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JPMorgan Chase London Whale H: Cross-Border Regulation¹

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Abstract

As a global financial service provider, JPMorgan Chase (JPM) is supervised by banking regulatory agencies in different countries. Bruno Iksil, the derivatives trader primarily responsible for the \$6 billion trading loss in 2012, was based in JPM's London office. This office was regulated both by the Office of the Comptroller of the Currency (OCC) of the United States (US) and by the Financial Services Authority (FSA), which served as the sole regulator of all financial services in the United Kingdom (UK). Banking regulators in the US and the UK have entered into agreements with one another to define basic parameters for sharing information gathered during bank examinations and even assisting one another with bank inspections under certain circumstances. However, even as JPM sought to stifle OCC and FSA supervision, cooperation between the US and UK regulators was minimal.

¹ This case study 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 D: Risk-Management Practices*
- *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 Z: Background and Overview.*

Cases are available at the Journal of Financial Crises.

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1. Introduction

On April 2, 2012, the Financial Services Authority (FSA), which regulated all financial services in the United Kingdom (UK), embarked on an ambitious restructuring plan specifically designed to ultimately replace itself with two successor regulatory agencies the following year. Not even a full week into the reorganization on April 6, the FSA was confronted by news reports that a London-based trader for JPMorgan Chase & Company (JPM) had taken sizeable derivatives positions that potentially exposed the bank to large losses, since the trader single-handedly distorted the market for insurance against default by corporate borrowers. In the end, this incident cost the bank over \$6 billion in market-related losses and an additional \$1 billion in government-imposed penalties.

The FSA had taken over the supervision of banks in the UK from the Bank of England in 1998, and the Authority evolved over the next decade to become the sole regulator of all financial services in the UK, in contrast to the patchwork of regulatory agencies in the United States. However, because this single regulator model was deemed inadequate in light of the financial crisis of 2007-09, the UK government overhauled its financial regulatory framework, replacing the FSA with the Prudential Regulation Authority and the Financial Conduct Authority in 2013.

As a global financial service provider, JPM is subject to supervision by banking regulatory agencies in different countries. JPM's commercial bank subsidiaries hold a US national charter and thus are regulated by the Office of the Comptroller of the Currency (OCC). Bruno Iksil, the derivatives trader referenced in the April 6 media reports, was based in the London office of JPM's Chief Investment Office (CIO). The OCC was the primary US-based regulator of CIO's activities both in the US and in the UK, including those of Iksil, since CIO's main responsibility was to invest excess deposits generated by JPM's commercial bank units. The FSA also regulated JPM's London operations, including those of the CIO.

Of course, JPM is not the only large US bank to have significant operations in the UK, just as some large British banks also have material operations in the US. As a result, banking regulators in the US and the UK have entered into Memoranda of Understanding with one another to define basic parameters for sharing information gathered during bank examinations and even assisting one another with bank inspections under certain circumstances. Despite the fact that the OCC and the FSA were parties to such a memorandum, the actual amount of cooperation in supervising JPM's London office appears to have been minimal. The US Senate subcommittee that investigated the 2012 trading loss matter made no mention in its 300-page report that the OCC ever requested assistance from its UK counterpart in examining CIO's London office.

Though all domestic and foreign banks operating in the UK are required by the FSA Principles for Businesses to deal with regulators in an open and cooperative way, the CIO withheld critical data from the FSA in 2012 about the dramatic increase in the size of Iksil's credit derivative positions and the continued losses suffered by his portfolio.

The remainder of the case is organized as follows. Section 2 describes the CIO and its London operations, as well as the agreement by US and UK banking regulators to share information. Section 3 surveys the evolution of the financial regulatory regime in the UK since 1997. Section 4 details FSA's complaints of being misled by JPM as the London Whale saga was unfolding in 2012. Section 5 concludes with a discussion of the penalties levied by the UK banking regulator against JPM, as well as the role of supervisory colleges. (See Appendix 1 for a timeline of key events pertinent to this case module.)

