

## VaR history

This text is based on an original document that was published in French on the website of Paul Jorion in early July 2017 and can be accessed in “Pieces Jointes No 16”. Here is a translation from French into English that has been completed in order to better complement the memorandum on the gains made by Jp Morgan through the “London Whale” events (see JPM gains in 2012).

## **One regulator, one bank, one VaR and only one VaR....**

### **Historically regulators are confronted with a specific dilemma with regards to the biggest banks**

Since 1913 the main regulator monitoring Jp Morgan was the Federal Reserve of new York. This financial markets watchdog was as keen to check upon the financial soundness of the bank as it was keen to preserve the capacity of the bank to produce high enough profits. What was behind the term “financial soundness”? It evolved over time but the general concept was to maintain a series of financial buffers that were meant to absorb many kinds of shocks: an economic crisis, the discovery of a fraudulent activity, a war, a terrorist attack, a fire, a widespread ruin among the customers, a failure of another bank or a business partner, etc.... At the end of the day the regulator mostly checked that the accounts were properly maintained, that the bank had some reserves in capital and some reserves in immediate liquidities. The regulator also checked that the bank itself was self-controlled. The higher the requirements on the financial soundness were, the higher the ensuing costs would be, and therefore the lower the profits. Yet neither of the 2 objectives – soundness and profits- should be achieved separately one from the other. It was really a fine balance and a dilemma actually....

What if the bank produced record profits by dismissing for example mandatory reserves? Blaming the bank would both hit the share price and cast a nasty shadow over the actual soundness of the bank, tainting its reputation and therefore endangering the future of the bank. Remaining silent for the regulator instead on those missing reserves for example would likely deceive investors and lead to an overinflated share price resulting from artificial profits. Soon or later the scam would be uncovered and may trigger a deep financial crisis. In both case the regulator would be held responsible for the failing. Thus neither of the 2 attitudes –blame or silence- for the regulator was leading to a positive outcome in the end if history was a guide. So the regulator had to make cautious steps right between the 2 evils. The resulting dilemma and its consequences were obvious as early as 1907: if the regulator did nothing, soon or later the markets would seize and panic. However, if a critic was disclosed publicly against a bank so that it indeed put in question its soundness, this would impact negatively its share price and its future profits. The bank then may survive IF it could prove at once that it had way enough tangible capital to shoulder the blame, the doubt and the market stress as long as needed. Most often it was a lethal move, something which would mandate indeed more rigorous provisions, which of course were found missing and which therefore mechanically would lower the expectations of profits in the future. The share price would fall then indicating that the bank was further under-capitalized and further under-protected with the current precautionary reserves. Naturally the regulator would then have to revise up the missing provisions which would then be liquidity reserves AND capital provisions. This in turn would further deplete the share price and therefore make the new requirements higher and so on.... At the end of the day, market players would be looking at what the bank would be worth tangibly so if it was to be dismantled through a bankruptcy proceeding. The market players would attempt to find a floor for the share price and would move fast the traded share price towards this “floor”. At this “floor” level, other banks would refrain from lending to this bank which likely would make market players revise the “floor” itself on the way down. They would stop at around \$1 since then the bank shares would be delisted and would become almost untradeable thereafter.

It was thus about a sort of death spiral that started usually after a public blame disclosed by the regulator. The sole alternative left was to either opt for the placement under receivership or the outright bankruptcy.... For a bank to just survive a huge public blame from regulators it had ironically

to be very, very sound, ie prove that its provisions were already set way beyond the future requirements of the watchdogs. And one must wonder then why the blame would have ever come up.

JpMorgan in 2012-2013 sailing through the “London whale” scandal and its litany of loud blames however will do much better than merely survive. As the main watchdogs of the financial planet were all disclosing their harsh criticisms on the public front stage in 2012 and 2013, one thing is certain: the share price of JpMorgan skyrocketed. This was neither a miracle nor a scam: whatever their alleged “recklessness”, “complacency”, “understaffing”, “lack of expertise”, or whatever else had been their excuse before, the watchdogs were watching that out as they were themselves being scrutinized at this moment. And, apart from a self-inflicted and short-lived drop in mid-May 2012, the bank’s share price would fly high rather than crash... As if it had known way in advance what would come out anyway.... This is quite paradoxical as such: what a control of the events on the side of JpMorgan! If once more history is a guide, this “London whale” outcome is quite unique. Something is wrong here: the timing of the blame maybe...

This dilemma for the regulators had typically led to a major scandal followed by the demise of the targeted bank among others. Thus it had been most often the outcome in the past especially between 1929 and 1933 (cf the case of Richard Withney and the Pecora commission). The problem then had solved painfully in 1934 with numerous bank failures, with the Glass-Steagall Act, with the creation of big government agencies like Fannie Mae and with the birth of the SEC among other key developments. This would not spare the USA from a long depression.... From then on, better was to prevent the dilemma or actually better was to make it occur only behind closed doors and rely on the integrity of all. It worked relatively well for almost 50 years....

Moving forward now, in 1992, a couple of short lived crisis had uncovered the growing risk that an otherwise “safe” bank may turn insolvent by means of derivatives exposures. The contagious effect of a public blame was more obvious than ever due to these derivative trades existing between the big banks already. And the size of these derivative exposures was growing exponentially. The SEC took over for what was considered the “number 1” risk for the banks at the time already (and for the financial markets as a consequence), namely the valuation of derivatives products. That could clearly induce a chain reaction among financial institutions. And that scary scenario could then turn a typical recession into a lasting depression. On paper all was “fine”...Until it was too late... Better was to act preventively before it was too late.... That initiative was taken in straight relation to the lessons learnt from the Great Depression of the 1930ies...

The SEC promoted then the “Mark to Market” concept. It was all about using “consensus prices”, a mandatory starting point before every market player in derivatives would set on the follow liquidity provisions in a prudent way, with a view to predate the next crisis to come as wisely as possible. How to determine those projective figures, as such rather speculative from an intellectual standpoint? The search for another consensus was the best guaranty that the industry as a whole would behave fairly well and that therefore the regulators would be spared their centuries old dilemma. Jp Morgan actively promoted the VaR which quickly became the cornerstone of those computations of provisions (or reserves) that would always come as a deduction from the current profits and to the detriment of shareholders. The VaR was thus much more than a mere standalone figure. It was the starting point of a track that uncovered the major liquidity risks, something which mathematicians would rather name “correlation risk”. This risk here would take many other different names depending on the circumstances: concentration risk, visibility risk, panic risk, price uncertainty risk, chain reaction risk, prisoner’s dilemma....Regulators and banks alike were all “prisoners” here.

The issue for any bank then, as much as it was for the regulators, routinely popped up in the finance jargon through what was called the “VaR consumption”. As said, it was much less the VaR figure alone that mattered than what constituted this summary number. Regulators, auditors and risk controllers were not fooled by the headline number. They mostly scrutinized already how this VaR effectively displayed the day to day market exposure of the bank. Indeed, if the bank printed a VaR

number that was significantly higher than the actual valuation risk that was reported *a posteriori* day after day through its “mark to market”, this meant that the bank exposed itself unduly to financial markets fluctuations. It matters to notice here that the VaR computation and subsequent analysis were totally dependent upon a “mark to market” process that was run consistently throughout the firm and across the many market participants. In particular the VaR of the firm could only be analyzed in a sound manner IF the firm had only ONE “mark to market” process and therefore ONE market price for each derivative product for the positions contributing to the Firm-wide VaR figure. One hopefully relied also on the fact that the main market players at least agreed upon one standard mark to market protocol among them to process the margin calls day after day.

