made five key observations regarding CIO and the losses, and these observations correlate to several of the topics you have requested this testimony address. First, CIO's judgment, execution and escalation of issues in the first quarter of 2012 were poor, in at least six critical areas: (1) CIO management established competing and inconsistent priorities for the Synthetic Credit Portfolio without adequately exploring or understanding how the priorities would be simultaneously addressed; (2) the trading strategies that were designed in an effort to achieve the various priorities were poorly conceived and not fully understood by CIO management and other CIO personnel who might have been in a position to manage the risks of the Synthetic Credit Portfolio effectively; (3) CIO management (including CIO's Finance function) failed to obtain robust, detailed reporting on the activity in the Synthetic Credit Portfolio, and/or to otherwise appropriately monitor the traders' activity as closely as they should have; (4) CIO personnel at all levels failed to adequately respond to and escalate (including to senior Firm management and the Board) concerns that were raised at various points during the trading; (5) certain of the traders did not show the full extent of the Synthetic Credit Portfolio's losses; and (6) CIO provided to senior Firm management excessively optimistic and inadequately analyzed estimates of the Synthetic Credit Portfolio's future performance in the days leading up to the April 13 earnings call.

*Second*, the Firm did not ensure that the controls and oversight of CIO evolved commensurately with the increased complexity and risks of CIO's activities. As a result,

significant risk management weaknesses developed within CIO that allowed the traders to pursue their flawed and risky trading strategies. On this point, the Task Force concluded that senior Firm management's view of CIO had not evolved to reflect the increasingly complex and risky strategies CIO was pursuing in the Synthetic Credit Portfolio; instead, they continued to view CIO as the manager of a stable, high-quality, fixed-income portfolio. As a result, they were less focused on CIO relative to client-facing businesses, and did not do enough to verify that CIO was well managed or that the Firm was fully applying its various risk and other controls to the Synthetic Credit Portfolio's activities. Compounding the matter, the CIO Finance function failed to ensure that its price-testing procedures for the Synthetic Credit Portfolio were being properly and rigorously implemented, and that it produced robust reporting and analytics regarding the portfolio's performance and characteristics.

*Third*, CIO Risk Management lacked the personnel and structure necessary to manage the risks of the Synthetic Credit Portfolio. With respect to personnel, a new CIO Chief Risk Officer was appointed in early 2012, and he was learning the role at the same time the traders were building the ultimately problematic positions. More broadly, the CIO Risk function had been historically understaffed, and some of the CIO risk personnel lacked the requisite skills. With respect to structural issues, the CIO Risk Committee met only infrequently, and its regular attendees did not include personnel from outside CIO. As a result, the CIO Risk Committee did not effectively perform its intended role as a forum for constructive challenge of practices, strategies and controls. Furthermore, at least some CIO risk managers did not consider themselves sufficiently independent from CIO's business operations and did not feel empowered to ask hard questions, criticize trading strategies or escalate their concerns in an effective manner to Firm-wide Risk Management.

CIO Risk Management made a number of key missteps, including failures to (1) review the appropriateness of the CIO risk limits used from 2009 to 2012; (2) ensure that the change to the CIO Value-at-Risk (“VaR”) model for the Synthetic Credit Portfolio in January 2012 was appropriate and being properly implemented; and (3) appreciate the significance of the changes in the Synthetic Credit Portfolio during early 2012.

*Fourth*, the risk limits applicable to CIO were not sufficiently granular. There were no limits by size, asset type or risk factor specific to the Synthetic Credit Portfolio; rather, limits in CIO were applied only to CIO as a whole. The absence of granular limits played a role in allowing the flawed trading strategies to proceed in the first quarter, especially as the positions grew in size.

*Fifth*, approval and implementation of the new CIO VaR model for the Synthetic Credit Portfolio in late January 2012 were flawed, and the model as implemented understated the risks presented by the trades in the first quarter of 2012. The model suffered from significant operational shortcomings that received inadequate scrutiny by CIO Market Risk, the Model Review Group, and the model’s developer in the model approval process. Moreover, although the model produced significantly different results from its predecessor, the personnel involved in reviewing and approving the new model required only limited back-testing.

## 2. Remediation

The Firm has taken comprehensive remedial steps to address deficiencies identified since the losses. These include the following:

*First*, the Firm has replaced the individuals within CIO responsible for the losses. The Firm has terminated the employment or accepted the resignations of the traders and managers who were responsible for the trades that generated the losses, and pursued the maximum

clawback of their compensation. The Firm also accepted the Chief Investment Officer's retirement, as well as her voluntary agreement to return or waive amounts that the Firm otherwise deemed subject to a clawback. The Firm has also substantially reduced (in some cases, to zero) the 2012 incentive compensation for a number of employees and, in addition to reductions for specific CIO employees, has also reduced the 2012 incentive compensation pool for all of CIO.

*Second*, the Firm has appointed a new, experienced CIO leadership team. The new leadership team began promptly to reposition CIO to focus on its basic mandate, and the Firm also has increased resources for key support functions within CIO, including Finance and Risk Management.

