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JPMorgan Chase London Whale D: Risk-Management Practices

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Abstract

JPMorgan Chase (JPM) prided itself on having the best risk-management practices in the financial industry, having survived the 2007-09 financial crisis in better shape than many competitors. Chief Executive Officer Jamie Dimon often spoke of the bank's "fortress balance sheet." A keen focus on risk management is vital to JPM's longevity, as is the case with all highly leveraged financial institutions. However, the JPM Task Force that investigated the $6 billion 2012 London Whale trading loss concluded that risk-management practices at the bank's Chief Investment Office (CIO), the unit in which the loss occurred, were given less scrutiny by senior management than those of the bank's client-facing businesses, despite the fact that the Chief Investment Office managed $350 billion in assets, an amount almost double JPM's total stockholders' equity at December 31, 2011.

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[1] This case is one of nine produced by the Yale Program on Financial Stability (YPFS) examining issues related to the JPMorgan Chase London Whale. The following are the other case studies in this case series.

- *JPMorgan Chase London Whale A: Risky Business*
- *JPMorgan Chase London Whale B: Derivatives Valuation*
- *JPMorgan Chase London Whale C: Risk Limits, Metrics, and Models*
- *JPMorgan Chase London Whale E: Supervisory Oversight*
- *JPMorgan Chase London Whale F: Required Securities Disclosures*
- *JPMorgan Chase London Whale G: Hedging Versus Proprietary Trading*
- *JPMorgan Chase London Whale H: Cross-Border Regulation*
- *JPMorgan Chase London Whale Z: Background and Overview*

Cases are available at the Journal of Financial Crises.

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1. Introduction

Jamie Dimon has been the public face of JPMorgan Chase & Company (JPM) since becoming the bank's Chief Executive Officer in December 2005 and Chairman of the Board in December 2006. Mr. Dimon often spoke of the bank's "fortress balance sheet," and JPM prided itself on having the best risk-management practices in the financial industry, surviving the 2007-09 financial crisis in better shape than many competitors. In fact, JPM acquired Bear Stearns investment firm and Washington Mutual bank during the height of the crisis in 2008 with strong encouragement and support from the United States (US) government.

Partially as the result of these acquisitions, JPM grew to become the largest US bank holding company, with almost $2.3 trillion in total assets at December 31, 2011. The holding company was managed on a line-of-business basis, with six major reportable business segments, listed below, and a "Corporate/Private Equity" segment. This latter segment included the firm's internal Corporate Treasury department, a private equity group, the Chief Investment Office (CIO), corporate staff units, and other centrally managed expenses.

- Wholesale Businesses
    - Investment Bank
    - Commercial Banking
    - Treasury and Security Services
    - Asset Management
- Consumer Businesses
    - Retail Financial Services
    - Card Services and Auto

Many of the risk management practices employed in the client-facing parts of JPM did not extend to the CIO, which was a consistently profitable internal unit that invested the bank's excess deposits (over loan balances) and also hedged risks associated with borrower default, interest rates, and mortgage servicing rights on behalf of other units within the bank. As a result of deficiencies in CIO's risk management, Bruno Iksil and a small team of derivatives traders in CIO's London office were able to undertake an ill-timed and ill-fated trading strategy in the first quarter of 2012 that ultimately cost the bank over $6 billion and the traders their jobs, while also tarnishing the reputation of both Dimon and JPM.

The JPMorgan Chase Management Task Force that conducted an internal investigation of the 2012 CIO losses concluded that risk management practices at CIO were given less scrutiny by senior bank management than those of client-facing businesses, despite the fact that CIO managed about $350 billion in assets, an amount almost double JPM's total stockholders' equity at December 31, 2011.

As an example of lax risk management, CIO operated without a Chief Risk Officer from its inception as a stand-alone unit in 2005 until January 2012, despite the key role that the business unit Chief Risk Officer was supposed to play in the JPM risk-management process. In addition, the CIO Risk Committee met only three times in all of 2011, and the committee's first meeting in 2012 was on March 28, almost a week after the head of CIO had ordered Iksil and his team to stop trading the credit derivatives that caused the losses.

