JP MORGAN: LONDON WHALE CASE

BACKGROUND, CASE AND RECOMMENDATION

BY GROUP 6

BENJAPA YODTHONG 5304640088

KASOM SIRIRANGSI TANTIWECHARAK 5304640252

NATTAPAT NGATHONG 5304640393

SUPANIDA INTHAYOONG 5304641052

PRONNALICH O.BIYOKVICHIT 5304640849

THANAPONG KHANCHAROENSUK 5304641177

WHAT DOES JP MORGAN DO?

- A LEADER IN FINANCIAL SERVICES
  - CORE PRINCIPLE: 'CLIENTS INTERESTS COME FIRST'
  - HAS BEEN OPERATING MORE THAN 200 YEARS
- BUSINESS
  - ASSET MANAGEMENT
  - INVESTMENT BANKING
  - PRIVATE BANKING
  - TREASURY AND SECURITIES SERVICES
  - COMMERCIAL BANKING

Source: CFA institute

BUILDING UP TO THE LONDON WHALE:

3 discrete components of JP Morgan trading strategy

1. Package A: JPM purchased credit default swaps (CDS) on high-yield bonds.

Package A (long CDS on high-yield bonds) could act as a hedge on a loan book.

* Unluckily, Package A was performing poorly. Thus JPM created package B. Package B was possibly intended to act as a hedge on package A.

2. Package B: JPM wrote substantial amounts of CDX.NA.IG.9, which is a basket of CDS on investment-grade bonds from 125 different issuers.

* But then again, the market was moving against package B, JPM sought to make up for it with trades on package C, rather than unwinding package B.

Source: CFA institute

BUILDING UP TO THE LONDON WHALE:

3 discrete components of JP Morgan trading strategy

3. **Package C**: JPM bought CDS on investment-grade bonds.

* It is unknown how much basis risk is introduced by package C, relative to either package B or to JPMorgan's actual loan book.

Nevertheless, all of this is like a dog chasing its tail, and that shouldn't happen with true hedges.

Eventually, the problem occurred with the Package B.

Source: The Wall Street Journal

THE LONDON WHALE: TIMELINE

- APRIL 6, 2012
  - Markets have been puzzled by unusual movements in some credit markets and buzzing about the identity of a trader dubbed "the London whale."
  - The trader is a J.P. Morgan Chase & Co. employee named Bruno Michel Iksil, who had been placing bets on an index called "CDX.NA.IG.9".
  - The index track the prices of credit-default swaps.
  - Which means he was betting on the improving credit of those companies, which he did through the index—CDX.NA.IG.9.
  - CDS.NA.IG.9 originally had 125 members, but credit events (DEFAULT) of CIT Group, Fannie Mae, Freddie Mac and Washington Mutual shrunk it to 121.

Source: The Wall Street Journal, Bloomberg

THE LONDON WHALE: TIMELINE

- MAY 11, 2012
  - J.P. Morgan has taken $2 billion in trading losses in the past six weeks and could face an additional $1 billion in second-quarter losses due to market volatility. (according to J.P. Morgan's reports)

- WHAT DID THE CEO SAY?
  - Mr. Dimon took "ultimate responsibility" for the trading losses in London, and cut his pay by 50% in 2012.
  - Ms. Ina Drew, the Cheif Investment Office (CIO), resigned from her job.

LOSSES: JP MORGAN VS OTHER

	JP morgan	other (source:dealbook.nytimes.com, bloomberg)
amount	$2 billion	estimated $6 billion
notes	amount that JP Morgan claims on mid 2011	an overall losses publicized by reporter according to an insiders information

HOW DID JP MORGAN DEFEND?

The banks want to be able to make trades as a hedge against their entire portfolio, not against particular, specific risks.

That's exactly the argument JPMorgan made about the trade that just went bad.

"The purpose of this is to hedge the macro risk of the company," a JPMorgan executive told ProPublica. "It's what we are supposed to be doing."

Source: Investopedia

HEDGE VS SPECULATIVE

	HEDGE	SPECULATIVE
HOW TO	Offsetting position in derivative	Bet or guess on where they believe market is headed
PURPOSE	eliminate volatility associated with the price of an asset	to make profit from fluctuations in the price of securities
RESULT (if success)	protected from any losses, also restricted from any gains	gain from profit
EXAMPLE	Jewelry maker have major contract due in 6 months - believe that gold price may increase so buy a 6-month futures contract	believe that a stock is overpriced so short sell the stock, wait for price to decline and buy back to make profit.

Source: sec.gov

WHY JP MORGAN GUILTY?