Questions

1. What resources did the OCC have available (both on its own and in partnership with UK regulators) to examine CIO's London operations? Did the OCC make sufficient use of these resources?
2. Could the timing of the FSA reorganization in April 2012 have contributed to weaker oversight of JPM at that time?
3. How did JPM attempt to stifle FSA/FCA supervision?
4. What role, if any, could supervisory colleges have played in preventing/detecting the London Whale incident?
5. What are the impediments to cross-border regulatory cooperation, and can these impediments be removed?

2. The Extent of US/UK Cross-Border Regulatory Cooperation

In 2005, JPM separated its CIO from its Treasury unit, with CIO becoming a separate unit within the bank. As JPM grew into the largest US bank holding company after the financial crisis of 2007-09, the CIO likewise grew in importance, managing approximately \$350 billion of low-risk fixed income securities by December 31, 2011. These securities were funded using excess deposits generated by JPM's commercial banking subsidiaries (i.e., deposits that had not otherwise been loaned to the bank's customers). By year-end 2011, the CIO had 428 employees based in New York and London, consisting of 140 front-office traders and 288 middle- and back-office staff (JPM Task Force 2013, 21).

Achilles Macris, who was the head of CIO's London office, had received approval in 2006 to begin trading credit derivatives, such as credit default swaps, as a way to hedge some of the credit risk emanating from JPM's commercial banking units. This effort to partially offset the bank's default risk eventually became known as the Synthetic Credit Portfolio (SCP), and this trading strategy led to total net revenue of almost \$1.8 billion from 2008 through 2011 (US Senate Report, 56).

Three London-based CIO employees were responsible for the SCP on a daily basis. Javier Martin-Artajo, the head of credit and equity trading, reported to Macris and directly oversaw the SCP. Bruno Iksil, who would come to be known as the "London Whale," reported to Martin-Artajo and was the senior trader for the SCP. Julien Grout was a junior trader and reported to Iksil (US Senate Report, 24-25).

Because CIO's main activities were closely related to JPM's banking subsidiaries, CIO's primary US regulator was the OCC. The OCC was established in the 1860s to charter, regulate, and supervise all national banks. By 2011, the OCC supervised about 2,000 banks using a staff of 3,700 employees stationed in over 60 field offices across the country grouped under four district offices (OCC Annual Report 2011, inside cover).

JPM is not the only large US bank to have significant operations in the UK. In fact, the OCC maintains an office in London to better supervise the international activities of the national banks under its jurisdiction. Likewise, various UK banks also have material operations in the US. The Bank of England entered into a joint Memorandum of Understanding (MOU) with the primary US banking regulators in 1996 "[i]n view of the fact that a number of banking organizations incorporated in the United States and the United Kingdom have material

operations in each of the respective jurisdictions” (BOE MOU, 4). The OCC, the Federal Deposit Insurance Corporation, and the Federal Reserve Board were party to this MOU.

In addition to calling for signatories to meet at least annually to discuss general supervisory developments and specific concerns about cross-border banks, the MOU calls for the sharing of information. The US and UK regulators agreed to share “material supervisory concerns” (if specific banks broke the law or otherwise operated in an unsafe or unsound manner), the status of remedial actions imposed on banks, and information contained in examination and inspection reports of cross-border branches and subsidiaries.

Though each country’s regulators would retain primary responsibility for examining all domestic and foreign branches and subsidiaries of banks headquartered in that country (i.e., a US regulator would examine US and UK branches of a US bank), the home country regulator could ask the host regulator to conduct an examination on its behalf “on an exceptional basis” (BOE MOU, 4-7).

The US Senate subcommittee that investigated the 2012 CIO losses made no mention in its 300-page report that the OCC requested assistance from its UK counterpart in examining CIO’s London office. However, this perhaps would have been a worthwhile undertaking. Whereas the OCC had examiners with derivatives expertise stationed in its London office, the agency “did not task any of its London staff to conduct examinations of the CIO’s London operations,” even though the SCP was pursuing complicated strategies involving credit derivatives (US Senate Report, 219).

