Markets&Finance

How JPMorgan Lost $2 Billion Without Really Trying

▶ The bank won't say, but clues are surfacing

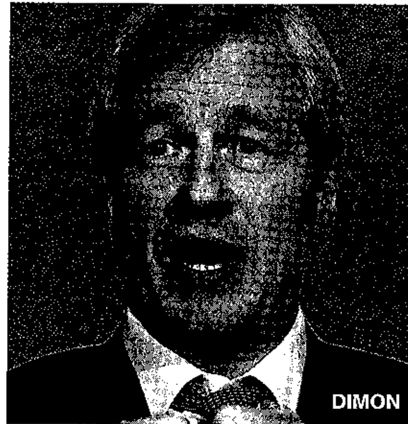
▶ "You can't just exit the position overnight"

The $2 billion trading loss that **JPMorgan Chase** announced in a hastily scheduled conference call on May 10 has its roots in credit-default swaps, the same derivatives that helped trigger the financial crisis—only this time there were no mortgages involved.

The bank has launched an internal investigation, regulators are swarming, and the Department of Justice has said it is pursuing a criminal probe. The bank has not yet released details of the money-losing trades. But based on publicly available information plus interviews with traders, former JPMorgan employees, and fund managers, it's possible to draw the basic outlines of what may have gone wrong.

The mistakes were made in the bank's Chief Investment Office, run by Ina Drew, who left the company on May 14. The office is in charge of managing excess cash and some of its investments. In the past five years, Chief Executive Officer Jamie Dimon has transformed the operation, increasing the size and risk of its speculative bets, according to five former executives with direct knowledge of the changes, Bloomberg News reported in April. The mandate was to generate profits, a shift from the office's mission of protecting JPMorgan from risks inherent in its banking business, such as interest-rate and currency fluctuations. A spokesman for the bank declined to comment.

Credit-default swaps are insurance-like contracts between two parties. The buyer makes regular payments to the seller, who must make the buyer whole if an insured bond defaults. In addition to buying credit-default swaps on a particular bond, investors can buy swaps on indexes of bonds, such as the ones created by **Markit Group**, a deriviatives firm. The indexes rise when economic conditions worsen and the likelihood of corporate bond defaults increases. Traders use them to speculate on changing credit conditions. Buying the index can be a way for someone who owns a lot of corporate bonds to hedge against a decline in their value.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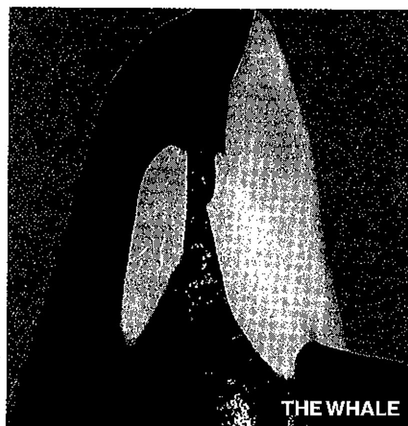
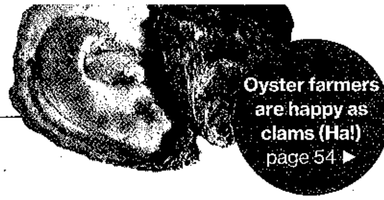

THE WHALE

PHOTO ILLUSTRATION BY 731; DIMON: MARIO TAMA/GETTY IMAGES; DREW: JPMORGAN CHASE & CO./BLOOMBERG; ALL CANADA PHOTOS/GETTY IMAGES

In 2011, JPMorgan profited by betting that credit conditions would worsen. In December, though, the European Central Bank provided long-term loans to euro zone banks, igniting a bond rally. Suddenly, JPMorgan's bearish bets were vulnerable. Early this year, London-based traders in JPMorgan's Chief Investment Office made offsetting bullish bets, according to market participants. It sold credit insurance using a Markit CDX North America Investment Grade Index that reflects the price of credit-default swaps on 121 companies that had investment-grade ratings when the index was created in 2007. The bank is thought to have sold insurance on the index using contracts that expire in 2017.

To protect against short-term losses, it also bought insurance on the index using contracts that expire at the end of 2012. That could have been a profitable strategy, because the 2017 insurance was more expensive than the 2012. And as long as the spread between the prices of the two contracts remained relatively stable, any decline in the value of one would be offset by an increase in the other, reducing the bank's risk of an overall loss on the position.

