Morgan's loss and bank regulation

A couple of weeks back, J.P. Morgan Chase reported a trading loss of $ 2 bn (which may well go up further), in its Chief Investment Office. As per Morgan's 2011 published balance sheet, the function of the CIO is to "manage capital, liquidity and structural risks of the firm" (a strange combination of functions!), presumably by taking positions in various markets. The Dodd Frank regulations (which are still to come into force) also permit hedges "in connection with and related to individual or aggregated positions" including, presumably, the loan book.

The CIO had made a profit of $ 5.09 bn in the three preceding years (The Wall Street Journal, May 17). This would include earnings on the surplus liquidity managed by it, and both fair value and realized gains/losses on the macro level hedges of "structural risks". Focusing on the latter, on first principles, the change in the value of the derivative contract used as a hedge has to be opposite to, and compensate for, the change in the value of the underlying exposure(s), either fully or substantially. How effective were the hedges in earlier years? What is the correlation between various credit risk indices used and Morgan's own historical losses from "structural risks"? In any case, should not any VaR measure or limit apply to the combined portfolio of the CIO's book and the changes in the value of the exposures it was hedging, for reporting or MIS purposes? Curiously, Morgan corrected the VaR of the CIO portfolio to almost double the earlier number, after the loss was acknowledged more than a month after the financial media publicized the strange goings on. Was the revision a simple calculation/methodology error -- or something else?

Turning to another question, "basis risk" – the difference between the price movements of two similar but not identical benchmarks, say, yield on 91-day T-bill and the 3 month LIBOR – has long been recognized, and its assumption is sometimes inevitable in

hedging operations. It is, however, also deliberately taken by traders to make money – it can then become an altogether different animal! Perhaps the most famous case of this nature occurred in 1998 -- the failure of Long Term Capital Management (LTCM) which had deliberately taken the basis risk on the gap between sovereign and corporate bond yields.

While, even in genuine hedging of structural risks in the market, there would inevitably be "basis" risk, this surely goes up with the aggregated credit exposures and complexity of the hedges. The so-called hedges were positions in a complex, synthetic credit index. Were the positions genuine hedges, taken in full consciousness of the basis risk, or were they aimed at making profits on their own? (Is "hedging" supposed to be a profit making activity?) This suspicion gathers strength by considering another of CIO's activities: the surplus liquidity was invested in residential mortgage backed securities and highly complex CDOs/CLOs, to increase yields. Given what happened in the market for such securities barely a few years back, these investments clearly had significant liquidity risks: surplus liquidity seems to have been "managed" by investing in instruments which increased liquidity risks but gave higher yields!

Complex instruments and operations, and the Morgan case, remind me of a story from Hindu mythology, of *Bhasmasur*, an "*asur*" created by the "*sur*s" (gods), to kill their opponents, the *asur*s: Bhasmasur had the unique gift of converting anybody into ash ("*Bhasma*") by putting his hand on the head of the enemy. After killing all the *asur*s, Bhasmasur turned on the *sur*s themselves. Banks created complex derivatives to render pricing and risks opaque, describing them as "hedges" (or safe investment instruments) to fool less knowledgeable customers. Too many unsophisticated players (including in India) have lost huge sums by looking at hedging as an avenue of making money! Has Morgan too fallen into that temptation? Morgan was not only the creator of the Value-at-Risk (VaR) models and methodology for managing risk now at the heart of capital regulation, but also of credit derivatives. Has Morgan itself become yet another victim of the *Bhasmasur* of complexity – of organization, of instruments, of difficulties in

controlling risks? Or was the CIO merely a fig leaf for proprietary trading, a way to evade the so-called Volcker rule?

The incident also raises several questions over the regulatory philosophy of the last couple of decades:

⇒ Is it safe to allow banks to develop their own risk measurement models for calculating capital charges?

⇒ Is the quasi-ideological faith in the wisdom and ability of the participants in financial markets, their rational expectations, really warranted? Or is this a way for regulators to reduce their own responsibility?

There are reports that the Basle Committee is reviewing the use of VaR to measure risks and capital. But this apart, as our central bank takes steps to implement Basle III, there is a strong case for it to develop its own skill base, in both domain knowledge and mathematics, to have an independent view having regard to our needs and environment, rather than blindly **"**copy paste**"** Basle regulations.

A.V.Rajwade
Email: avrajwade@gmail.com