Back to the “VaR consumption” concept now, the regulators had their say. If the firm exposed itself unduly, either because it was unable to apply one price per derivative instrument across the firm’s different businesses or because it simply consumed “not enough” or “too much” VaR, then the bank would have to either reduce its exposures altogether or improve its “mark to market” firm-wide process or both actually. Whichever the case, this would be publicly disclosed and would sound like a major hit to the reputation of the bank. It would appear indeed that this financial institution did not control well its risks and/or did not value its exposures properly.

Furthermore, assuming that the firm in question had indeed a consistent “mark to market” process across its different businesses AND a reportedly consistent “VaR consumption”, if the bank did not make enough profits based on the actual utilization of this VaR, the shareholders might well sell their shares to buy the one of more profitable banks on paper. And the regulators would not like then to inherit of a situation whereby a big bank found itself in structural crosshairs with investors. As to the other markets players, depending on the size of the bank being at risk they might or might NOT want to see the rumor spread against their big competitor for fear they might be dragged down themselves in the trap. They were all aware of the “systemic risk” whereby banks would fail in a chain reaction. And so investors were.... The savings and loans crisis was the last example to date in the early 1990ies. Since then, those regulators had to actively take over and find a place to lodge any big falling bank but in confidential meetings behind closed doors. At any rate they would avoid disclosing their real concerns live. That was the one lesson learnt from the Great Depression: the regulators had to be pro-active but secretly. The banking sector is NOT like any other sector of the economy, even if it is quoted in the financial markets among the other sectors. Since those days of the 1930ies, the markets had grown and modernized....But the dilemma was here to stay in the form of a “prisoner’s dilemma”.

### **The handy myth of “efficient markets”....**

The following descriptions are meant to show as simply as possible the strategic relation between the current accounting and regulatory standards, among which the “mark to market”, the VaR, monitoring of the “VaR consumption”, and recent History. Those standards are interconnected indeed through many major events that have left marks on our everyday lives over the last 50 years. The genesis of the VaR has to be well understood in order to grasp the significance of the “London Whale” events as they actually unfolded in 2012 and thereafter.

In 1900, the world population counted about 1.7 billion people. The G7 group (USA-UK-Japan-Germany-France-Italy-Canada) represented 22% of the world population. Sometime towards the end of the 1960ies, after 2 world conflicts and the Cold War, the world population had grown close to 4 billion. The G7 then only weighed 14% of the total. The atrocities of the Vietnam war announced the end of the open or hidden conflicts of great magnitude. The “Eurodollars” derivative contracts were spreading across the planet in an attempt by the USA to sponsor a more peaceful “international trade” platform. The economists perceived well the stakes and the origin of this brand new currency of exchange. But they could not see all the consequences of this deep rooted regime shift....The US dollars backed daily trades that were in fact based upon “credits” that the USA granted routinely to the oil-exporting countries in exchange for what was then called the “black gold”. The USA played as a mere “middle-man” in theory here some would say, bridging the gap between the gold standard and the “black gold”.

These euro-dollars credits were not meant to be spent on the American land. But where would they be saved in the meantime? No-one knew the answer. And yet they were useful to almost all the other countries as a currency day to day. Yes the euro-dollar contracts served both as derivatives and almost hard currency. The financial markets trading these “Eurodollars” displayed a remarkable efficiency, unseen in the past. There seemed to be the birth of a “world currency” embodied by the term “Dollar” but one that was mostly a derivative contract. One could easily “explain” this new efficiency by the “technological progress” observed in the “communication means”. This was when Apple, Microsoft, Hewlett-Packard, Intel and other corporate “success stories” burgeoned through the “Silicon Valley” project. There was no need to carry tons of gold bullions by ship, cars or horses of whatever physical means of transportation. Money was “dematerialized”. The physical borders seemed to evaporate thanks to tiny silicon chips and “0-1” bits. Was this the dawn of a new empire, ie the “information empire” or the irreversible dilution of the very notion of “sovereignty”? Henry Kissinger among others opened the way to a reasoned peace on the international political stage.

Some renowned economists revisited the visionary calculus of Louis Le Bachelier (1900) and produced a more contemporaneous version through a model in 1973 that computed financial risks and remain today the ground base of all the current risk management systems. This model is also the cornerstone of the regulatory standards and Basel standards that are determining still today the liquidity provisions in the banking industry along with the capital requirements. The little irony is that the model in question was designed originally to evaluate a “credit risk” that was NOT visible in the market prices. Yet this model in practice would be extensively used to “price” options based on observable market prices assuming that “there is NO credit risk”..... This little tweak will allow the massive expansion of trading and derivatives for now 50 years and counting. Thus Paul Samuelson, Robert Merton, Fisher Black and Myron Scholes contributed to provide the financial industry with a mathematical approach for the financial risks which will become genuinely revolutionary.

What are the fundamental assumptions supporting this model? One assumption, only one at the end of the day, supports this model and brings up a massive consequence as a corollary. What is the assumption itself? A market player who is sufficiently well informed and rational can hedge his exposures to a crisis up until the last minute, in theory. Why is that? Because, any price change, however massive it is, will develop through a series of small increments in the middle of which any market player could find a way to hedge his risks if needed. This assumes that the ones being in need to protect themselves will catch enough of those small increments to execute their operations.

If the short early history of the “euro-dollar” is a guide, it sounds reasonable. Although in practice it is almost never possible. This assumption above sounds like “almost perfect” markets efficiency, doesn’t it? This hedging philosophy that is lent to the market players is a principle, not an obligation in the model itself. Some would hedge their risks while some would not at any moment in time, therefore providing both sides of any trade. This is where the “balance” of the market is found in this theory. Indeed the adventurous minds can always make bets or ignore the dangers. As to those who look for safety first and foremost, they will be ready to make sacrifices in order to preserve their wealth. At any moment in time therefore, a choice would be proposed by the financial markets for an undefined but unlimited amount of money. As it sounds here, the bigger the markets, the better it is for all of us: any player of any size would always be able to find risk-takers and secure his own investments in a safe harbor. From this permanent choice an equilibrium would be born, sitting between fear and greed, through which a ‘riskless rate’ would be drawn out as being the ultimate return that a risk averse or “wise” investor could realize over time. The legend was born here through this model assumption that a wise investor may sail through the different crisis safely and thus would finally profit from this “riskless rate” over the long run. The “invisible hand” depicted by Adam Smith seems transfigured towards the end of the 20ieth century in the form of a perfectly tangible return on capital, the tangibility of which came from what looked to be “skyrocket scientific” calculations. This “riskless rate” was miraculously not nil, even less negative. It appeared to be close to the yield offered by the US treasury bonds as per the data available then looking backward.