JPMorgan bought and sold so many contracts on the Markit CDX that it may have driven price moves in the $10 trillion market for credit swaps indexes tied to corporate health, according to market participants. At one point the cost of insurance via the index fell 20 percent below the average cost of insuring the individual bonds that composed the index. "The strategy overall got too big," says Peter



Oyster farmers are happy as clams (Ha!) page 54 ▶

Quoted

"Every bank has risk. It's just a matter of how well people manage it, and what they do with it, and how they allocate the risk across different spectrums. I don't think you want to live in a world where banks don't take risks."
—Drew Matus, senior U.S. economist at UBS Securities

Tchir, a former credit derivatives trader who now heads TF Market Advisors, a New York trading firm. "Once their activity was moving the market, they should have stopped and got out."

Sensing an opportunity, some hedge funds bought the 2017 contracts and sold credit insurance on the underlying bonds, hoping to profit when the relationship between the prices returned to normal. But because JPMorgan continued to be a big seller of insurance, the prices got even more out of whack, giving the hedge funds a paper loss. That led some traders to complain about the situation to the press. On April 5, Bloomberg News published a story saying that Bruno Iksil, a London-based trader for JPMorgan, had amassed a position so large that he may have been driving price moves in the credit derivatives market. The information was attributed to five traders at hedge funds and rival banks who requested anonymity because they were not authorized to discuss the transactions. Iksil's influence on the market spurred some counterparts to dub him the London Whale.

Once the news got out, things quickly went south for JPMorgan. Hedge funds increased their bets that prices would come back in line. Thanks to their trades plus deteriorating credit conditions, the prices of the 2017 index contracts rose more than the prices of the 2012 contracts. JPMorgan's paper losses mounted.

Compounding the losses were the sheer size of the bets, which made it difficult for the bank to unwind its trades. "These had to be massive positions" to inflict the loss JPMorgan suffered, says Michael Livian, CEO of Manhattan asset manager Livian & Co. and a former credit derivatives specialist at Bear Stearns. "And when you build that kind of size in the credit derivative market, you have to know you can't just exit the position overnight."

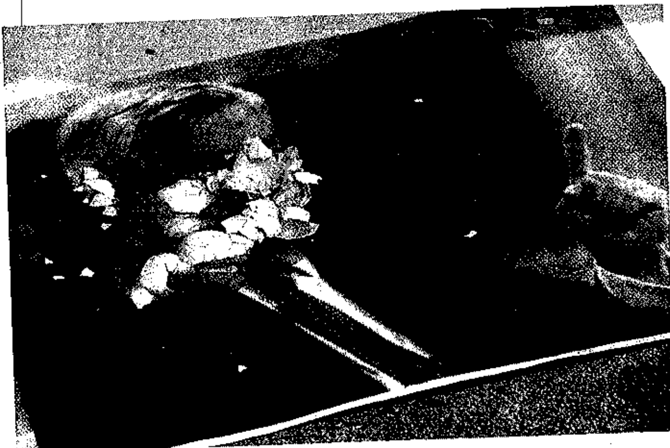
On the May 10 conference call, Dimon confessed: "The portfolio has proven to be riskier, more volatile, and less effective as an economic hedge than we thought." For JPMorgan, the nation's largest bank, the stakes are far bigger than a $2 billion paper loss. Since the bank announced its loss, investors have driven the stock down 13 percent, knocking $20 billion off the company's market value as of May 16.

The episode has reignited the debate over how much freedom banks should have to make bets. Dimon had been a vociferous opponent of the Volcker Rule, a section of the Dodd-Frank financial reform law that would greatly limit the kinds of risks banks can take. Now, as Dimon himself pointed out, the proponents of the rule can point to JPMorgan to buttress their case. "This is a very unfortunate and inopportune time to have had this kind of mistake, yeah," he said in an appearance on NBC's *Meet the Press*.

The loss also raises the question of why the bank was putting shareholders at risk to gamble in a market of arcane indexes, where specialized hedge funds seek to profit from pricing anomalies. "JPMorgan was definitely in the very dark gray area between insurance and speculation," says Robert Lamb, a finance professor at New York University who has studied risk on Wall Street. "To be the one side of the market and to think you were immune from the crowd on the other side is not safe, sane, or reasonable."