JPMorgan Chase Agrees to Pay $200 Million and Admits Wrongdoing to Settle SEC Charges

Firm Must Pay $920 Million in Total Penalties in Global Settlement

FOR IMMEDIATE RELEASE
2013-187

Washington D.C., Sept. 19, 2013 — The Securities and Exchange Commission today charged JPMorgan Chase & Co. with misstating financial results and lacking effective internal controls to detect and prevent its traders from fraudulently overvaluing investments to conceal hundreds of millions of dollars in trading losses.

Sarbanes-Oxley Act (2002)

Public companies are required to

* create and maintain internal controls that provide investors with reasonable assurances that their financial statements are reliable
* ensure that senior management shares important information with key internal decision makers such as the board of directors.

LAW SUIT

- U.S. Authorities filed civil cases against two former J.P. Morgan traders who were colleagues of "London Whale" Bruno Iksil, alleging they sought to hide the mounting losses in early 2012.

- However, the U.S. Attorney's office agreed not to prosecute Mr' Iksil, who was cooperating with the investigation.

- In October 2013, it emerged that JP Morgan had agreed to pay the fine money which will be split among regulators,

1. $300 million going to the Office of the Comptroller of the Currency,
2. $200 million going to the Securities and Exchange Commission,
3. $200 million to the Federal Reserve and
4. $220 million to the U.K. Financial Conduct Authority.

RECOMMENDATIONS: FOR FIRM

1. Conflict of interests and Moral Hazard : The Board of Directors and CEO

   Jamie Dimon who are both the current "Chairman" of the Board of Director and JPM's CEO should not hold the two positions at the same time -> To let the Internal Auditors do their jobs properly!

2. Placing more importance in Risk Management

   Ethics and Code of conduct Problem: traders intent on concealing loss

   Reward the Whistle-blowers   Punish the wrongdoers

   When loss occurs to a certain level, traders must follow the strict procedures stated in the operational manual

RECOMMENDATIONS: FOR FIRM

3. Emphasizing on Risk Assessment: Value At Risk

Dimon claimed that "the change the bank made to the VAR was flawed"

4. Management: The higher-ups should always know what going on in the organization

More stringent on the system of approval/ reporting/ operating process

The traders should immediately report to their superiors if something goes wrong

RECOMMENDATIONS: FOR THE REGULATORS

1. Clarifying the definite of Volcker rule

    Hedge V.s. Bet

2. Inspecting, Notifying and Give Warning -> Break up/ Split bank's holding position when it is too big, even it claims that it was the act of Hedging

    For the case of London Whale, Iksil had been building up his position in CDX for a long time before resulting in a huge loss. The loss would not be this big if his positions in CDX were small

Smaller position is less likely to cause "Market Distortion" and result in "Market Manipulation"

-> one of the charges that forced JPM to pay $100M on top of the $920M

RECOMMENDATIONS: FOR THE REGULATORS

When large trading losses occur in financial institutions, the industry and regulators rightly ask: "How can these losses continue to occur when the industry has very sophisticated systems and processes to prevent them?"

3. Issuing more severe punishment/ penalty to the one responsible

Recommendations: Striping working license, Banning from the industry for X years

4. Separating depository unit with the unit that invest their own money

Lessen the Moral Hazard Problem: Too big Too fail

Prevent Bank Runs when the firm made a huge loss

VOLCKER RULE

- Paul Volcker
- Section 619 in Dodd-Frank wall Street Reform and Consumer Protection Act
- Modern Glass-Steagall Firewall
- Prohibits US government-backed banks from making certain kinds of speculative bets for their own benefit, rather than their clients
- Ban hedge fund, private equity fund and proprietary trading by commercial banks
- Financial institutions are not allowed to have deposit in excess of 10% of the whole country's deposit
- (Aug2010) Set the maximum percentage commercial bank can invest in hedge fund and private equity at 3% of its capital

VOLCKER RULE

Purpose

- Separate the role of commercial banks: take deposit VS invest in risky securities
- Minimize conflict of interest between bank and clients
- Control risk
- To ensure that 'London Whale case' won't happen again

Advantage

- Manage panics and contagion, or the way panic spreads, in the financial markets.
- Could have prevented the losses by Iksil because it requires banks to show how trades work as hedges instead of as proprietary trades

Disadvantage

- Reduce competitiveness (US investment banks will be at an automatic competitive disadvantage compared with European or Asian counterparts)
- Reduce efficiency and profit of banks
- Banks have lobbied heavily against the Volcker rule, arguing that it will restrict market-making and other standard banking practices.

THANK YOU :)

“Q&A”