*Third*, the Firm has adopted a variety of governance measures to improve its oversight of CIO, and ensure that CIO is better integrated into the rest of the Firm. For example, the Firm has instituted new and robust committee structures within CIO, and has taken steps to enhance the Firm's internal audit coverage of CIO activities and ensure tight linkages among CIO, Corporate Treasury and other operations within the Firm's Corporate sector.<sup>2</sup> The Firm has also integrated the existing CIO Valuation Control Group ("VCG") staff into the Investment Bank's Valuation Control Group. In addition, the Firm has established a CIO Valuation Governance Forum ("VGF") as part of a Firm-wide initiative to strengthen the governance of valuation activities. The Firm has also mandated that the CIO Corporate Business Review be conducted with increasing frequency, and with the same rigor as similar reviews for the Firm's client-facing lines of business.

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<sup>2</sup> The Corporate sector (also referred to as the "Corporate/Private Equity" sector) comprises Private Equity, Treasury, Chief Investment Office, and Other Corporate, which includes corporate staff units (such as Audit, Finance, Human Resources, and others) and other centrally managed expense.

*Fourth*, the Firm has overhauled the Risk Committee for CIO and enhanced the independence of the CIO Risk function. For example, the new CIO Chief Risk Officer's functional reporting practices now conform to his official reporting line; there is no confusion about his accountability to the Firm-wide Risk function. His compensation and career advancement will be controlled by the Firm Chief Risk Officer, with input about his performance from others, as appropriate. CIO's Risk Committee has been renamed the CIO, Treasury and Corporate Risk Committee, and now has broader responsibilities, covering Treasury and Corporate functions as well as CIO, and significant representation beyond CIO. The committee now meets on a weekly basis, and attendees also now include other members of senior management, from within and outside of CIO.

*Fifth*, CIO has implemented new or restructured risk limits covering a broad set of risk parameters. Furthermore, the Synthetic Credit Portfolio – after significant de-risking – was transferred at the end of the second quarter of 2012 from CIO to the JPMorgan Investment Bank, which has an experienced team of traders and risk managers who were better positioned to close out the remaining positions.

*Finally*, under the guidance of its Chief Risk Officer, the Firm conducted a comprehensive self-assessment of its entire Risk organization and, as a result, has implemented a series of improvements both Firm-wide and within the lines of business. In addition to working to improve model development, review, approval, and monitoring, the Firm is reaffirming and, where appropriate, revising its market risk limits across all of its lines of business, and has already introduced additional granular and portfolio-level limits. It has strengthened the Firm-wide limit excession policy to provide for more rapid escalation and a more thorough review. It is working to further improve market-risk reporting, and has made substantial enhancements to

risk reports presented to the Board of Directors' Risk Policy Committee ("DRPC"). The Firm also has restructured its Firm-wide Risk Operating Committee in order to increase focus on identifying and implementing best practices across the Firm. Finally, the Firm has enhanced the structure of its Risk Governance Committee and established a Firm-wide Risk Committee.

**B. Oversight of CIO and the Synthetic Credit Portfolio**

You have asked that I address five specific oversight-related topics: (1) oversight of CIO and the Synthetic Credit Portfolio generally; (2) oversight of the Synthetic Credit Portfolio's trading strategies and risk management; (3) oversight of hedging activities by the Synthetic Credit Portfolio; (4) oversight of valuation practices; and (5) oversight of risk and capital models. Several of these topics are addressed above in the context of specific Task Force observations and remedial actions; I separately discuss below oversight of hedging activities and valuation practices.

With respect to oversight of the hedging activities, let me note at the outset that CIO no longer engages in the type of trading that generated the losses in the Synthetic Credit Portfolio and has refocused on its core mandate of traditional Asset and Liability Management. Future synthetic credit positions will be within applicable risk limits, linked to a particular risk or set of risks that they are designed to offset, and subject to specified documentation, reporting and monitoring requirements.

As to valuation practices, the Firm determined in July 2012 that CIO's internal controls over valuation of the Synthetic Credit Portfolio suffered from a material control weakness as of March 31, 2012. Since this discovery, the Firm has restructured and enhanced its independent valuation control group in order to remedy this shortcoming.

## **C. Communications with Third Parties**

### **1. Investors**

You also asked that I address actions taken to inform investors about the Synthetic Credit Portfolio. The Firm made two relevant disclosures to the market relating to the Synthetic Credit Portfolio during the first half of 2012: on an April 13, 2012 earnings call, and in a May 10, 2012 Form 10-Q and accompanying analyst call. With respect to both, the Firm subsequently learned information that caused it to make a further disclosure to the market.