—Roben Farzad, with Mary Childs and Shannon D. Harrington

***The bottom line** Big bets on arcane credit derivatives left JPMorgan vulnerable to moves by hedge funds and rival traders.*



Demonstrators outside JPMorgan's annual meeting in Tampa put egg on Dimon's face

Investments

The Moneyman Behind The Dodgers Deal

- **A seasoned financier pays a premium for a storied team**
- **"There's only one L.A. Dodgers franchise"**

Mark Walter, chief executive officer of investment firm **Guggenheim Partners**, is a Chicago resident with Cubs season tickets. When the financially troubled Los Angeles Dodgers franchise went on the market, he didn't let loyalty get in the way of dealmaking. Walter is the controlling partner of the group—it includes former Los Angeles Lakers player Earvin "Magic" Johnson and baseball executive Stan Kasten—that purchased the Dodgers for $2.15 billion in a deal that closed on May 1.

Walter's foray into sports ownership doesn't mean he's giving up his day job running Guggenheim, where he has refashioned a manager of family money into a global firm that manages more than $125 billion and provides investment banking services. Walter, 51, has built up the company's offerings in exchange-traded funds, the fastest-growing product in the money-management industry, thanks to the acquisitions of fund providers Claymore

CLOCKWISE FROM TOP: BILL HOGAN/CHICAGO TRIBUNE/GETTY IMAGES; JOHN BIEVER/SPORTS ILLUSTRATED/GETTY IMAGES; JIM STEM/BLOOMBERG; NATHANIEL WELCH/BLOOMBERG

Bloomberg VIEW

Something's Rotten in Banking—and It's Not Just Barclays

Heads Should Roll

You might have missed the latest bank scandal, the one involving Barclays, in the hubbub of the U.S. health-care ruling and the euro salvage plan. If so, here's what you need to know: On June 27, Barclays, the U.K.'s second-largest bank by assets, admitted that it deliberately reported artificial borrowing costs from 2005 to 2009. The false reports were used to set a benchmark rate, the London interbank offered rate, or Libor, which affects the value of trillions of dollars of derivatives contracts, mortgages, and consumer loans. The bank agreed to pay a hefty $455 million to settle charges with U.S. and U.K. regulators, and on July 2, Chairman Marcus Agius resigned.

On July 3, Chief Executive Officer Robert Diamond also resigned. Agius then reversed his decision to quit; he will stay on to lead the search for a new CEO. In an apology to employees before he stepped down, Diamond wrote that some of the misconduct occurred on his watch, when he was head of Barclays Capital, the investment-banking unit. Diamond was already in the doghouse with investors: In April, 27 percent of shareholders, upset that Barclays had missed profit targets, voted down his $19.5 million pay package.

Heads should roll at other banks, too. Regulators and criminal prosecutors, including officials at the U.S. Department of Justice, are investigating at least a dozen other firms to determine whether they colluded to rig the rate. Among them: Citigroup, Deutsche Bank, HSBC Holdings, and UBS.

Run properly, big banks have just as much a right to exist–and thrive–as any other corporate entity. But it's difficult to defend an industry that defrauds the market with fake interest rate figures, thereby stealing from other banks and customers. The Libor case reveals something rotten in today's banking culture. And we hope the investigations will expose the bad actors, lead to jail terms for those who knowingly manipulated the market, and force out the senior managers and board directors who participated in or overlooked such conduct.

In the Barclays settlement documents, regulators released smoking-gun e-mails that reveal the extent of the dirty dealing between bank traders (looking to protect profits and bonuses) and senior officials in bank treasury units (hoping to convince markets that their banks weren't in financial difficulty). The two aren't supposed to collude, but it's obvious that the Chinese walls between them come with ladders.

Libor and its euro counterpart, the Euribor, are benchmark rates determined by banks' estimates of how much it would cost them to borrow from one another, in different time frames and currencies. The banks submit sheets of numbers every weekday morning, London time. An adjusted average of the rates determines the size of payments on mortgages and corporate loans worldwide. The rates also serve as an indicator of the health of the banking system. Because some submissions aren't based on real trades, the potential exists for manipulation.

A Barclays banker responsible for reporting borrowing rates was told to make the bank look healthier than it was by not revealing that borrowing costs had risen. An e-mail he wrote to a supervisor confirms that he complied: "I will reluctantly, gradually and artificially get my libors in line with the rest of the contributors as requested," he wrote. "I will be contributing rates which are nowhere near the clearing rates for unsecured cash and therefore will not be posting honest prices," he continued, referring to rates in the overnight money market.

At times, Barclays traders sought to affect rates on dates when interest-rate derivatives contracts were fixed or settled, thus profiting more from trades, according to documents made public by the U.S. Commodity Futures Trading Commission, one of the agencies conducting the Libor probes. Here's an e-mail about the three-month rate from a senior Barclays trader in New York to the London banker who submitted the rates: "Hi Guys, We got a big position in 3m libor for the next 3 days. Can we please keep the lib or fixing at 5.39 for the next few days. It would really help. We do not want it to fix any higher than that. Tks a lot."