One may summarize the assumption called “efficient markets hypothesis” as: “a crisis is always manageable ahead of time”, or, as per a more commercial version, “the markets offer a riskless rate of

return for investors who are risk averse but remain active on the long run". Such was the credo that took shape sometime around 1973 and onwards. One may summarize now the new credo as: "in the 1920ies the business activity became the main source of wealth for all and in the 1970ies the markets became the main channel of this wealth for all". That was not a fact as the great depression of 1930ies had taught the whole planet. But that no doubt was the prevailing belief as to how a sovereign economy should be run, ie bridging the gap between "savers" and "risk takers". A whole population of "investors" was born and they had to be "protected" from the scams. Regulators were aware then of their quite historical role on making this credo just credible over time. They had to prevent first and foremost a repeat of the Great Depression of the 1930ies. In that regard this "efficient market hypothesis" was a cornerstone for the belief to live longer in everyone's mind. Yet, it remains to be seen how this credo worked in practice..... Since History will bring its own denial ahead of times....

In May 1971 already, the President Nixon had showed that the unforeseen events were actually always there in the background making the markets gap actually, as opposed to "move gradually". Sovereign or not, the US domestic dollar would now stop being converted automatically into Gold. But the Dollar could still be converted in... US dollars of course... This sounds like quite a circular reference. This is what it is. This is also the logic behind the unique assumption of the "efficient markets" and what the model describes ultimately. As long as people believe in it, the credo may work through the many ups and downs. This is the "Emile Coué method" some would say, full stop.

Some people could indeed have guessed the advent of this change in the "US Dollar vs Gold" parity since the matter was heavily debated already before May 1971. But it remained pure speculation anyway since no-one else than the president of the United-States Richard Nixon could ever know WHEN and HOW this change would occur. Even then, what was the actual horizon of projections that the US president Nixon could control by himself? In either case, change or no change, the "protection" or the "outright exposure" towards such events was just a mere speculation. Long live the credo...

### **Optimism is the Bet of the time....**

Protect or hedge oneself against what exactly by the way? Who could have predicted the consequences that we know today? The oil-exporting countries, locked with their "Eurodollars", waited 2 years actually before reacting. Then they would constitute a diverse block towards the end of 1973, observing with quite a delay the regular fall of the US dollar versus gold. There would be a first oil shock. Then there would be a second oil shock. Next, after these many irreversible gaps, the state terrorism will make its first steps in the shadow of a flailing cold war. Sorrow would pervade the Olympic games of Munich in 1972. The OPEP conference itself would turn bad in Vienna in December 1975. The public was alerted upon a new kind of threat. China sped up all of a sudden of opening towards the Western countries, the G7 in particular. Soon enough Russia broke the ice through the Glasnost with Michail Gorbatchev only few years later. None of these events could be hedged even remotely. But surely people wondered whether it would ever be possible to anticipate that somehow....

One speculation grew towards the end of the years 1970ies: the US government might default on its debt because of the endemic inflation being itself the byproduct of the successive oil shocks. What if a third oil shock surged coupled with synchronized terrorist attacks? Would Russia and China support "the West"? Who would honor the "Eurodollar" contracts"? How big the next un-hedge-able gap would be? Any conspiracy theory would do the job to provide answers..... None would be reliable anyway even if it predicted the ultimate outcome correctly. One wonders then what the "riskless rate" was expected to be in the future. Paul Volcker, the one man behind the "Volcker Rule" in 2012, was then chairman of the Federal Reserve, the entity which "presumably" was setting the "riskless rate" wisely for the whole financial planet.

All of a sudden Volcker would hike the "riskless" short term rates violently starting in 1979. Within the following 5 years, the inflation would fall as projected as per Volcker's plan from 10% to 4%.... That was a predictable outcome. What else? Without risk the "risk less" rates of the US treasury?... Not quite...It looked like a success granted as far as the headline inflation rate was concerned....But

the Savings and Loans banks in the US were now entrenched into a slow yet certain decimation. Thus the creditworthiness of the USA although looking better was not unharmed. The “riskless” rates went down on the follow but the American small savers had not profited from it really, starting with the customers of the savings and loans banks.

Who should be trusted by the small depositors and small investors towards the end of the 1980ies in the middle of “star wars”, the “nuclear threat”, in case the terrorists had miraculously opted to stop their own attacks? Lethal radiations or bombs....The Federal Reserve cannot be trusted so much...What a wonderful choice the savers and depositors were left with! The belief was in danger. The “belief” was dead again? Long live the “belief”! Paris, Bonn, Milan, Tokyo etc....All the capitals of the rich countries of this planet launched their financial “Big Bang” in response. They deployed their market driven activities and infrastructures. They encouraged savings, popular shareholding, privatizations of the “blue chip” corporate. And they provided their big banks with means to trade on derivatives. If the G7 regulators wanted to avoid a repeat of the 1930ies, the G7 governments on their side were re-creating the mood of the 1920ies so far.

The whole world adopted here what would be called the “Black and Scholes” model mentioned before and therefore all of the G7 countries endorsed like one man this “markets are efficient” assumption. This was a real act of devotion. What was initially an intellectual effort to best apprehend a “credit/liquidity” risk that was fundamentally uncertain, became in a twist of history a “reliable mathematical formula” that would be used to “price” the future uncertainty in the markets. Could one ever believe in this? Everyone tried to in any case. What was originally a tentative attempt to bracket a range of uncertainty on valuations became a “handy pocket calculator” to price any option based upon fundamentally uncontrollable risks. But better was to hope for the best. Who would think otherwise at the end of the 1980ies while the financial markets started a seemingly unending rally? Sounds like the late 1920ies? Yes, very much so...Tales of fortunes made in one day blossomed among the “traders”, the “Yuppies”, the “dealers”, the “brokers”, the “bankers” in fact....

Then came the incident of October 1987. One speculation had pushed the former one...It really felt like the end of the 1920ies. Ben Bernanke was becoming a famous scholar who was drawing more and more parallels between the 1920ies and the 1980ies. He set the focus of his conclusion on credit spreads already, ie the cost of liquidity. It was not the time yet for Bernanke to chair the Federal Reserve. Alan Greenspan was the one who had just replaced the now legendary Paul Volcker as president of the Federal Reserve upon decision of re-elected Ronald Reagan as people said. Markets were sensing a gap risk was close... A bit like Anakin Skywalker....The financial markets like one man were “worried” and “fearful”. So was the rumor that looked like a “reasoning”....Volcker had saved the USA as people thought then. But he had come from a democrat side of the political arena. Reagan was a republican, right? So Volcker had left to be replaced by an advocate of the most liberal thesis who yet had very little credibility.

In short, politics here came to blur a perfect economic scheme in place some feared... Yes, in September 1987, Alan Greenspan sparked mostly defiance. And that was enough to shake the planet. As a result, the New York markets crashed in one day by more than 20%, sometime in October 1987.... Was It a genuine gap or not? One must wonder what the ground was for the revered “market efficiency” in hindsight beyond the act of devotion.... And here, every rational thinking, inspired by the crisis of 1929, would suggest that maybe the end of the world was near....But not for long, no....The time of one day was enough actually, right?... Who could ever have hedged such an unpredictable “down and up” move and upon which rationale other than gambling as in a casino to get rich quick? Who could simply have tried that? Well those who did would get even richer, provided they had survived in the meantime.

That was casino gambling. The so-called “black and scholes” model had literally failed here. From then on the price of “risk” would be highly dependent upon the path followed by the markets. This was a radical rebuttal of the key assumption: the “smile” in option “implied volatility” proved that markets were inefficient most of the time if not all the time in providing the needed liquidity to any player, large or small. The path to any crisis remained in fact unknown until the very last minute and

no market player would be able to know it in advance. This was the start of good common sense where one concluded that markets were unable to predict and therefore offer a price for a hedge against a deep rooted crisis. What was the point then in trying to build a “hedge” for such circumstances? Which market counterparty indeed would be solid enough to stand by its contracts through the debacle? This prospect was definitely scary. Ironically while the so-called handy “black and scholes formula” was no more than a collective illusion, it would be even more broadly adopted on the follow. It was surely perfect for a “credo”. Optimism remained the Bet of all.