As to the April 13, 2012 earnings call, as you are aware, Mr. Braunstein stated that the Firm was “very comfortable” with the positions in the Synthetic Credit Portfolio, and Mr. Dimon agreed with an analyst’s characterization of the publicity surrounding the Synthetic Credit Portfolio as a “tempest in a teapot.” Those statements turned out to be wrong, of course, though they were the product of good-faith efforts to assess the Synthetic Credit Portfolio. As described in the Task Force Report, in the period leading up to April 13, Mr. Dimon and Mr. Braunstein, among others, requested that CIO provide information and analyses about the Synthetic Credit Portfolio in light of recent press coverage relating to the Synthetic Credit Portfolio. These analyses concluded, in broad terms, that the Synthetic Credit Portfolio was generally “balanced,” that the market was currently dislocated, and that mark-to-market losses were temporary and manageable. One of the traders in particular expressed confidence that mark-to-market prices in the Synthetic Credit Portfolio would “mean revert.”

The losses in the Synthetic Credit Portfolio, however, increased in the weeks after the April 13 earnings call. These losses prompted senior Firm management in late April to direct non-CIO personnel to review and, ultimately, assume control of the Synthetic Credit Portfolio. A team led by a senior member of Firm-wide Market Risk examined the portfolio, and after

analyzing, among other things, correlations of the positions and sensitivities under a range of market scenarios, the team concluded – and informed senior Firm management – that the Synthetic Credit Portfolio faced much greater exposure than previously reported by CIO. The team also found that the market’s knowledge of CIO’s positions would make it even more challenging to reduce the risks presented by those positions.

In addition to this risk-related review, in preparation for the filing of its Form 10-Q for the first quarter of 2012, the Firm undertook a review relating to the valuations of positions in the Synthetic Credit Portfolio. Based on this review, the Firm concluded that its marks at March 31 for the Synthetic Credit Portfolio complied with U.S. Generally Accepted Accounting Principles. This conclusion was reached in consultation with the Firm’s outside auditors, PricewaterhouseCoopers LLP (“PwC”).

On May 10, the Firm disclosed that there were significant problems with the strategy for the Synthetic Credit Portfolio. In Mr. Dimon’s words, the strategy was “flawed, complex, poorly reviewed, poorly executed, and poorly monitored.” The Firm disclosed that the Synthetic Credit Portfolio had incurred more than \$2 billion in mark-to-market losses up to that point in the second quarter, with the possibility of additional future losses and volatility.

Shortly after May 10, the Task Force was formed to investigate the causes of the losses. In the course of our ensuing work, we became aware of evidence – primarily in the form of electronic communications and taped conversations – that raised questions about the integrity of the marks in the Synthetic Credit Portfolio in March 2012. After consulting with PwC, the Firm concluded that it was no longer confident that the March 31 marks reflected good-faith estimates of the fair value of all the instruments in the Synthetic Credit Portfolio. Accordingly, on July 13, the Firm announced that it would be restating its first-quarter net income, to lower it by \$459

million. At the same time, the Firm also announced that it had been expeditiously reducing risk in the Synthetic Credit Portfolio and that the cumulative year-to-date losses through June 30, 2012 had grown to approximately \$5.8 billion.

## 2. Regulators

Finally, you asked about actions taken to inform regulators about the Synthetic Credit Portfolio. The Task Force's focus was the causes of the losses, and as a result, a detailed timeline of the Firm's communications with its regulators relating to the portfolio was beyond our scope. As a general matter, we try to be very open and communicative with our regulators, and they generally have access to whatever information they seek about matters like trading positions. Unfortunately, as we have said before, to the extent that we were wrong about the riskiness of the Synthetic Credit Portfolio in mid-April, we were also wrong when we discussed the portfolio's losses with our regulators at that time. And thereafter, when the losses in the Synthetic Credit Portfolio accelerated at the end of April, we should have been proactive in keeping our regulators so informed. That said, as noted in the Task Force report, senior Firm management and the new CIO leadership team recognize the importance of an open and transparent culture, including in its communications with the Firm's regulators. The Firm has been working and will continue to work to ensure regulators consistently have full and timely visibility into CIO's activities, and to enhance a culture of prompt and complete disclosure in accordance with regulators' expectations.

## **III. Policy Considerations**

JPMorgan and its regulators have a common interest in ensuring that the Firm has the right risk controls in place; CIO no longer engages in the types of trades that generated the losses in the Synthetic Credit Portfolio. Future synthetic credit positions in CIO will be subject to

appropriate reporting and monitoring requirements, and linked with appropriate documentation to a particular risk or set of risks that they are designed to offset. We believe that the changes we have made appropriately reflect the approach to hedging outlined in the proposed Volcker rule, in that they impose strong internal controls over hedging, including requirements that all hedge transactions be properly documented and monitored. We also understand that Congress and our regulators will determine the appropriate regulatory and policy response to ensure that the issues we faced are not repeated by us or other institutions.

#### **IV. Conclusion**

As described above, the Task Force does not believe that the CIO losses stemmed from any one specific act or omission. Rather, the Task Force concluded that the losses were the result of a number of acts and omissions, some large and some seemingly small, some involving personnel and some involving structure, and a change in any one of which might have led to a different result. This experience has caused substantial and healthy introspection at the Firm and recognition of the need for continued improvement in multiple areas. Ultimately, the Task Force concluded that this incident teaches a number of important lessons that the Firm is taking very seriously. Thank you for the opportunity to participate in this hearing and I am happy to answer your questions.