(When the Bank of England’s duty to supervise UK banks was transferred to the Financial Services Authority in 1998, the MOU was carried forward to reflect this fact. Likewise, the MOU remained in effect after the Financial Services Authority was replaced by the Prudential Regulation Authority and the Financial Conduct Authority in 2013. See Section 3 for a further discussion of the evolution of the financial regulatory regime in the UK.)

3. Overview of the UK Financial Regulatory Regime

At the same time that London-based JPM employee Bruno Iksil was ramping up the size and complexity of his credit derivative trading strategy at the start of 2012, the financial regulatory regime in the UK was undergoing its most profound changes in more than a decade.

In 1997, the Chancellor of the Exchequer began the process of merging banking supervision and investment services regulation into the existing Securities and Investment Board, which then changed its name to the Financial Services Authority (FSA). In stark contrast to the longstanding patchwork of banking and financial regulatory agencies in the US, the scope of the FSA’s authority grew over the following decade, until it became the sole financial services regulator in the UK (FSA History).

1. Banking supervision (1998, from the Bank of England)
2. UK stock listings (2000, from the London Stock Exchange)
3. Securities and futures markets (2001)
4. Investment management (2001)
5. Mortgage finance (2004)

6. Insurance (2005)

Due to the perception that this single-regulator model had proven inadequate during the financial crisis of 2007-09, and shortly after the change of government in the UK in May 2010, the Chancellor of the Exchequer announced in June 2010 that the UK government would overhaul its financial regulatory framework, including replacing the FSA with two new successor agencies, the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA) (FSA Regulatory Reform). (See Figure 1.)

Figure 1: Primary Responsibilities of the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA)

The Prudential Regulation Authority (the PRA), which will be a subsidiary of the Bank of England, will be responsible for promoting the stable and prudent operation of the financial system through regulation of all deposit-taking institutions, insurers and investment banks.

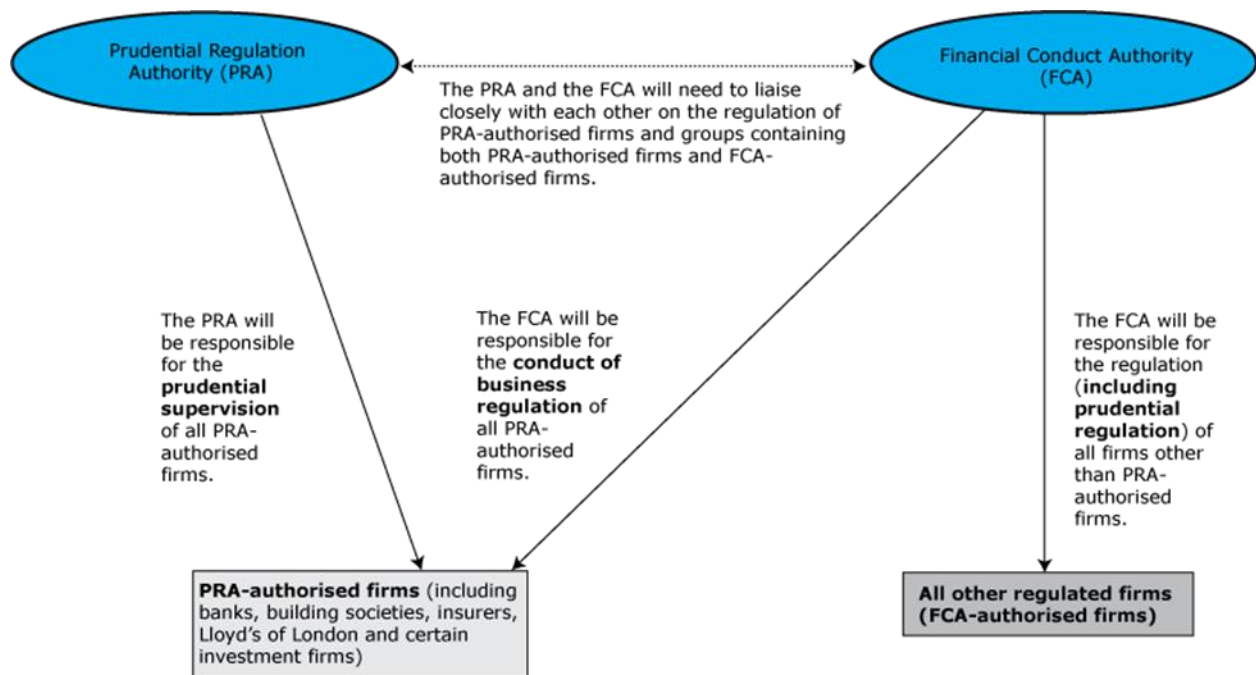
The Financial Conduct Authority (the FCA) will be responsible for regulation of conduct in retail, as well as wholesale, financial markets and the infrastructure that supports those markets. The FCA will also have responsibility for the prudential regulation of firms that do not fall under the PRA's scope..

