The Truth About JP Morgan's $2 Billion Loss

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Before we can understand what's really going on with JP Morgan's loss (which will probably end up being a lot more than $2 billion), we need a little background.

JP Morgan:

- Is the world's largest publicly-traded company
- Is the largest bank in the U.S. … the biggest of the too big to fail banks which are killing the American economy
- Is the largest derivatives dealer in the world (and see this), and derivatives are inherently destabilizing for the economy
- Essentially wrote the faux "reform" legislation for derivatives, which did nothing to decrease risk, and killed any chance of *real* reform
- Is the *creator* of credit default swaps – which caused the 2008 financial crisis, and is the asset class which blew up and caused the loss
- Has had large potential exposures to credit default swap losses for years
- Has replaced the chief investment officer who made the risky bets with a trader who worked at Long Term Capital Management … which committed suicide by making risky bets
- Went completely *insolvent* in the 1980s
- … and again in 2007 (and was saved both times by the government at taxpayer expense)
- Heads – with Goldman Sachs – the Treasury Borrowing Advisory Committee, which helps set government financial policy
- Has a reputation of being the most risk-averse of the big Wall Street players
- Was kept alive by a huge government bailout … but used the money to invest in India and other projects which won't really help Americans

- Has made a killing by kicking companies (and see this) and governments (and here) when they are down, engaging in various types of fraud (update), allegedly manipulating the silver market, and profiting on misery by acting as the largest processor of food stamps in America

In addition, JPM's CEO Jamie Dimon:

- Is a Class A Director of the Federal Reserve Bank of New York, which is the chief bank regulator for Wall Street (including JPM). Indeed, Dimon served on the board of the Federal Reserve Bank of New York at the same time that his bank received emergency loans from the Fed and was used by the Fed as a clearing bank for the Fed's emergency lending programs. In 2008, the Fed provided JP Morgan Chase with $29 billion in financing to acquire Bear Stearns. At the time, Dimon persuaded the Fed to provide JP Morgan Chase with an 18-month exemption from risk-based leverage and capital requirements. He also convinced the Fed to take risky mortgage-related assets off of Bear Stearns balance sheet before JP Morgan Chase acquired this troubled investment bank

- Has a reputation of being the "golden boy" and smartest guy on Wall Street

- Has been the chief spokesman and advocate for deregulation of banks, and has lectured, scolded and cajoled everyone who has questioned his banking practices

- Jokes about a new financial crisis happening "every five to seven years"

What Does It Mean?

Pundits and consumers alike are reacting to JP Morgan's loss like a startled herd of sheep.

They somehow believed that the "best of the breed" bank and CEO – the biggest boy on the block – was immune from losses. Especially since JPM has been so favored by the Feds, and Dimon was so favored that he was being groomed for Secretary of Treasury.

And the fact that the head cheerleader for letting banks police themselves has egg on his face is making a lot of people nervous.

And that the biggest of the too big to fails *could conceivably fail.*

The government says its launching a criminal probe into JPM's trades.

Ratings services have downgraded JPM's credit, and many commentators have noted that other banks may be downgraded as well.

Elizabeth Warren is calling for Dimon to resign from the New York Fed:

Even CNBC is now calling for Glass-Steagall to be put back in place.

Banking expert Chris Whalen writes:

> Someone at the Fed should have at least secondary accountability for the JPM losses if the VaR model/process was faulty. Is there any accountability for incompetent, badly managed federal bank regulators? As our colleague Janet Tavakoli wrote in the Huffington Post: "The U.S. can count on JPMorgan to continue both long and short market manipulation and take its winnings and losses from blind gambles. Shareholders, taxpayers, and consumers will foot the bill for any unpleasant global consequences."
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> We think that the loss by JPM is ultimately yet another legacy of the era of "laissez-faire" regulation and even overt Fed advocacy for the use of OTC derivatives by US banks. Fed officials such as Pat Parkinson, who retired as head of the Fed's division of supervision and regulation in January, were effectively lobbyists for the large banks and their derivatives activities. It seems a little ridiculous for the same Fed officials who caused the problem over the years to now be tasked with investigating JPM, much less regulation of large bank dealings in OTC instruments.