Bankers submitting rates responded to such requests as if they were routine: "For you, anything," and "done ... for you big boy," according to the e-mails. Not that the efforts went unappreciated: "Dude. I owe you big time!" one trader wrote to a Libor submitter. "Come over one day after work and I'm opening a bottle of Bollinger."

Barclays traders also coordinated with counterparts from other banks. In an instant message, one Barclays trader wrote to a trader at another bank: "If you know how to keep a secret I'll bring you in on it, we're going to push the cash downwards.... I know my treasury's firepower ... please keep it to yourself otherwise it won't work."

The Libor system, overseen by the British Bankers Association, operates much the way it did in the 1980s. Even after the news media uncovered evidence of manipulation in 2008, the bank lobby did little to reduce conflicts or improve the veracity of its numbers. The best solution, as Bloomberg View has advocated, is to end Libor and create a benchmark using data from actual loans, rather than relying on banks to tell the truth about their borrowing costs.

The real tragedy of the scandal is the apparent lack of ethics or self-restraint among the people involved. Following billions of dollars of trading losses at JPMorgan Chase's out-of-control London unit, the latest installment of the Big Bank Follies offers yet more proof that the industry shouldn't be trusted to regulate itself. ⓑ

▶ *To read Michael Kinsley on the Supreme Court and Susan Crawford on whether Google is a monopolist, go to: Bloomberg.com/view*

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Number of peer-to-peer lending websites set up since 2007

yuan missing, calling it the first Ponzi scheme in the country's peer-to-peer lending business.

Qiu is happy with his returns: 14.2 percent on an annualized basis in two months. His loans have included 500 yuan for an apartment renovation and 400 yuan to a paint seller in Chongqing. He does have concerns: "I am still not sure whether my investment is legal or not," he says. "I can manage default risks by screening borrowers, but there is nothing I can do if the whole website turns out to be a scam." —*Bloomberg News*

The bottom line *Loans brokered online increased to 6 billion yuan in the first half of 2011, 300 times the total for all of 2007.*

Wall Street

For Bankers, The Thrill Is Gone

- More rules and less risk-taking make jobs seem pointless
- "There's no sexiness, there's no fun, there's no intellectual intrigue"

Sean George kneeled in the Church of St. Paul the Apostle in Manhattan. He wasn't praying. A gash below his right brow bled into his eye and down his nose. Then a knee to his groin sent him to the floor. George, 39, head of credit derivatives trading at Jefferies Group, was making his Muay Thai kickboxing debut at the church on June 22. His eye was swelling shut by the time he lost in a split decision. It was the happiest he's been all year, he says. "Right now at work I'm making less risk decisions–and I enjoy taking risks," says George, who headed investment-grade credit-default swap trading at Deutsche Bank before he joined Jefferies last year. "If you're in it for the game and the fight, the game's over and the fight's over."

Wall Street set pay and profit records half a decade ago by wagering billions of borrowed dollars on lightly regulated products that didn't exist a generation earlier. The rewards, which swelled even after the financial system almost collapsed in 2008, have been replaced by restrictions and malaise, according to interviews with more than two dozen current and former bankers and traders. Some, like George, are seeking their kicks in less regulated jobs. Others say their view of the industry is turning gloomy as bad news piles up. **JPMorgan Chase** is being investigated for trades that caused at least $5.8 billion in losses, **Goldman Sachs Group** reported its worst first half since before Lloyd Blankfein became chief executive officer in 2006, and **Barclays** was fined a record £290 million ($450 million) for trying to rig global interest rates.

Banks are facing new regulations designed to prevent another global credit crisis. Limits on proprietary

Why did the CEO cross the road? page 62 ▶

99 PROBLEMS and the Chick IS ONE

trading, or bets with firms' own money, and rules requiring them to hold more capital make it more difficult to use borrowed funds to boost returns. As global economic growth slows, clients are refraining from the kinds of deals that power Wall Street profit. "There's no sexiness, there's no fun, there's no intellectual intrigue, either," says Ethan Garber, who ran proprietary credit arbitrage portfolios for Credit Suisse Group and Bear Stearns. "A lot of my friends who actually lingered for the last four years are all now getting fired anyway." Today, Garber, 45, is CEO of IdleAir, a company that provides electricity at truck stops.