Source: FSA Regulatory Reform.

Banks, insurers, and major investment firms (referred to as “PRA-authorized”) are dual regulated; that is, they are supervised by the PRA for prudential matters and by the FCA for conduct issues. All other financial firms are supervised by the FCA for both prudential and conduct matters (FSA Regulatory Reform). (See Figure 2.)

In preparation for the change, FSA reorganized itself internally into a so-called “twin peaks” operating model, separating prudential and conduct regulation on April 2, 2012, a year before the official legal creation of the PRA and FCA on April 1, 2013. (FSA Regulatory Reform) Importantly, the start of the FSA transition on April 2, 2012, came at the beginning of the very same week in which the huge size and complexity of Iksil’s credit-derivative bets were exposed in articles published by Bloomberg and the *Wall Street Journal* on April 6.

Figure 2: Prudential Regulation Authority and Financial Conduct Authority



Source: FSA Regulatory Reform.

4. Misleading the FSA/FCA

One of the reasons given by the FCA in its 2013 final notice penalizing JPM was the bank's failure to be open and cooperative with the regulator. (The final notice covered events that took place in 2012, when the FSA was still the UK banking regulator, but the notice was issued in September 2013, by which time the FSA had been replaced by the FCA as discussed in Section 3.) FSA's claim that JPM was not forthcoming about CIO's trading activities was based on a written request made by the FSA in November 2010 that it be informed of:

- (a) any significant growth in assets or change in CIO's Europe, Middle East and Asia portfolios, including the SCP; (b) any significant change in CIO's level of risk appetite; (c) any material change to portfolio mandates or risk limits allocated to CIO's Europe, Middle East and Asia portfolios, which included the SCP; and (d) material changes to CIO's Europe, Middle East and Asia strategy. (FCA Final Notice, 42)

The FSA would hold quarterly supervisory meetings with JPM. The first-quarter 2012 meeting took place on March 28 and was attended by London-based CIO and SCP management. The SCP was discussed during the meeting, but JPM personnel did not inform the FSA of certain important facts.

Though JPM provided analysis to the FSA showing that the SCP had lost \$170 million through February and was expected to lose an additional \$51 million in March, the trading strategy had in fact already lost a total of \$298 million by March 27. (SCP would go on to lose \$319 million just on March 31, for a total of \$719 million for the quarter.) JPM sought to placate the FSA about the size of the losses with analysis showing that SCP's Value at Risk (VaR) had apparently decreased from an average of \$92 million during January to only \$48 million by

March 16. However, the bank neglected to mention that the primary reason for the drop was because CIO changed the risk model that is used to calculate VaR at the end of January. Likewise, JPM did not inform FSA that the size of the credit derivative positions in the SCP had more than doubled from \$51 billion of net notional value at December 31, 2011, to \$131 billion by March 26. (SCP would grow to \$151 billion of net notional value by March 31.) In addition, JPM did not notify the FSA that the breach of a key risk limit less than a week before the March 28 meeting between the bank and the regulator had finally caused the CIO to halt active trading of the SCP on March 23 (FCA Final Notice, 42-43).