### **The “mark to market” protocol, the Number 1 defense against the risk No 1: the fall in performance...**

The temptation was too high. As to the alternative solution, there was none that was pleasing to hear. The big financial instrument was available. The derivative products were here too. The trading fees were generous and provided the banks with a timely surplus of income. The investors noticed on their side the ongoing demise of the Savings and Loans banks. The mood was full on investing in financial markets for every household. Why going counter the trend by admitting defeat before having battled? Thus everyone jumped on the train and organized oneself. On the side of the banks, trading rooms were built up in ever larger open spaces, hosting more and more traders who simply quoted prices from morning to evening. One hope was that by growing their reach in the world population, the financial markets may find their Eldorado of liquidity among the ever larger traded volumes and the hopefully ever larger number of players. It was just a cynical hope.

This was indeed contemporaneously the start of securitizations whereby companies front-loaded future “promised” payments to receive instant “cash”. What was this operation here, the securitization one? At the end of the day, the bank transformed some “tangible” assets into an option that was plain “virtual”, ie a derivative. How? The bank took valuable assets, sold them to an “entity” the only tangible aspect of which was that it existed through the fact that it had a legal designation. In short the “entity” had a mailing address somewhere on the planet. That was enough. One may well say it was a pure shell meant for accounting purposes. It was indeed just that. But it could trade in financial markets! The shell entity financed its purchase of those assets thanks to the sole ability of the “securitizing” bank to be able to raise some money across the worldwide financial markets by means of other derivatives trades at the end of the day. And here the bank structuring this shell entity kept for itself what could make the most profits while being the least costly in case of crisis. On the way the bank earned fat fees for structuring the operation.

One may guess then what was being “off-shored” here into the shell entity by the bank or any other corporate and why. The securitization process started at the end of the 1980ies. It was a protocol that finally eliminated the distinction that one may make intuitively between a “tangible” asset (like a house, a bond or a stock) and a derivative exposure that is a typical “intangible” asset. Who was already the main sponsor of the securitization since the middle of the 1970ies? This was the US government through its agencies called Fannie Mae and Freddie Mac mostly. When did this securitization industry take off really? Sometime in the 1960ies, right when the “Eurodollars” and the international derivatives markets were also expanding uniquely so....Was it a coincidence? Or was it simply the solution that the United-States had found to create those options for themselves, sheltering their financial industry and securing some extra financing based on those available “Eurodollars” liquidity reserves for their economy?

Thus the “financial tool” solution made to appease the worldwide tensions was being deployed across the G7 and beyond. But the system still had kept its flaws that would pop up at regular intervals. During this period of the late 80ies--- early 90ies, the incidents would be numerous in financial markets. They regularly reminded the authorities of the 1907 crisis, the 1929 crisis and its subsequent depressions of the following years. The PIBOR in Paris exploded to 20% briefly but long enough to make devastations in the Parisian trading rooms in 1991. The so called “asset swap” positions, in which a derivative was imitating perfectly the underlying risks of an asset, were NOT so harmless far from it. People realized that the immediate liquidity risk, embodied wrongly by the consensual PIBOR fixing, could NOT be hedged neatly. Smokes and mirrors...As a consequence a structural risk showed

its ugly face: the “basis risk”. It was the direct legacy of the “credo” in fact, this “tangible belief” that things “should” work over time provided we all survive. That belief itself was intangible at critical moments unfortunately.

A “tangible belief” is nice conceptually but it is NOT real. Any outside observer will hear about the “irrational exuberance” of the markets in the following decades. The expression shows the tangible presence of this belief and the obvious irrationality sitting right underneath. In practice this “basis risk” was the expression of this “belief that does not work in fact” day to day. The “basis risk” is therefore a fundamental risk. Yet lawyers would call it quietly a “documentation risk” suggesting that this was maybe just a tedious and tiny second-order danger “paperwork related”. But it was in reality quite real and became material anytime the markets seized. Indeed one could not access the same liquidity with one’s market counterparties depending upon the contract that governed the trades that had been done. When one traded an asset that was quoted on well monitored markets there was one kind of contract that committed to the best liquidity facilities. When one traded on “over the counter” (or OTC) derivatives, one got just minimal guarantees about future liquidity facilities. If one thus bought an asset on an “organized market” and found a “hedge” through an “OTC” contract that mimicked “perfectly” the risk of the asset in question, one would just enter a “greater fool’s” game since the “OTC” counterparty would determine the unwind price of the “basis” here. And if this counterparty was in dire straits at one point in time, it would make the others pay for its own survival. What else would basic common sense suggest here? This of course would endanger just all the other market players related in business to this counterparty. And this would mechanically spread to just all the other market players since everyone bank had made bets on “basis” trades massively no later than 1991 whenever it could. One can try to figure out how it works when one starts hedging OTC exposures with other OTC exposures therefore creating “skew” risks.....The latter are just way more unpredictable....

This basis risk as described above would always bear the same pattern in the future. The Credit Default Swaps, and therefore just all the instruments employed in the “tranche book” of CIO that will bring up the “London Whale” case, were “OTC”. And they were hedging other OTC “basis risks”...

On the face of it, this “Basis risk” was almost invisible in the “market risk” reports. They were “legal risks” on paper, not “market risks”. As to whatever is “legal”, it is “confidential” and therefore vastly undisclosed. As a way of example, one may look at the “identical underlying” keyword when searching through any 10-Q or 10-K report of Jp Morgan for example. One would see how the bank is assertive in its ability to compound a \$3 000 billion outstanding amount of credit derivatives that just have some “identical underlying” but definitely have all the same a massive “basis risk” embedded into it. ...\$3 trillion of “basis risk” here that were here for credit derivatives alone.....The figure is higher for Jp Morgan if one adds the other “basis risks” related to other “hedgies” and “cash” assets like CLOs, ABS, CDOs, structured notes for example....This \$3 trillion figure alone is 150% of the whole balance sheet size of the bank of the time in 2012....

It was big already back in 1991. This “basis risk” relied only on the instant liquidity that the markets could provide and was ultimately a legal risk indeed. Do not hope that a lawsuit would save the bank exposed to a “basis risk”. Legal proceedings take years and the margin calls have to be paid “tomorrow first time in the morning”. This “time disconnect” may have massive, even lethal, quick economic consequences for any bank or any country. And, as exemplified by the 1971 dollar de-pegging vs gold or by the PIBOR explosion in 1991, the liquidity provided by the financial markets could only be quite limited in times of duress.

While the “basis risk” surged in banks’ ledgers and regulators’ radar screens, Georges Soros became famous when he and his hedge fund managed to push the glorious British Pound £ out of its pre-defined corridor versus the other major glorious currencies of the G7. Even the powerful Bank Of England, even the wealthy and mighty United Kingdom, could be lethally exposed to a basis risk through instant margin calls. Was Soros a genius or the Devil? He was neither one, nor the other. His endeavor certainly was a sign of the times....The legal enforcement or the very principle of sovereignty were put into question day after day through this ever growing “basis risk”. Europe



decided to speed up its own financial integration by launching the project of the “euro”, the future common currency. Mitigating the “basis risk” by spreading it through many countries and a larger population was maybe a solution. “Economic integration only... we will see later about the laws”. That was a new credo. What would be the point of going further than a mere pragmatic “basis risk” containment? Was it necessary to merge many sovereigns into one as the United States had done two centuries earlier while the whole concept of sovereignty was anyway dissolving? No it was not necessary at all but the Euro was dearly needed in Europe no doubt.