And Reuters correctly notes:

> JP Morgan Chase's loss is the perhaps inevitable result of the interaction of two policies: too big to fail and zero interest rates.
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> Too big to fail, the de facto insurance provided by the U.S. to financial institutions so big their failure would be disastrous, provides JP Morgan and its peers with a material advantage in funding and as counterparties. Depositors see it as an advantage, as do bondholders and other lenders. That leaves TBTF banks flush with cash.
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> At the same time, ultra-low interest rates make the traditional business of banks less attractive, naturally leading to a push to make money elsewhere. [See this.] With interest rates virtually nothing at the short end but not terribly higher three, five or even 10 years out, net interest margins, once the lifeblood of large money center banks, are disappointingly thin. Given that investors are rightly dubious about the quality of bank earnings, and thus unwilling to attach large equity market multiples to them, this puts even more pressure on managers to look elsewhere for profits.
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> Investors believe, rightly, that the largest banks won't be allowed to fail; what they also appear to believe is that they very well may not be able to prosper and that to the extent they do shareholders won't fairly participate.
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> What would you do if you had a built-in funding advantage but little demand for your services as a traditional lender, i.e., one which borrows short and lends long? If you are anything like JP Morgan Chase appears to be you will put some of that lovely liquidity to work in financial markets, hoping to turn a built-in advantage into revenue.
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> JP Morgan stoutly maintains that the purpose of the trades was to hedge exposure elsewhere, as opposed to being proprietary trading intended to generate profits. That's contradicted by a report from Bloomberg citing current and former employees of the chief executive office, including its former head of credit trading. http://www.bloomberg.com/news/2012-05-14/dimon-fortress-breached-as-push-from-hedging-to-betting-blows-up.html
>
> The Volcker Rule, now being shaped, is intended to stop such speculative trades, though in practice debating what is a hedge and what isn't is a sort of

angels-dancing-on-the-heads-of-pins argument which makes effective regulation almost impossible.

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The keys are motive, opportunity and ability. Profits – and the investment office is reported to have made considerable ones in the past – provide a more believable motive than simple hedging. Opportunity is afforded by the combination of a privileged funding cost combined with poor alternative places to put money to work elsewhere in the banking business. While there may be some active borrowers, and TBTF banks enjoy an unfair advantage in serving their needs, the trans-Atlantic balance-sheet recession means households and businesses are showing a preference for paying back loans rather than taking them out.

Bruce Lee, chief credit officer of Fifth Third Bancorp, which isn’t TBTF, was frank about this recently, saying that the value of deposit funding was now at its lowest in his career.

Finally there is ability, and like common sense all bankers believe they have the ability to trade successfully despite the wealth of historical evidence to the contrary.

While events show clearly that JP Morgan wasn’t able to adequately manage its own business, an attack on it engaging in speculation doesn’t actually hinge on that.

There is clearly a public policy outrage here because should JP Morgan find itself in difficulties due to speculation the taxpayer will end up paying the freight. That’s probably not even the worst of it. All of the profits that TBTF banks make through speculation have been subsidized and enabled by the taxpayer. It is obvious that managers and employees have an incentive to take risks because, after all, TBTF may not be forever but they will capture 35 or 40 percent of the inflated takings so long as it lasts. Even if JP Morgan never blew up speculative trades, we should still oppose them so long as they are made possible and profitable by government policy.

Raising interest rates in order to remove an incentive to speculation probably wouldn’t work; low rates are the result of too much debt as well as a palliative for that disease.

The Volcker Rule won’t be effective; it is impossible to distinguish hedges from speculation and either can blow up banks.

The better alternative is to end the policy of too big to fail, preferably while at the same time forcing all banks out of the business of market speculation through a revival of the kind of Glass-Steagall-like policy which encouraged a small and useful financial sector for decades, forcing those that want government insurance to act like utilities, taking deposits, processing payments and making simple loans.

Let the investment banks take their risks, take their chances and suffer their losses – as separate entities.

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