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JPMorgan may tip Wall Street's hand on ploys to beat Volcker

May 11 2012 Rachel Wolcott

JPMorgan Chase & Co's revelation that it had trading losses of at least $2 billion on a failed hedging strategy may have tipped the hand to one way Wall Street executives plan to get around the Volcker Rule.

The incident shows how firms could use the pending rule's hedging exemption to do proprietary trades and still technically be compliant with Volcker. It could allow firms to keep some proprietary trading desks, but portray them to regulators as something else, such as portfolio hedging.

"What does this say about the long-term effectiveness of the Volcker Rule? For all we know, these JPMorgan trades could have been in compliance with the hedging exemption," said Jeff Berman, a partner at Clifford Chance in New York.

The Volcker Rule, part of the Dodd-Frank U.S. financial regulatory overhaul, is meant to prevent risky trading by big banks, which have resisted the measure. The rule, named after its originator, former Federal Reserve Chairman Paul Volcker, aims to restrict banks from short-term trading of derivatives and other financial instruments for their own accounts. It also aims to limit federally insured, deposit-taking financial institutions from making risky bets, while allowing them to continue market-making and hedging activities.

JPMorgan said the $2 billion mark-to-market losses came from a synthetic credit portfolio run by its Chief Investment Office.

The office is supposed to make broad bets to hedge the bank's portfolios of individual holdings, such as loans to speculative-grade companies. However, some hedge funds have complained recently that it was actually making big proprietary bets.

"If it truly was a hedge they would have made money. It makes no sense that a hedge would go in the same direction as your customer's risk," said former investment banker and hedge fund executive George Michaels, chief of G2 FinTech, a software provider for investment management firms.

If it was a bet, the blowup at JPMorgan's CIO could give some insight into one way investment banks plan to get around Volcker - by wrapping up prop trading to look like risk management.

Said a regulatory lawyer with expertise in the rule, "I don't know if (JPMorgan) intended it that way, but what it does is it points up some weaknesses in Volcker. It also shows a hedging position can be just as risky as a naked position.

"Furthermore, what hedging is, is indeterminate, because there is no requirement in the Volcker rules currently that says the initial position has to be taken at the behest of the customer or has to arise in the banking book or anything like that."

So what might look like a hedge could be a plain old bet. If a bank is hedging a risk - meaning it is acquiring a position to carry the risk of another - it is assumed that the first position was taken as some sort of legitimate business purpose and was taken prior to the second position.

In fact, it is more likely that both the initial position and the hedge were taken at the same time so as not to be uncovered for any period. Theoretically, both trades could be proprietary; but because they offset each other, either completely or partially, they might be permitted under Volcker. And what the JPMorgan loss has shown is these so-called hedges can be just as risky as proprietary trading.

A loss makes it harder to call a prop trade a hedge, said Joe Spivack, a risk management expert at banking consultancy CEIS Review Inc.

"If you think of hedging and trading as a genie, you can't put the genie back in the bottle," once the hedge has failed, Spivak said. "Somebody is always going to say if it was a hedge, how comes it lost money? It is very tough," he said.

The regulatory lawyer, who requested anonymity citing industry ties, added, "It's really unclear what this trade and other hedging trades are supposed to hedge specifically because of the portfolio-wide risk management function they have. Even though the rules try to get firms to be specific about that, they're never going to be specific enough."

JPMorgan's loss demonstrates that proprietary trading should be left to hedge funds because they understand the risks better than banks, Michaels said. Hedge funds are also more accountable to investors who will ask tough questions about trading strategy and risk management.

Jamie Dimon, JPMorgan's chief executive, has been one of the most vociferous opponents of regulations such as the Volcker Rule.

According to the Center for Responsive Politics, a Washington-based group that tracks corporate spending on lobbying, JPMorgan spent $5.8 million lobbying lawmakers to water down banking regulation. Ironically, this latest incident may prove Dimon's point: Policing this kind of proprietary trading activity is just impossible.

(Additional reporting by Emmanuel Olaoye and Julie DiMauro of Compliance Complete)

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