The remainder of the case is organized as follows. Section 2 explains JPM's risk-management framework and governance structure, including responsibilities at the Board of Directors, senior management, and line-of-business levels. Section 3 describes specific flaws in the CIO risk function and possible reasons for those shortcomings. Section 4 concludes with a discussion of remedial measures undertaken by JPM to improve risk management across all units of the bank including CIO. See Appendix 1 for a timeline of key events pertinent to this case module.

Questions

1. Why were CIO's risk management practices given less scrutiny by senior bank management?
2. What deficiencies resulted from this lack of attention?
3. Will the actions taken by JPM following the bank's self-assessment of its risk function in the aftermath of the London Whale trades prove effective in mitigating similar incidents in the future?

2. Risk Management at JPM

Cognizant of the risks facing it as a highly leveraged financial institution, JPM devoted 43 pages of its 2011 Form 10-K annual report to the Securities and Exchange Commission describing the firm's risk management practices, beginning by noting "[r]isk is an inherent part of JPMorgan Chase's business activities." JPM identified the following nine major risks that affect the bank (JPM 10-K 2011, 125).

1. Liquidity
2. Credit
3. Market
4. Interest Rate
5. Country
6. Private Equity
7. Operational
8. Legal and Fiduciary
9. Reputation

JPM's risk management framework and governance structure consisted of both quantitative and qualitative elements. Bruno Iksil and his fellow team of traders within JPM's CIO responsible for the London Whale losses generally ignored the quantitative risk limits, metrics, and models that were in place to measure and monitor the amount of market risk they took. In addition, the traders mismarked the fair value of certain of their derivative positions in an attempt to hide their losses from management, thereby also hiding how much risk they took. (These topics and deficiencies in certain other aspects of CIO risk management are covered in Zeissler, et al. 2019B and Zeissler, et al. 2014C.)

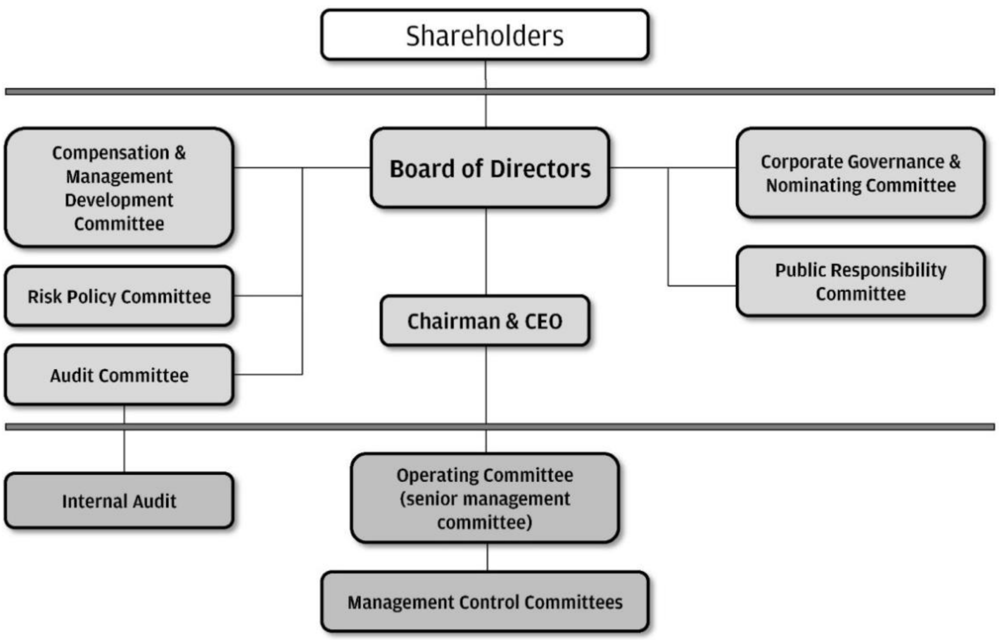
On April 4, 2012, just two days before Bloomberg and the *Wall Street Journal* released the first reports about the London Whale trades, JPM issued a proxy statement and notice of its 2012 annual shareholders meeting. The proxy statement summarized JPM's corporate governance structure, including the five principal committees of the Board of Directors. (See Figure 1.)