In the USA the ongoing systematic slaughter of the Savings and Loans banks was getting to an end, showing that even in the USA, even the small savers were now exposed to international events. The market of “Junk bonds” was born announcing the birth of the future “High Yield” market. Investors discovered that normally highly rated debtors may turn out to be crooks at times. This market of “Junk bonds” that was unlikely to be honored by investors was born on the cemetery of the Savings and Loans banks. There was no “risk-free” rate any longer on the planet... There was no place to hide for investors.... But no-one would confess it.

The authorities became then aware of the quite limited liquidity that financial markets could provide in effect by themselves. They therefore also became aware of the permanent risk that this superficial flow of liquidity could break down, suddenly, something which would have devastating consequences. Who could be a substitute for a judge or a state in case of a litigation involving international market players from now on? Which dispute occurring on financial markets would not turn out to be “international” as soon as it involved a big bank of the G7? There had to be a “consensus”, a “line in the sand”, a zone of “neutrality” on the permanent legal battlefield that the financial markets now constituted. So the regulators started with the very beginning, ie pragmatically established a consensus on market prices so that everyone could at least agree day to day on the variations of those prices. Thus the performance of the market players would be measured consistently one versus the others. By “consistent” one must understand that the regulators would see what the market players themselves saw as the consensus. Margin calls of the day would be paid. And naturally this raised the next question: “what about the next days, once some would have entered quietly in dire straits?”.... What if a player had to actually unwind since he could not be able to face the next margin calls? The dilemma ran full circle as expected.

It was wise already to adopt some distance towards this blind consensus since these prices were NOT tradable ones. In a crisis time for which there were many examples at hand, the unwind prices would induce a much worse performance than what the consensus would suggest and impose on routine margin calls. Likewise, the consensus prices being close to “mid” prices they certainly did NOT include the unwind costs. Therefore, even if this was not a crisis time, the ultimate performance should NOT be as good as what the consensus indicated through its own fixing prices. This also was very well known as early as 1991. This is why it was really definitely wise to run a price selection process that was competing inside the bank against the “consensus” one. And it had to be one competing process that was actually fully independent. This is what the CIO London Office contributed to achieve no later than early 2007 for Jp Morgan through its “tranche book” daily P&L estimate.

The consensus was just a starting point indeed ensuring that all the market players had reached a common ground. Next liquidity reserves would be set in that they were meant to cover “unwind costs” of all sorts. Other risk measures would be deployed in order to set “capital provisions” on top of those “liquidity reserves”. Thus between 1992 and 1993 the SEC, the OCC, the “group of thirty” presided by Paul Volcker himself and Jp Morgan’s CEO of the time (Denis Weatherstone), imposed the “Mark to Market” protocol in that prospect. It was plain strategic as one can see now. This was NOT only about pure daily financial performance in the context of the time. The Berlin Wall had fallen. The first war against Irak was ending. International terrorism was spreading. Banks of the G7 were all becoming international through their trades in financial markets.... They were exposed to this nasty “basis risk” at least. And sovereignty was eroding surely so.... The world population grew faster and faster and had then reached 5.9 billion. The G7 weighed only 11.2%. Which law could be applicable for sure across the planet? None. This “mark to market” protocol was therefore fundamental and itself

presided on the subsequent determination of capital provisions and liquidity reserves for the banking system as a whole to withstand any future shock. How to make this starting point a success?

**The VaR was created as the cornerstone for the determination of liquidity reserves and safety provisions in capital terms....**

There was one sure thing that was checked by the SEC then: the derivatives must be placed in so-called “trading” books, so that they are subject to this strategic “mark to market” protocol. Exceptions were allowed but only under extensive documentation and justification. Here again, the SEC did not act alone or randomly. It called independent consulting firms for help in the systematic review of the US banking industry (see the SEC Annual report of 1992). They would verify all the portfolios of the banks. The argument was simple: the variation of prices in the market could not be ignored. At the very strict minimum, market players had to adjust one to the other by means of “consensus prices”. Next, any fatal “incident” had to be predated by means of precautionary reserves and provisions in capital, that were themselves taken right after the valuation that had been based on “consensus” prices. This “valuation” here was clearly the Number One risk. But “Number Two” mattered as much... And with regards to securing the “soundness” of every bank, it was just a starting point. These liquidity reserves in particular were critical as obviously the financial markets were NOT efficient even though they displayed a semblance of liquidity in routine conditions.

3 factors were listed at the time to help determine the reserves and provisions, ie 20 years before the “London whale” events. They were disclosed by the main regulators monitoring JpMorgan already. First, the prices could vary, at times a lot, one day to the next. This mandated a first reserve. Jp Morgan shined on this matter making popular the VaR among the market players and the regulators altogether. This VaR would be a central standard quickly adopted by all stakeholders. Second, the authorities and Jp Morgan alike strongly advised to measure the uncertainty surrounding the quoted prices which served as the basis for making the consensus, the valuation and the VaR computation day after day. How to do that neatly? Well, estimate the inherent “model risks” everywhere as soon as mathematical formulae were combined with gross market prices. And have recourse to a price source that was “INDEPENDENT” from the unit taking the risks on the markets. Third, the authorities and Jp Morgan alike, recommended to add a “credit cost reserve” which would have taken into account 2 risks; the liquidity and concentration risks altogether, and the default risk of one market counterparty going bankrupt.

The fourth factor was not yet discussed openly at the time and that was the “chain reaction” risk, or what is called these days the “systemic risk”, or else the risk of contagion. This fourth factor is what will trigger the 2008 financial crisis. It was based upon the initial implementation of the first 3 factors mentioned above throughout all the market players at the onset of the crisis to come. In 2007, all market players could see the crisis coming based upon the reserves and provisions that they already had set. They could also quickly compute that reserves may be insufficient here and there. They knew that one failure may be lethal for them. The markets would therefore seize in 2007 before time precisely because of this fear of a contagion, specifically with the knowledge that reserves may not suffice if some of the market participants were to run short of liquidity at the very same time. They were not seizing unduly as history again was quite a good guide over the last decade....

This is also this “contagion” risk that Dimon had tried to predate ahead of time with this “tranche book” and HIS CIO back in 2006. This is this “contagion” fear that was in the background of the “London whale” scandal too among all the regulators involved. As it would turn out in 2012 and onwards, this “contagion” fear had no ground as far as the “CIO tranche book” was concerned despite the prevailing ambiguity of Jp Morgan itself all along and the stated “fears” of regulators then.....

Back in 1992-1993, ie 20 years before, the VaR simply became the base ground for the minimal reserve amount to be taken in order to shoulder the fundamental market risk, namely the “mark to market” valuation change from one day to the next. The VaR was thus the necessary byproduct of another necessary crucial consensus. Alan Greenspan had settled his credibility then and for long by not hiking the interest rates between 1991 and 1993. He no doubt dreaded a repeat scenario of October

1987...or a new oil war...or a furthering of the Savings and Loans bank slaughter into the much bigger cluster gyrating around the big US investment banks.... Did the latter actually have enough capital to cover the next crisis? Did they set sufficient liquidity reserves to predate their potential unwind costs on derivatives and other assets placed in “mark to market” book? The answer is secret right? But it was NOT unknown.