The following week began with the internal reorganization of the FSA into separate prudential and conduct business units on Monday, April 2, and ended with the first news stories about the London Whale trades on Friday, April 6. Like its counterparts in the US, the FSA was caught off guard by the media reports and immediately requested more information from the bank about Iksil and his trading activities. In a conference call on April 10, CIO London management assured the FSA that the SCP had not materially changed since the March 28 meeting and that the news stories were about credit derivatives that were “broadly a hedge of the firm’s exposures outside CIO.” However, CIO management failed to inform the FSA that cumulative losses from the portfolio in question were more than \$700 million during the first quarter and were expected to and in fact did exceed \$1 billion by the end of the April 10 trading day (FCA Final Notice, 43-44).

The JPMorgan Chase Management Task Force (JPM Task Force) launched its internal investigation of the CIO losses in May 2012, and senior bank management met with the FSA on June 20 to discuss the initial findings of the investigation. Though the JPM Task Force was aware by this date that the SCP traders may have incorrectly reported the fair value of the credit derivatives they traded in an effort to hide their increasing losses and that the bank’s legal advisors had started interviewing the SCP traders as a result, this information was not shared with the FSA. JPM senior management only informed the FSA on July 2 that the bank had uncovered evidence causing it to doubt the accuracy of the SCP fair value reporting process. Not long thereafter, JPM announced publicly on July 13 that it was restating first-quarter earnings, reducing consolidated total net revenue by \$660 million from \$26.712 billion to \$26.052 billion, which in turn reduced after-tax net income by \$459 million from \$5.383 billion to \$4.924 billion (FCA Final Notice, 45).

5. Aftermath

On September 19, 2013, the FCA joined with banking regulators in the US to announce a global settlement with JPM pertaining to the 2012 London Whale trades. The FCA, the Federal Reserve Board, the OCC, and the Securities and Exchange Commission (SEC) penalized JPM a total of \$920 million. One month later, the Commodity Futures Trading Commission (CFTC) also settled with the bank for a penalty of \$100 million.

While the various regulatory agencies focused on different elements of the CIO losses in their respective settlement agreements with the bank, the FCA levied a penalty of £137,610,000 (about \$220 million) because JPM’s “conduct demonstrated flaws permeating all levels of the firm: from portfolio level right up to senior management, resulting in breaches of Principles 2, 3, 5, and 11 of the FCA’s Principles for Businesses” (FCA Press Release).

In its September 19 press release, the FCA commented that the joint settlement agreement resulted from a “significant cross-border investigation” and thanked the following US parties “for their cooperation”: the SEC, the US Attorney’s Office for the Southern District of New York, the Federal Bureau of Investigation, the OCC, the New York Federal Reserve Bank, and

the CFTC (FCA Press Release). However, the Federal Reserve Board, the OCC, and the SEC did not mention the existence of any cross-border investigation in their respective press releases of September 19 announcing the settlement.

Though MOU, such as the one between the US and the UK, have existed on a bilateral and multilateral basis for many years, some of these cooperative arrangements were later formalized as “supervisory colleges” in the 2000s. In response, the Basel Committee on Banking Supervision (BCBS) published *Good Practice Principles on Supervisory Colleges* in 2010 pertaining to these “permanent but flexible structures for collaboration, coordination, and information-sharing among the authorities responsible for and involved in the supervision of cross-border banking groups” (BCBS 2014, 1).

Figure 3: Financial Conduct Authority Principles for Businesses

Principle 2 requires regulated firms to conduct their business with due skill, care, and diligence.

Principle 3 requires regulated firms to take reasonable care to organise and control their affairs responsibly and effectively with adequate risk management systems.

Principle 5 requires firms to observe proper standards of market conduct.

Principle 11 requires firms to deal with their regulators in an open and cooperative way and to disclose to the FCA or PRA appropriately anything relating to their business of which the FCA or PRA would reasonably expect notice.

