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# Perspective: The 'London Whale'



By Claudia Zeisberger, Affiliate Professor of Decision Sciences and Entrepreneurship and Family Enterprise at INSEAD and Andrew Chen (INSEAD MBA '13J)

**As headlines of apparent risk management failure or weak oversight inside one of Wall Street's largest institutions abound, we argue that the story of a loss of 0.25 percent of the bank's assets is getting too much face-time from regulators and the press.**

In August, the US Attorneys' Office filed the first criminal charges in connection with the 'London Whale' trading scandal. Javier Martin-Artajo and Julien Grout of J.P. Morgan stand accused of wire fraud, falsification of books and records, false filings with the U.S. Securities and Exchange Commission, and conspiracy to commit all of the above. The 'London Whale' himself, Bruno Iksil, escaped prosecution after cutting a deal with U.S. authorities to cooperate fully with the investigation. The press had a field day and the financial market community is watching with fascination/ horror as the various penalties are being doled out to J.P. Morgan. It is time to get our facts straight:

All three traders were directly involved and responsible for the bank's Structured Credit Portfolio (SCP) which is part of the Chief Investment Office (CIO) at J.P. Morgan and was led by Ina Drew, a longtime J.P. Morgan employee, since 2005. The CIO was not a proprietary trading or risk taking unit; instead it was set up as a cash management vehicle to invest the

bank's excess cash, amounting to US\$350 billion by the end of 2011. Given the low-risk mandate, the vast majority was invested in the least risky and most liquid fixed income securities.

The reporting lines and relative seniority for the SCP were as follows:

Ina Drew – CIO Global Head (New York)

Achilles Macris – Head of International Investments (London)

Javier Martin-Artajo – Head of European Credit/Equity  
(London)

Bruno Iksil – Trader/SCP (London)

Julien Grout – Junior Trader/SCP (London)

In an upcoming case study, the authors explore whether the bank's Chief Investment Office (CIO) had a clear mandate that was properly aligned with the firm's risk appetite and whether it had consistent and detailed reporting that could have brought the losses earlier to management's attention.

### **Conflicting mandates**

The SCP was first launched in 2007 to serve as a passive credit hedge for the CIO portfolio, given its inherently long fixed income exposure. It primarily invested in the Markit CDX and iTraxx credit indices, which were the most liquid credit indices in the market, though far less liquid than the typical fixed income instruments in the portfolio. Despite its origins as a passive hedge, the SCP generated US\$1 billion of positive returns in 2009, as credit spreads widened sharply. Seeing the potential for the SCP to be profitable, the traders managing the SCP began to apply an active and opportunistic strategy by targeting specific events in the credit markets.

Towards the end of 2011, J.P. Morgan management wanted to reduce the Risk Weighted Assets (RWA) across the firm. For the CIO, this meant reducing the size of the SCP, which was a large contributor of RWAs. This task was to be handled by Iksil and Grout, who were directly managed by Martin-Artajo. Because the SCP had grown significantly in size, the traders were not able to sell their positions without taking large losses. By exiting

large illiquid positions (of which the market was well aware), they would undoubtedly have pushed prices against themselves. Notably, this was similar to the dilemma LTCM (Long Term Capital) had in 1998 – large exposures, significant basis risk, illiquidity and the market knew their positions. The traders found themselves with conflicting mandates of reducing the bank’s RWA exposure on the one hand and not turning an understated unrealised loss into a much larger realised loss.

As a solution, the SCP traders suggested to Ina Drew that they reduce RWA by “hedging” the SCP, which ironically was itself a hedge. This would reduce *net* portfolio exposure, but result in greatly increasing the *gross* exposure; selling less-liquid off-the-run credit increased the portfolios basis exposure. Drew approved this approach, as she also wanted to avoid realising large losses upfront. As so often, the desire to avoid taking large losses upfront probably magnified the final damage. A little pain early may have prevented a lot of pain later.

### **Weak reporting, weak oversight**

Importantly, Drew completely relied on Martin-Artajo, Iksil, and Grout for detailed updates on the SCP. She regularly received reporting for the CIO portfolio as a whole, but not of its various components. Furthermore, because it was not a client facing business and possibly because Ina Drew was held in high regard, the inner workings of the CIO faced less scrutiny than J.P. Morgan’s other lines of business. Without rigorous oversight, the CIO continued to be seen as a low risk conservative cash management vehicle. Only the SCP traders knew exactly how disproportionately risky the credit portfolio was, relative to the rest of the CIO’s exposure. Those same traders were given wide latitude regarding portfolio valuations in ambiguous situations, as per the valuation policy of the CIO, even though the CIO’s own protocol was to defer to the valuations of J.P. Morgan Investment Bank. Perhaps it is not a surprise that this contradictory valuation policy was deemed “Needs Improvement” during the CIO’s latest internal audit.

As part of the new trading approach, the internal CIO risk group implemented a new risk model which increased their de facto risk limits. While not against company policy for an individual business unit to develop its own risk model, it was very unusual. This model received provisional approval from the firm-wide risk group, subject to further analysis that was never completed. Interestingly, the internal CIO risk group reported to Drew and not to firm-wide risk, undermining their independence. With ultimate risk management and portfolio management responsibilities resting with Ina Drew, there was a

clear conflict of interest. Furthermore, because she was the main point of contact with senior management, she was essentially the only person who could escalate situations as necessary. In the case of the SCP, the full extent of the problem remained in-house until it was too late.

### **Who is really at fault?**

In the wake of the events of the 'London Whale', Ina Drew and several of the senior CIO members resigned. J.P. Morgan sacked the traders involved and began to clawback their compensation. This episode also triggered a review of firm-wide risk management policies across all business lines. The cumulative loss of unwinding the portfolio was US\$6.2 billion and was a black mark against J.P. Morgan's previously solid reputation for risk management. While it's clear that the traders being charged played an important role, perhaps it's worth asking whether and how this situation could have been prevented? That is not to say J.P. Morgan would have been able to avoid all trading losses, but if independent and regular reporting, risk management, and valuation policies were instituted within the CIO and the broader company, would the London Whale have never grown to such proportions? Or are trading teams at financial institutions inherently set-up to focus on the generation of profits, accepting the fact that the occasional whale will just enter the fray?

Dispite the admission of guilt and the penalties which will surely be doled out by the various agencies over the coming month, the fact remains that a US\$6 billion loss in the CIO pales in comparison to J.P. Morgan's profits of US\$24 billion in its firm wide trading books.

Public discourse often anchors our thoughts, so let us offer an alternative: Indeed, US\$6.2 billion is a large loss; but 1.77 percent of the assets managed by the CIO sounds like a mere drop in the bucket. The fact is that J.P. Morgan's last 12 months (Q3 2012 to Q2 2013) profit of US\$24 billion was 20 percent less than it would have been ex-Whale - the bank did not even come close to a net loss. A 0.25 percent loss of its assets in the context of an active market maker, liquidity provider and trading institution surely does not deserve such scrutiny.

Will the regulators and shareholders have the guts to change the way risk is being taken inside financial institutions? I would argue that as long as the profits are rolling in, we will continue to accept the occasional collateral damage in the shape of a whale. Time to get the context right.

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