In November 1993, Greenspan warned: a rate hike was near in time.... He wished the Big US banks like JpMorgan would discipline themselves. They would not do that well enough as a group. The financial markets seemingly ignored the warning and pursued their high flying rally in bond and stock markets. The derivatives markets were here, growing amid enormous volumes helped in that by both big banks and hedge funds. The “basis risk” kept snowballing. But in February 1994, Greenspan hiked rates. And he would keep hiking until the end of 1994. The bond markets slowly but surely crashed. Greenspan may well have detected at the time the early signs of a speculation related to the fact that rates had stayed too low for too long. Whether it was actually a speculation of his or not, the correction on bond markets induced large losses among the biggest banks, sparked the postponement of promising mergers, triggered few changes at the top of the most prestigious banks. The shock stopped there in the immediate future. On the side of the hedge funds, the hit remained highly confidential. But in the back legal proceedings had started and lawyers scrutinized many derivatives contracts of many kinds....Regulators watched all that closely.

The subsequent consequences upon the international bond markets would prove that the infinite interconnection between market players left no room for complacency. The systemic risk thus made its official entry among the major dangers right in the follow up of this 1994 bond market crash in the USA. Some people called it the “butterfly effect”. The “basis risk” was not far but left in the backyard then... This series of rate hikes from the FED would spark a violent currency crisis in Mexico in 1995 which itself shall spread to the South-East Asian countries in 1997. People may blame derivatives, hedge funds and banks because obviously the “basis risk” was the transmission axis of the financial stress started by the US rates hikes. And obviously “traders” had traded these damning derivatives.

But this was not so simple as these greedy players had bet on short term for sure. The fact is that the contagion took some 12 to 18 months to cross the seas. A sailing boat would have done the trip much faster. This is close to eternity for any market speculator. The derivatives certainly made matters worse. Georges Soros was suspected.... It felt like the British Pound episode but with this time really dramatic consequences over so many human lives. The shock in these parts of the world would be devastating, sordid, unfair for the populations affected. But Soros or other short term gamblers had little to do with it. The proof would come “soon” after....a deflation tsunami would flood back from Asia to Europe (of course) and Brasil along with Russia altogether at the beginning of 1998. If anyone wonders: no, a gambler cannot induce a deflation shock like this one across the planet. One main reason is that deflation is killing the bread and butter of most speculators. Indeed speculators need bank credit to be able to place their leveraged bets in the markets. And bank credit crashes down in a deflation, therefore killing the speculators themselves. Thus if just one of them speculators was mad enough to try he would be mashed and reduced to ashes by his counterparts almost instantly. Apart from invoking now the tenebrous “systemic risk” that is just a set of multiple counterparty risks inherited from “basis” risks, there was no clear-cut explanation. There was no need for an explanation actually. The banks worldwide then were cutting “inter bank credits”....for fear their own reserves would not be high enough...

One thing was certain though: the VaR had many shortcomings. The VaR was really the very “minimum minimorum” measure on a daily basis of what a market player could face as an immediate loss in financial markets. Worse, as the actual losses in times of crisis were high multiples of this VaR yardstick, it was actually quite hard to reduce the Var Itself in practice when emergency called it. Thus the VaR was a very small figure when compared to potential extreme losses. It called reserves and provisions that were high multiples of the VaR figure itself. Yet the VaR experience uncovered quite clearly the most critical liquidity issues and systemic risks at play during a crisis. So the VaR definitely became the gauge of the overall financial risk that sailed across the whole planet every single day.

It was more than ever the gauge for analyzing provisions in capital and determining liquidity reserves. The former and the latter would count as a high multiple of the VaR figure itself knowingly so. The stakes were high as the “systemic risk” showed that, irrespective of what the speculators would do, irrespective of the typical “cushions” like liquidity reserve or capital provisions were, should the losses repeat themselves several days in a row, it would start a worldwide financial “Tsunami”. Already then the root of this cataclysm was to be found in the derivatives markets, especially the CDS markets looking forward (Credit Default Swaps, the most commonly traded credit derivatives)

### **The correlation risk is the target for all the regulators involved since 1998 for good reasons....**

The “financial tsunami” would apparently land on the shores of the hedge fund industry through the incident caused by the high profile demise of LTCM. Here one could have summarized 25 years of recent history since the US president Nixon had broken the US Dollar-Gold peg. The fundamental inefficiency of the financial markets was easy to sketch then. Looking through the lens of the “basis risk” for market players, or “documentation risk” for lawyers’ dictionaries, one could see the thread. Was it over? Not a single chance as History again was quite a reliable guide. Back in 1971, the US government had made official the existence of a basis risk on the US dollar between “domestic bank accounts” and “off-shore bank accounts”. This was clearly unavoidable while the “euro dollars” traded in ever growing volumes through derivatives contracts that travelled over the whole planet. The two oil shocks, the terrorism, the October 1987 flash crash, the demise of the Savings and Loans banks, the birth of the High Yield market in 1991 were as many expressions of this “basis risk”. The regulators targeted this “basis risk” when they introduced the “mark to market” protocol in 1992 in a forceful manner. Jp morgan popularized the VaR as a way to actually grow as much as possible derivatives trades in a self-consistent measure of the needed liquidity reserves and capital provisions. The bond market crash of 1994 and its subsequent “Tsunamis” showed what to expect in the future: an ever-present “systemic risk”.

Credit default swaps would be then created in order to minimize the mandatory liquidity reserves and capital provisions for the whole worldwide financial industry. The CDS were just spreading the “basis risk” danger farther across the planet. This led to even more toxic basis risks like the one for example that appeared between GKO (short term Russian debt) and respective CDS.... That was “too good to be true” and yet some former Nobel Prize laureate’s teams would fool themselves on the matter. While the yield on some GKO was 100% per annum (Yes!), the CDS protection cost “only” 50% (yes again...). Thus an investor could hope to make 50% of return per annum through buying the GKO and buying the corresponding protection on CDS (100%-50%=50%). That was “backed by the White House” said the whisper along the corridors of power....That was mad.... This led to a mad conclusion. This conclusion led to a predictable “discovery”: the CDS were just patches meant to blur even further the systemic risk by spreading it to a greater number of financial institutions in larger volumes hitting potentially just everyone when the time would come. After the GKO explosion which induced the demise of LTCM, the ensuing crisis would only confirm the role played by the CDS markets. The “dot.com” bubble, the triplet “Worldcom/Qwest/ENRON” only brought more certainty on the matter.

The CDS trades were “make-up” at best. In practice they make the containment of systemic risk ever more impossible since the players involved were just more and more numerous over time. If only those CDS markets had not been “OTC” but instead they were traded though highly regulated platforms. But the banks would always oppose the move fiercely. And no government or regulators had the capital to “clear” this “basis risk” at its immediate expense if a crisis occurred.... Officially the banks unanimously claimed that they would lose the confidentiality of their own business if the CDS were publicly traded on regulated markets. What a convenient excuse for the authorities!