The Risk Policy Committee "provides oversight of the CEO's and senior management's responsibilities to assess and manage the Firm's credit risk, market risk, interest-rate risk, investment risk, liquidity risk, and reputational risk, and is also responsible for review of the

Firm's fiduciary and asset management activities." In 2011, the committee was chaired by James Crown (president of Henry Crown and Company, a privately-owned investment company), with David Cote (chairman and chief executive officer of Honeywell International) and Ellen Futter (president of the American Museum of Natural History) serving as committee members (JPM Proxy 2012, 3-5, 8-9).

JPM used a formal framework to link the firm's appetite for risk with its return targets, capital management, and other controls. The Risk Policy Committee approved the risk appetite policy on behalf of the Board. Chief Executive Officer Jamie Dimon established JPM's overall risk appetite and also approved the risk appetite that the head of each of the bank's lines of business had set for their unit (JPM Proxy 2012, 11).

Figure 1: JPM Corporate Governance Structure



Source: JPM Proxy 2012, 8.

The stated aim of JPM's risk-management framework was "to create a culture of risk awareness and personal responsibility throughout the Firm where collaboration, discussion, escalation and sharing of information is encouraged." Consistent with encouraging personal responsibility, JPM's risk-governance structure was "based on the principle that each line of business is responsible for managing the risk inherent in its business, albeit with appropriate Corporate oversight" (JPM 10-K 2011, 125). The following corporate functions provided oversight.

1. Risk Management: "coordinates and communicates with each line of business through the line of business risk committees and chief risk officers to manage risk"

2. Chief Investment Office (CIO): "responsible for measuring, monitoring, reporting and managing the Firm's liquidity, interest rate and foreign exchange risk, and other structural risks"
3. Corporate Treasury: same responsibilities as the CIO
4. Legal and Compliance: "oversight for legal risk"

JPM assigned primary responsibility for the nine risks to the four functions as shown in Figure 2.

The Risk Management function was headed by the bank's Chief Risk Officer (Barry Zubrow to January 2012, and John Hogan thereafter). The Chief Risk Officer reported to Dimon, was a member of the senior management Operating Committee, and had accountability to the Board and its Risk Policy Committee.

Figure 2: Nine Major Risk Types and Four Corporate Functions with Risk-Management Responsibilities

	Risk Management	Chief Investment Office*	Corporate Treasury*	Legal and Compliance
Liquidity Risk		■	■	
Credit Risk	■			
Market Risk	■			
Interest Rate Risk		■	■	
Country Risk	■			
Private Equity Risk	■			
Operational Risk	■			
Legal Risk				■
Reputation Risk**				

* These units are also responsible for foreign exchange risk and "other structural risks."
** Reputation risk was not directly assigned to one of the four functions, since "maintenance of the Firm's reputation is the responsibility of each individual employee at the Firm."
Source: JPM 10-K 2011, 125, 167.

3. Risk Management in CIO

Though sharing some similar responsibilities, as noted above, the CIO unit was spun off from the Corporate Treasury department in 2005 as a separate group within JPM. Ina Drew, who served as JPM's Chief Investment Officer, was appointed to lead the CIO.

CIO played an important role at JPM, being primarily responsible for managing $350 billion of the bank's excess deposits, an amount roughly double JPM's total stockholders' equity of $184 billion at December 31, 2011 (JPM 10-K 2011, 179). One of CIO's secondary roles was to use derivatives such as credit default swaps to partially offset the risk that someone who borrowed from JPM might not repay their debt. This risk was to be hedged by CIO's Synthetic Credit Portfolio (SCP), which was run out of London by senior trader Bruno Iksil, junior trader Julien Grout, and their superior Javier Martin-Artajo. The SCP was the source of JPM's $6.2 billion "London Whale" loss.

The JPMorgan Chase Management Task Force (JPM Task Force) was formed in May 2012 to investigate the reasons for the CIO losses and to suggest remedies. In its report issued in January 2013, the JPM Task Force concluded that risk-management practices at CIO were given less scrutiny by senior bank management for a number of reasons (JPM Task Force 2013, 94-96).