Source: FCA Press Release.

In June 2014, the BCBS revised these recommendations, now entitled *Principles for Effective Supervisory Colleges*, to reflect changes in supervisory best practice that arose from the recent financial crisis. See Appendix 2 for a summary of the seven principles.

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Appendix 1: Timeline of Key Events

1997		Financial Services Authority (FSA) formed in the United Kingdom (UK) as a successor to the Securities and Investment Board.
1998		FSA took over banking supervision.
2000		FSA took over approval of UK stock listings.
2001		FSA took over regulation of investment management firms, as well as securities and futures markets.
2004		FSA took over mortgage regulation.
2005		FSA took over insurance regulation. JPMorgan Chase & Company (JPM) spun off its Chief Investment Office (CIO) as a separate unit to invest the bank's excess deposits.
2006		CIO approved a proposal by Achilles Macris to trade credit derivatives.
2010	June	The UK Chancellor of the Exchequer announced that the government of the UK would overhaul the financial regulatory framework, including abolishing the Financial Services Authority (FSA) and splitting its functions into two new successor agencies.
2011	December 31	CIO had 428 employees and managed a \$350 billion portfolio of low-risk fixed income securities.
2012	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	FSA held a quarterly supervisory meeting with JPM.
	April 2	FSA reorganized itself internally into a so-called "twin peaks" operating model, separating prudential and conduct regulation.
	April 6	Bloomberg and the <i>Wall Street Journal</i> published the first news stories about the "London Whale."
	April 10	FSA met with CIO London management for the first time since the media stories. CIO management did not inform the FSA that cumulative losses from the SCP book were more than \$700 million during the first quarter and were expected to, and in fact did, exceed \$1 billion by the end of the trading day.
	July 13	JPM restated Q1 earnings, reporting additional pre-tax losses of \$660 million due to the SCP (\$459 million after tax).
	December 31	Year-to-date SCP losses = \$6.2 billion.
2013	April 1	FSA replaced by the Prudential Regulation Authority and the Financial Conduct Authority.
	September-October	Four regulators in the US and one in the UK reached settlement agreements with JPM, totaling \$1.020 billion in penalties.

Appendix 2: Principles for Effective Supervisory Colleges

Principle 1: College objectives

“Supervisory colleges should enhance, on an ongoing and confidential basis, information exchange and cooperation among supervisors to support the effective supervision of international banking groups. Colleges should enhance the mutual trust and appreciation of needs and responsibilities on which supervisory relationships are built.”

Principle 2: College structures

“Supervisory colleges should be structured in a way that enhances effective oversight of international banking groups, taking into account the scale, structure and complexity of the banking group, its significance in host jurisdictions and the corresponding needs of its supervisors. While a college is a single forum, multiple or variable substructures may be used given that no single college structure is likely to be suitable for all banks.”

Principle 3: Information-sharing

“College members should do their best to promptly share appropriate information with respect to a banking group’s principal risks, vulnerabilities and risk management practices. Mutual trust and willingness to cooperate are key for effective two-way information-sharing. To facilitate this process, supervisory colleges should strive towards confidentiality agreements among college members, such as those contained in memoranda of understanding.”

Principle 4: Communication channels

“Communication channels within a college should ensure the efficiency, ease of use, integrity and confidentiality of information exchange. The home supervisor should make sound communication channels available to the college and host supervisors should use them appropriately and regularly.”

Principle 5: Collaborative work

“Supervisory colleges should promote collaborative work among members, as appropriate, to improve the effectiveness of the oversight of international banking groups. Collaborative work should be by agreement among supervisors and should recognize national legal constraints.”

Principle 6: Interaction with the institution

“Interaction between the college members and the banking group should complement the interaction that individual supervisors (both home and host) have with the specific entity they supervise.”

Principle 7: Crisis preparedness

“Supervisory colleges are distinct from but complementary to crisis management and resolution structures. The work of a banking group’s supervisory college should contribute to effective crisis management planning.”

Source: BCBS 2014, 4-18.