

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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**Senate Investigations Subcommittee Holds Hearing
and Releases Report on JPMorgan Chase Whale Trades**

WASHINGTON – Following a nine-month probe, the U.S. Senate Permanent Subcommittee on Investigations will hold a hearing tomorrow entitled, “JPMorgan Chase Whale Trades: A Case History of Derivatives Risks and Abuses,” and release a 300-page, bipartisan report with new information on the credit derivative trades that lost at least \$6.2 billion last year.

The whale trades were conducted by traders in the London office of the Chief Investment Office (CIO) of JPMorgan Chase & Co., America’s biggest bank and largest derivatives dealer. The Subcommittee’s investigation has determined that, over the course of the first quarter of 2012, the CIO used its Synthetic Credit Portfolio (SCP) to engage in high risk derivatives trading; mismarked the trading book to hide losses; disregarded multiple indicators of increasing risk; manipulated risk models; dodged regulatory oversight; and misinformed investors, regulators, and the public about the nature of its risky derivatives trading. The Subcommittee’s investigation has exposed not only high risk activities and abuses at JPMorgan Chase, but also broader, systemic problems related to the valuation, risk analysis, disclosure, and oversight of synthetic credit derivatives.

“Our investigation opens a window into the hidden world of high stakes derivatives trading by a major bank,” said Sen. Carl Levin, D-Mich., Subcommittee Chairman. “The whale trades show how synthetic credit derivatives, when purchased in massive quantities through complex trading strategies, can become a runaway train of unstoppable losses. The whale trades demonstrate how derivative valuation practices can be manipulated to hide losses, and how derivative risk controls can be bypassed or manipulated to conceal risk. The American people have already suffered one devastating economic assault rooted in Wall Street excess, and they can’t afford another caused by unchecked derivative abuses. When Wall Street plays with fire, American families get burned. It’s time to put away the matches.”

Senator John McCain, R-Az., the Ranking Member on the Subcommittee, added the following: “The Subcommittee investigation sheds new light on this shameful example of an American financial institution operating with a ‘too big to fail’ mentality. JPMorgan’s actions reveal how even a bank boasting a ‘fortress balance sheet’ can be easily seduced by the promise of huge profits through high-risk trading. JPMorgan gambled away billions of dollars through risky and exotic trades, then intentionally hid its losses from investors and the public, showing

complete disregard for risk management procedures and regulatory oversight. While JPMorgan misled federal regulators, those same regulators failed to use the tools at their disposal to uncover the bank's deceptions. JPMorgan's 'Whale Trades' echo the reckless and irresponsible behavior that led to the financial collapse that struck our nation's economy four years ago. While I will need to closely examine any future legislation aimed at addressing some of the misconduct identified in this report, Wall Street must be reminded that it cannot gamble with our nation's financial security, and that American taxpayer dollars should never be used as poker chips in JPMorgan's casino."

In its investigation, the Subcommittee reviewed over 90,000 documents and conducted over 50 interviews and briefings. The hearing, which begins at 9:30 a.m., on March 15, 2013, will take testimony from current and former JPMorgan Chase executives and representatives of its primary regulator, the Office of the Comptroller of the Currency (OCC). At the hearing, the Subcommittee will also release nearly 100 hearing exhibits, including internal bank and OCC records, emails, and telephone call transcripts.

The Levin-McCain report makes the following findings of fact.

- (1) **Increased Risk Without Notice to Regulators.** In the first quarter of 2012, without alerting its regulators, JPMorgan Chase's Chief Investment Office used bank deposits, including some that were federally insured, to construct a \$157 billion portfolio of synthetic credit derivatives, engaged in high risk, complex, short term trading strategies, and disclosed the extent and high risk nature of the portfolio to its regulators only after it attracted media attention.
- (2) **Mischaracterized High Risk Trading as Hedging.** JPMorgan Chase claimed at times that its Synthetic Credit Portfolio functioned as a hedge against bank credit risks, but failed to identify the assets or portfolios being hedged, test the size and effectiveness of the alleged hedging activity, or show how the SCP lowered rather than increased bank risk.
- (3) **Hid Massive Losses.** JPMorgan Chase, through its Chief Investment Office, hid over \$660 million in losses in the Synthetic Credit Portfolio for several months in 2012, by allowing the CIO to overstate the value of its credit derivatives; ignoring red flags that the values were inaccurate, including conflicting Investment Bank values and counterparty collateral disputes; and supporting reviews which exposed the SCP's questionable pricing practices but upheld the suspect values.
- (4) **Disregarded Risk.** In the first three months of 2012, when the CIO breached all five of the major risk limits on the Synthetic Credit Portfolio, rather than divest itself of risky positions, JPMorgan Chase disregarded the warning signals and downplayed the SCP's risk by allowing the CIO to raise the limits, change its risk evaluation models, and continue trading despite the red flags.
- (5) **Dodged OCC Oversight.** JPMorgan Chase dodged OCC oversight of its Synthetic Credit Portfolio by not alerting the OCC to the nature and extent of the portfolio;