First, CIO did not need to meet government regulations applicable to client-facing businesses within JPM, such as the Truth in Lending Act that protected consumer borrowers. CIO was part of JPM's Corporate/Private Equity group, not part of one of the bank's six reportable business segments (JPM 10-K 2011, 79).

Second, CIO was consistently profitable before 2012, and the SCP added over $1.8 billion to the bank's pre-tax income from 2008 through 2011.

Third, CIO's primary portfolio was invested in Treasury bonds and other investment-grade (high-quality, low-risk) fixed-income securities, which is a conservative investment approach that was consistent with how other banks managed their excess deposits.

Fourth, although the net notional size (i.e., the net underlying par value on which credit protection was bought or sold) of SCP increased from $4 billion to $51 billion during 2011, this was still relatively small in comparison to CIO's $350 billion bond portfolio resulting from the excess deposits.

Fifth, the dramatic increase in the size of the SCP book in 2011 and the first quarter of 2012 was obscured by the implementation of a new Value at Risk model in January 2012 that appeared to show that CIO market risk had remained roughly constant.

The JPM Task Force concluded that insufficient scrutiny of CIO by top bank management resulted in the following negative outcomes:

> 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 precise 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. And finally, the Task Force has concluded that CIO management, along with Firm-wide Risk Management, did not fulfill their responsibilities to ensure that CIO control functions were effective or that the environment in CIO was conducive to their effectiveness. (JPM Task Force 2013, 12-15)

Despite the vital role that the line-of-business Chief Risk Officer was supposed to play in the risk-management process, CIO did not have a true Chief Risk Officer from its inception as a stand-alone unit in 2005 until January 2012. Peter Weiland served as CIO's senior-most risk officer (in his capacity as head of Market Risk) from 2008 to January 2012, but he initially reported directly to Ina Drew, who was JPM's Chief Investment Officer and the head of CIO. This resulted in a lack of independence between trading and risk-management functions.

After criticism from regulators in 2009, Weiland began reporting directly to Zubrow, the JPM Chief Risk Officer at the time, while continuing to report indirectly to Drew. However, Weiland testified to the US Senate that this change in reporting relationships made no meaningful difference in practice and that his job was descriptive (to make sure that risk metrics were properly calculated and disseminated), rather than prescriptive (to enforce limits and challenge trading decisions if needed).

In January 2012, just as Iksil proposed to aggressively ramp up the size of the SCP's derivatives positions, JPM made several changes to risk personnel. At the firm-wide level, Zubrow moved from Chief Risk Officer to become head of Corporate and Regulatory Affairs (before announcing his retirement in October 2012). John Hogan, previously the Chief Risk Officer of JPM's Investment Bank, took over for Zubrow.

One of Hogan's first acts was to appoint Irvin Goldman to be CIO's first official Chief Risk Officer, based on the recommendation of Drew and Zubrow. Though Goldman previously worked for Drew as a portfolio manager and then as head of CIO Strategy, he had never served in any risk-management capacity at JPM prior to this promotion.

Furthermore, the CIO Risk Committee was not in a position to act as an effective check on risk taking by the traders. Unlike risk committee meetings in other JPM business lines, CIO Risk Committee meetings usually included only CIO personnel. Making matters worse, the CIO Risk Committee met only three times in all of 2011, and the committee met for the first time in 2012 on March 28, after Drew had ordered her employees to stop trading the SCP book on March 23. The JPM Task Force noted that "[h]ad there been senior traders or risk managers from outside CIO or had the CIO Risk Committee met more often, the process might have been used to more pointedly vet the traders' strategies in the first quarter of 2012" (JPM Task Force 2013, 100).

4. Aftermath

In its report, the JPM Task Force held Zubrow, in his capacity as JPM Chief Risk Officer until January 2012, at fault for certain failures of the CIO Risk function. "The CIO Risk organization was not equipped to properly risk-manage the portfolio during the first quarter of 2012, and it performed ineffectively…during that period" due to shortcomings in structure and personnel, coupled with inadequate limits and controls on the SCP (JPM Task Force 2013, 8). Zubrow announced his retirement from JPM in October 2012, effective February 2013.