Risk is what drew George and the colleagues he respects to Wall Street, he says. At his peak, he could bring in millions of dollars in a single month. Trading was intense: During one credit-default swap deal he smashed a phone against his desk, sending part of it three rows away—"one of the records for the best break," he says. Sam Polk, 32, who traded credit derivatives at Bank of America and King Street Capital Management, a New York hedge fund, described the lure of Wall Street before he left in 2010: "You could be a twentysomething trader three years out of school, able to go to any restaurant or club or ballgame on any night that you wanted, and it was totally paid for," he says. "It was a tremendous feeling of power."

Robert McTamaney likens the shift on Wall Street to a "dulling down of the colors." He helped run Goldman Sachs's equities trading business in Asia until he left last year. "The socks are higher, the skirts are longer," he says. "It's like styles: They change, and you've got to change with it or be left behind."

Another former Goldman Sachs partner, Robert Jones, mourned the loss of experimentation. "You're not going to be able to attract the same kind of creative people that are looking to develop innovative new strategies in an environment where innovation is frowned upon," says Jones, 55, who helped found and lead the bank's quantitative equity fund management unit before leaving in 2010. Increased regulation, he says, "has taken a lot of the fun out of the game."

McWelling Todman, a professor of clinical psychology at the New School in New York, says restrictions frustrate risk takers. "If you're essentially telling them to be like everybody else and to follow rules, you're amputating a large part of who they are, who they consider themselves to be," Todman says. The response to curtailed risk is similar to chemical withdrawal, according to Leo Goldberger, an emeritus psychology professor at New York University, who studied stress. "It would be like a drug addict not getting what he has to have," he says.

"I understand their frustration, but we can't go back to a world of vast risk-taking," says Eugene White, an economics professor at Rutgers University. "You have individuals who take risks and get the private gains, whereas if their gamble fails the cost is socialized." Even as compensation costs have declined at Goldman Sachs, the firm paid each employee an average of $225,789 for the first six months, five times what a starting New York City firefighter would make in a full year. U.S. unemployment has been stuck above 8 percent for 41 consecutive months.

For George, the Muay Thai fighter, fulfillment is less about the money than the excitement. "People are sad," he says of his colleagues on Wall Street. "They don't have any risk. There is nothing to be stressed about." George says he likes working at Jefferies, which is less regulated than the biggest banks. Even so, he says, Wall Street is "not the same industry that drew me in." Two years ago he opened C3 Athletics, a martial arts training center in Stamford, Conn. And he has already scheduled another fight. "I'm excited about that," he says.

—Max Abelson and Stephanie Ruhle

The bottom line *Tighter regulation and institutional risk aversion have left many bankers frustrated and looking elsewhere for excitement.*

Quoted

"This verdict should not deter the SEC from investigating the financial industry and current regulations and modify existing regulations as necessary."
—Statement from a jury that acquitted a Citigroup executive sued by the SEC for negligence in the sale of a mortgage-related investment

Deals

Canada's European Shopping Spree

▶ Northern takeovers pick up as the U.S. and China pull back

▶ "Part of it is valuations...and part of it is currency"

Canadian companies and pension funds are on a European acquisition binge, even as U.S. and Chinese buyers slash spending on takeovers there. Europe's low valuations and the robust Canadian dollar are spurring deals by Canadian companies such as **Brookfield Asset Management** and **Alimentation Couche-Tard.** "Canadian companies are basically punching above their weight in the European market," says Julian Brown, head of corporate finance for Canada at PricewaterhouseCoopers in Toronto.

The transatlantic dealmaking is part of a shift in Canada's outward focus away from the U.S. in favor of other foreign markets. America's economic recovery has lifted stock prices, making assets more expensive, and cash-rich Canadian buyers are looking for new markets outside North America to deploy resources.

With Canadian companies and funds boosting spending on deals in Europe by 58 percent in the year's first half to $15.1 billion, Canada was the second-biggest acquirer in Europe after the U.S., whose deal volume there fell more than 50 percent, to $54 billion. Canada's economy is about one-tenth the size of its southern neighbor's. Chinese companies cut European takeovers by a third in the same period, to $4.5 billion. Overall European acquisitions by foreign buyers fell 38 percent as Greece, Italy, and Spain dragged down the Continent's economy.

Canada's European acquisitions this year have run the gamut of industries, from Couche-Tard's $3.5 billion deal for service stations operated by Norway's **Statoil** to **CGI Group**'s $3.1 billion acquisition of U.K. computer services provider **Logica**. Couche-Tard, the Laval (Quebec)-based operator of convenience stores, wants to "take a good shot at growth opportunities"

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