In practice every bank printed vastly improved profits from the use of CDS. The regulators were called here straight back to their century old dilemma. They would let the bank “dance while the music played” on CDS markets as Chuck Prince (CITIGROUP CEO in 2007) would say. The public

authorities were letting the “basis risk” volume grow and grow. There was therefore only one possible solution for central banks in any future crisis: cut the rates down to zero for as long as needed in order to avoid a series of bankruptcies among the banks that mechanically would induce a full storm depression. Inflation would not matter....The subsequent crazy rallies in stock markets would not matter....

One got farther and farther away from the mythical “riskless rate” of the Black&Scholes model. Didn't it? The “credo” had become a religion. All those events and decisions were driven by this incompressible “documentation risk”. They would also give birth to many other sorts of basis risks in the following years, among which the “skew risk” or the “correlation risk” in CDS markets....

The dilemma had become just more sophisticated with the advent of derivatives, mark to market, VaR and systemic risk. The decisions of the regulators involved in liquidity reserves and capital provisions would remain based nevertheless on simple projections, themselves driven by actual correlation measures as uncovered by the VaR analysis. These projections, however speculative they were, were vital when one considered the “systemic risk” that threatened to surge at any moment. From these projections one inferred mathematically the reserves and provisions as per the prevailing standards, be they Basel II, Basel 2.5 or Basel III or else. These figures were mandatory for any bank to be allowed to keep operating in the financial industry.

Here the century old dilemma was ever present in the backyard. These figures indeed were the minimum amounts of capital and liquidity “at hand” that a bank MUST have in case a crisis occurred. That was just a moving target actually. That most likely would be insufficient for some banks at some critical juncture. The standards were just other “consensual views” coming on top of the “market protocol” based itself upon initial “consensus prices” as described above. There was no certainty here that any bank complying with those standards would survive the next crisis. But at least a relative certainty was reached on the fact that every bank met the “minimum standard requirements”.

The rule on paper was crystal clear: either the bank had those liquidity reserves and capital provisions and it thus could keep operating, or the bank did not meet the standards and it was to be shut down. Thus was still the duty of regulators to monitor routinely this compliance and eventually place one bank in receivership or any kind of defeasance scheme otherwise.

Usually, a bank that was caught short of reserves or provisions had about 3 months to correct the shots. If not, regulators were mandated to act radically. Every regulator dreaded the moment when a big bank would be caught short of reserves. This was here the pre-written script for the latest financial crisis of 2008. After the subprime losses had spread through the banking system in the summer of 2007, regulators started asking all the banks to revisit their liquidity reserves and capital provisions. This just sped up the freeze on inter-bank credit which would lead mechanically to the certain death of some banks. Towards the end of 2007 the Bear Stearns Bank was required to raise capital and increase reserves. It did not comply.... It was sold for \$1 a share to Jp Morgan by the Federal Reserve in early March 2008. In June 2008, it was Lehman Brothers that was on target....Lehman failed to raise capital during the summer of 2008.... And Lehman Brothers was set in bankruptcy in early September 2008 under the close monitoring of Jp Morgan again....and so on with Merrill Lynch, Goldman Sachs, Citigroup, Morgan Stanley etc...

That was all in the US as it seems. Was the tsunami contained in late 2008? Not at all.... Instead the G7 countries would have to put a ton of money on the table, indebting themselves more than they should ever have. In 2017, their public debt is growing relentlessly as a result, the public services get consequently more and more depleted, and public discontent tends to push populist or neo-extremism to the top of the political powers... The “credo-turned-into-religion” morphs now into a model of society. It now really feels almost like the depressive 1930ies: all governments claim a “solid growth” that most people do not recognize in their day to day life. Growth is just a ghost of what it was since 1998 while official inflation figures vastly underestimate the actual drift in consumption prices. There is no such “hedonistic” economy apart from social networks illusions and reality shows....one had

rather call it a “bellybutton-istic economy”. The dilemma of regulators has not disappeared in 2008, far from it. It rather seems now to shape the whole economy, the social life and the laws themselves.

It was still the same dilemma and the same dreadful script that prevailed in 2004 already when BankOne and Jamie Dimon got married to JpMorgan-Chase. On the façade, that looked to be the “deal of the century”. In the backyard, the brand new capital of the new-born mammoth was based mostly on intangible considerations. Indeed, \$42 billion, or 40% of the capital of the brand new banking group, were generated ex-nihilo through the merger itself by a pencil move in black ink (\$35 billion of Goodwill and \$7 more billions of ‘other intangibles’). To be sure, those \$42 billion here would come right through the merger on top of the already existing but meager \$8 billion goodwill and few other intangibles in the ledgers of the merging entities. This kind of huge phenomenon was not usual for a massive financial corporate weighing then “just” \$100 billion in total.

This quite fresh capital, \$42 billion, had been created just with a “pencil” in the accounting ledgers of the new banking group. Added to just \$8 billion it was still insufficient to safely balance the lack of liquidity reserves that would be needed for the next crisis to come. The issue at JpMorgan had persisted since 1998 in fact as well as across the whole banking industry in fact, notoriously so. The CDS markets expansion had been a clear sign of the problem: banking capital and liquidity reserves were in short supply. The regulators were openly worried. The collateral and margin call processes at the ISDA (International Swap Dealer association) had tried to cover as many risks as it could. But the Basel II standards multiple successive versions reminded always the main dangers, ie the “counterparty risk” and the “model risk” especially for the Credit Default SWAPS (CDS). They remained unsolvable. The regulators had observed in 2005 that no bank actually was fully reserving for those dangers. They all relied on each other at the end of the day to bail them out....Markets were efficient, no?...The reference ran full circle. Fortunately the golden personality of Jamie Dimon was here and \$42 billion of capital would be created out of the blue...What if Jamie Dimon had not been born yet? Was there another “providential” manager on this planet to fit the role job for \$42 billion?

This is then likely so, in 2004, that one can sketch what happened in the follow up of this peculiar merger of JpMorgan-Chse with BankOne. Through a well timed coincidence of events, one could imagine that the regulator probably required that the brand new \$100 billion worth in capital megabank (with \$42 billion of intangible capital) set a sort of liquidity reserve massive fuse.... Just in case JpMorgan-Chase-BankOne had one day to unwind positions hurriedly in the markets even though its capital provisions may look only “sufficient on paper” thanks to the recent \$42 billion of intangibles....By a no less timely coincidence the CIO was created by Jamie Dimon with a mandate at the new banking group that was quite different from the one that other CIOs had in other banks. Did the other banks have about 40% of their capital basis in “intangibles”? The answer is “No”. And even more coincidentally, the regulators likely again required the brand new banking behemoth to be equipped with a quite tangible protection against the “correlation” risk that is best embodied through the labels “counterparty risk” and the “model risk” as flagged constantly in CDS markets.

Of course this protection would be quite a “particular strategy” as the OCC would have to confess in 2012 in the midst of a crass “unawareness”. That would be a “synthetic Credit portfolio” surely so for the regulators and the top executives alike. The fact is nevertheless that this book was actually called the “core book” or the “tranche book” by those who were instructed to implement it and monitor it. The shift in designation, from “synthetic Credit” to “tranche”, namely from the likely original requirements of regulators to an actual execution being closely supervised by the CEO Dimon all along, is quite natural. Indeed the “synthetic credit tranches” were by design the favored instruments for all market players to address the “basis risk”, the “skew risk”, the correlation risk, the model risk, ie the counterparty risk overall. Thus, when talking extensively in 2012 and later about the “tranche book” of CIO, all the regulators and the bank stubbornly mentioned this “SCP” for “Synthetic Credit Portfolio” and refused to use the word “Tranche book”, they actually showed the bottom line of the scandal. The bottom line was that they, the regulators, had been the very initial sponsor of this “Core Credit (Tranche)” book at JpMorgan. And the denied it by sticking to their “SCP” label...