The JPM Task Force also held Douglas Braunstein, the JPM Chief Financial Officer, responsible for weaknesses in financial controls over the SCP and for the failure of the CIO Finance function to properly monitor the evolution of the SCP book during the first quarter of 2012. Braunstein stepped down as Chief Financial Officer at the end of 2012. (Goldman resigned in July 2012, and Weiland resigned in October.)

Hogan, the JPM Chief Risk Officer since January 2012, led a self-assessment of the risk function in CIO and each of the other lines of business, focusing on three major areas.

First, with respect to model governance and implementation, JPM initiated plans to identify the significant valuation and risk models across its business units, to store all models in a central database, to minimize how different models treat the same products, and to review old or rarely used models (JPM Task Force 2013, 113).

Second, with respect to market risk and governance, Chetan Bhargiri was promoted from Managing Director of Market Risk at JPM's Investment Bank to Chief Risk Officer of CIO, Treasury, and Corporate. Mr. Bhargiri had already hired 20 risk-management officers by January 2013. JPM reviewed and revised market-risk limits across all lines of business, adding more granular limits, including numerous portfolio-specific limits at CIO for the first time (JPM Task Force 2013, 114).

Third, with respect to risk independence, JPM created a firm-wide risk committee. The existing CIO risk committee with its many shortcomings was discontinued. It was replaced by the CIO, Treasury, and Corporate Risk Committee, which began to hold weekly meetings chaired by Bhargiri and by Matthew Zames, the JPM co-Chief Operating Officer. In addition to taking place much more often, the risk committee meetings now included senior managers from inside and outside CIO, including Mr. Hogan (JPM Task Force 2013, 116).

In September and October 2013, the Commodity Futures Trading Commission, the Federal Reserve Board, the Office of the Comptroller of the Currency (OCC), the Securities and Exchange Commission, and the United Kingdom's Financial Conduct Authority announced settlement agreements with JPM, penalizing the firm a total of $1.020 billion and requiring it to admit wrongdoing in certain instances. (OCC Press Release 2013-140, USCFTC 2013)

While the various regulatory agencies focused on different aspects of the 2012 CIO losses in their respective settlements with JPM, the OCC levied a $300 million fine (the largest single piece of the penalty) against JPM for unsafe and unsound banking practices that were caused by "inadequate oversight and governance to protect the bank from material risk, inadequate risk management processes and procedures, inadequate control over pricing of trades, inadequate development and implementation of models used by the bank, and inadequate internal audit processes" (OCC Press Release 2013 and report 2013-140). (Omissions in JPM's disclosures to the OCC, as well as failures by the OCC to properly supervise the bank's risks, are explored in Zeissler, et al. 2014E.)

The Federal Reserve Board penalized JPM $200 million for failing "to appropriately inform its board of directors and the Federal Reserve of deficiencies in risk-management systems identified by management" (FRB Press Release 20130919).

In an internal memo dated March 31, 2014, JPM said that it would recombine the CIO and Treasury units, which is how asset-liability management function is traditionally structured at most banks (Braithwaite and Massoudi 2014).

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Appendix 1: Timeline of Key Events

2012	January	John Hogan replaced Barry Zubrow as JPM Chief Risk Officer. Hogan appointed Irvin Goldman to be the first official Chief Risk Officer of the Chief Investment Office (CIO).
	March 23	Ina Drew (JPM Chief Investment Officer and head of CIO) ordered the CIO traders to stop trading the Synthetic Credit Portfolio (SCP).
	March 28	CIO Risk Committee held its first meeting of 2012.
	April 6	Bloomberg and the *Wall Street Journal* published the first news stories about the "London Whale."
	May	The JPMorgan Chase Management Task Force (JPM Task Force) was formed to investigate the reasons for the CIO losses and to suggest remedies.
	July	Goldman resigned.
	October	Zubrow announced that he would resign from JPM, effective February 2013. Peter Weiland, CIO Head of Market Risk, resigned.
	December 31	Year-to-date SCP losses = $6.2 billion. Douglas Braunstein stepped down as JPM Chief Financial Officer.
2013	January	The JPM Task Force issued its report.
	September-October	Four regulators in the US and one in the UK reached settlement agreements with JPM, totaling $1.020 billion in penalties.