failing to inform the OCC when the SCP grew tenfold in 2011 and tripled in 2012; omitting SCP specific data from routine reports sent to the OCC; omitting mention of the SCP's growing size, complexity, risk profile, and losses; responding to OCC information requests with blanket assurances and unhelpful aggregate portfolio data; and initially denying portfolio valuation problems.

- (6) Failed Regulatory Oversight.** The OCC failed to investigate CIO trading activity that triggered multiple, sustained risk limit breaches; tolerated bank reports that omitted portfolio-specific performance data from the CIO; failed to notice when some monthly CIO reports stopped arriving; failed to question a new VaR model that dramatically lowered the SCP's risk profile; and initially accepted blanket assurances by the bank that concerns about the SCP were unfounded.
- (7) Mischaracterized the Portfolio.** After the whale trades became public, JPMorgan Chase misinformed investors, regulators, policymakers and the public about its Synthetic Credit Portfolio by downplaying the portfolio's size, risk profile, and losses; describing it as the product of long-term investment decisionmaking to reduce risk and produce stress loss protection, and claiming it was vetted by the bank's risk managers and was transparent to regulators, none of which was true.

The Levin-McCain report makes the following recommendations that may curb derivative risks and abuses.

- (1) Require Derivatives Performance Data.** Federal regulators should require banks to identify all internal investment portfolios containing derivatives over a specified notional size, and require periodic reports with detailed performance data for those portfolios. Regulators should also conduct an annual review to detect undisclosed derivatives trading with notional values, net exposures, or profit-loss reports over specified amounts.
- (2) Require Contemporaneous Hedge Documentation.** Federal regulators should require banks to establish hedging policies and procedures that mandate detailed documentation when establishing a hedge, including identifying the assets being hedged, how the hedge lowers the risk associated with those assets, how and when the hedge will be tested for effectiveness, and how the hedge will be unwound and by whom. Regulators should also require banks to provide periodic testing results on the effectiveness of any hedge over a specified size, and periodic profit and loss reports so that hedging activities producing continuing profits over a specified level can be investigated.
- (3) Strengthen Credit Derivative Valuations.** Federal regulators should strengthen credit derivative valuation procedures, including by encouraging banks to use independent pricing services or, in the alternative, prices reflecting actual, executed trades; requiring disclosure to the regulator of counterparty valuation disputes over a specified level; and requiring deviations from midpoint prices over the course of a month to be quantified, explained, and, if appropriate, investigated.

(4) Investigate Risk Limit Breaches. Federal regulators should track and investigate trading activities that cause large or sustained breaches of VaR, CS01, CSW10%, stop-loss limits, or other specified risk or stress limits or risk metrics.

(5) Investigate Models That Substantially Lower Risk. To prevent model manipulation, federal regulators should require disclosure of, and investigate, any risk or capital evaluation model which, when activated, materially lowers the purported risk or regulatory capital requirements for a trading activity or portfolio.

(6) Implement Merkley-Levin Provisions. Federal financial regulators should immediately issue a final rule implementing the Merkley-Levin provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act, also known as the Volcker Rule, to stop high risk proprietary trading activities and the build-up of high risk assets at federally insured banks and their affiliates.

(7) Enhance Derivative Capital Charges. Federal financial regulators should impose additional capital charges for derivatives trading characterized as “permitted activities” under the Merkley-Levin provisions, as authorized by Section 13(d)(3) of the Bank Holding Company Act. In addition, when implementing the Basel III Accords, federal financial regulators should prioritize enhancing capital charges for trading book assets.

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