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Occupy the SEC: JP Morgan's "London Whale" Fiasco Highlights the Need for a Strong Volcker Rule

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On May 10, 2012, JP Morgan Chase's (JPMC) CEO Jamie Dimon announced that its "Chief Investment Office" had lost $2 billion from a trading scheme that was intended to mitigate the bank's risks through hedging.

JPMC claims that the CIO office was meant to hedge its overall investment exposures by investing in high-quality securities. In fact, the CIO office was placing gargantuan bets on risky credit default swap (CDS) indices. These bets had nothing to do with true hedging of risks. In fact, they were of such magnitude that the trader responsible for them was feared throughout the markets, receiving various monikers including "Voldemort" and the "London Whale."

This embarrassing episode for JPMC highlights the extent to which major banks will engage in risky proprietary trading and try to disguise it as risk management. It also highlights the importance of the Volcker Rule. In fact, Dimon admitted that "this plays right into the hands of the pundits out there" who support a strong Volcker Rule. Dimon is right.

The Volcker Rule, an important part of the Dodd-Frank Act of 2010, seeks to reduce the need for financial bailouts by limiting the ability of banks to engage in speculative betting. Occupy the SEC (OSEC) has previously issued a 325-page comment letter to the nation's banking regulators, asking for strong enforcement of the Rule. In our comment letter we outlined a number of ways that banks could get around the Proposed Volcker Rule, while still complying with the rule's language, and thereby continue to engage in speculative betting. The "Voldemort" incident illustrates many of the concerns we expressed in that letter. Here are some of our high-level points:

- The CIO office's activities may not have occurred in the Bank's trading account, which would render them to be outside the scope of the Volcker Rule. OSEC has argued for an expansive interpretation of "trading account" to cover just this type of speculation.
- OSEC has criticized the current version of the Rule for interpreting the term "hedging" to include a wide swathe of activities, whether at the desk level or the portfolio level. The Voldemort incident highlights the risks associated with such a broad interpretation.
- JPMC's hedging activity may have been inaccurately characterized as a form of "asset-liability management," which is permitted in the current draft of the Volcker Rule. We argue that hedging (and "portfolio" hedging in particular) continues to be incredibly problematic from a risk management, and safety and soundness standpoint.
- It illustrates the tremendous shortcomings of metrics like VAR, internal risk management procedures, and investment principles (i.e. banks' risk plans are deeply flawed, and their metrics are largely useless.) In our letter we highlighted how many of the metrics used in the industry are inadequate for calculating risks associated with illiquid assets.

We hope this incident will raise public awareness about the dangers resulting from proprietary trading at government-subsidized institutions. We encourage citizens to contact their regulators and encourage them to finalize the Volcker Rule as strictly as possible.

OSEC's comment letter on the Volcker Rule can be found here and a petition to the regulators asking for strong enforcement of the Volcker Rule is available here.

Occupy the SEC is a group of concerned citizens, activists, and financial professionals with decades of collective experience working at many of the largest financial firms in the industry. In February, Occupy the SEC filed a 325-page comment letter on the Volcker Rule NPR, which is available at http://occupythesec.org.

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