This “SCP” label could only have existed in the mouth of regulators talking in 2005 already with top executives of the firm about this “particular strategy of protection” for the whole banking behemoth. As such, by refusing to adopt the ultimate “trading label”, the regulators and top executives alike displayed their own longstanding intimate but shameful familiarity with the future travails of this portfolio. Such shyness indeed in adopting the known name could only be explained by a denial of their original responsibilities in the debacle that would ensue. Otherwise they would not have cared, would they? They should never have had any difficulty switching from their “SCP” to the “Core credit (tranche)” book. The bank indeed could only have employed “tranches” along with “indices” as these were the best vectors of protection. Another clue lies in the fact that ONLY JpMorgan would deploy such a “solution” against systemic risk among its peers. The other big banks did not follow the initiative of JpMorgan here. This is likely because regulators did NOT want the other big banks to do the same. This is also likely because they did not “need” to. Here the megabank Jpmorgan would have detracted from its long history as a “standard setter” for the banking industry. And there was a reason.

Still, back in 2005-2006, when Dimon monitored the implementation of the “tranche book” in as many detail as he could (see Artajo, Macris and Drew here), the intent was certainly good. It was about to cover for a possible crash of 40% of the capital basis of the brand new banking behemoth “Jpmorgan-Chase-BankOne”. Some would say it was a “good cause”. They should wonder though why the group needed so much those \$42 billion of new intangibles in the first place and therefore this “particular strategy” on ‘tranches’ through a quite peculiar CIO on the follow.

The top management of the bank targeted in absolute secret vital hedging strategies for the firm as a whole. Was Dimon deploying a standalone strategy or was he rather addressing the regulators’ dilemma? The regulators monitored it like oil on fire probably. Who would ignore then behind closed doors that the second biggest US bank had 40% of its capital in “intangible assets”? Maybe this is this quite close monitoring process starting in 2004-2005-2006-2007 that actually prevented the NBIA post-implementation review to be even started (see the Sarbanes-Oxley law 2003). For sure this “particular strategy” was not at all about hedging a risk that the bank had wanted to have in the first place. No. If the bank had taken this one risk here or there, that would always be its decision. Not the one of regulators, right?.... Why was it there then? It was secret. The old dilemma was back on the front-row seat....either the bank loved this one risk and kept it...or the bank did not like this other risk any longer and unwound it wisely so....There was no chance that the bank or the regulators would ever back a fanciful “tale of a protection whereby the bank overexposed itself in a shadowy fashion to some prop trading risks” ....Just basic common sense here....The goal behind this CIO and this “SCP” was clear for them in 2006: it was all about predated a massive “systemic risk” that was daily scrutinized through the “correlation risk” as showing in the VaR analysis. Yet the regulators did not know and above all WOULD NOT KNOW how to address the issue in practice for JpMorgan....Back then, in 2005-2006, the axis was quite visible, embodied so well by those \$42 billion of fresh goodwill. In designing the protection, the senior management hesitated between, by another coincidence no doubt, the already blatant abuses in subprime lending, or the salient flaws or the models applied by the main rating agencies (Moody’s or S&P) about the CDO-CLO-ABS tranches. The actual correlation between the 2 phenomena was itself also very obvious: that was the “counterparty risk”....

**The paranoia was extreme at the top of Jp morgan. The senior management needed “screen guys”**

Contrary to just all the future allegations of the bank on the matter, there was no room left to chance or moral hazard on the ways and means applied to protect the firm against this “correlation risk”. Be that for the design of the strategy itself, for the deliberations on the implementation in details, for the valuation process, for the internal reporting, for the public disclosures, even for the confidential communications with regulators, the most extreme paranoia was the rule for the very top executives. They operated on really humongous amounts on a really scary matter: the regulators’ secular dilemma.

In such context, how natural it is to imagine that those very senior managers, as per the rules in force since 1993 about their own accountability on derivatives performances, wished to have a concurrent

set of market prices, a concurrent measure of the main risks, and a comprehensive reporting system that brought them all the potential differences with the “consensus”. They wanted to see everything indeed but they also wanted to remain in the shadow with regards to the markets players. They were aware that they would move their pieces like an elephant in the room right under the scrutiny of just all the financial markets which were always so keen to buy on the rumors and other gossips that they considered as “privileged information”.

Jp Morgan was a world class player and one of the biggest (if not the biggest on CDS markets actually). Those very top senior executives had to have decoys and baits for the many sharks swimming around. They quite naturally would use “screen men”. But they would not make use of too many men since in practice they simply could NOT execute the trades or rely on the army of IB traders to do the job. Could those few “screens” be simply existing traders at the IB? Well the answer was clearly “no” for at least 3 strong reasons...First, those traders already had a mandate to make money for the bank as risk takers. This “screen” added objectives that would conflict with the initial mandate. Most likely there would be long periods where the hedge would NOT make money and would be perceived as a “waste of time” at best by the trader in charge. This may destroy his motivations and incentives. Second, the IB “traders” names were to change over time since the senior managers would likely change the implementations over time. Thus very soon, there would be many IB traders that would have acted as “screens” for a time and then have stopped acting as a “screen”. Yet the strategic information would be there among these many IB traders who could have ‘talked’ with the many bank clients and with many other market players in the future. Thus the confidentiality could definitely NOT be secured. Third, the senior management wanted to have “traders” who were just “screen guys”, ie human beings who would be financially totally dependent upon the goodwill of those senior top executives. That did NOT fit well with the IB culture based upon self-undertaking, and even with the “traders” culture that is all about self-motivation. Thus picking IB traders would be counter-productive, strategically stupid and culturally absurd.

Thus the senior managers needed “screen men” who executed like typical “traders” in the markets but who were NOT employed under the typical status of “traders” inside the bank Jp Morgan. All this had to be made crystal clear by the way to the “screen men” in question: “shut up”, “trust us” and “just do what you are told to do”. Thus the very top senior management recruited 2 to 3 “screen men”, no more, in a unit that was independent from the economics of the IB or from the other trading activities of the group. They lodged those “screens” at the quite peculiar CIO created by Dimon. Oh they knew quite a lot of things those few “screen men”! But they were just pawns anyway as they knowingly NEVER had the full picture. They were sort of “empowered” like an electric device that could only be set in motion at will once Dimon had put the plug in the slot. They were just marionettes. That too was well known inside the bank but ALSO outside the bank over the years.

These guys were expendable surely so given the stakes at play. This “correlation” risk was indeed well flagged inside at Jp Morgan, but also at every regulator top levels, and at every other bank top management levels as early as 2007. Thus, given the magic \$42 billion of intangible capital that had just been created, although this extensive use of “screen guys” was quite questionable, as the “London Whale” scandal will show, the regulators could only “approve” the NBIA and all the related matters present or future.... even though transparency was NOT the rule.... Much worse events were in the making around this strategic protection that regulators had required....If there ever was an “incident” or a “mistake”, who would pay for the “broken glasses”? Regulators will NEVER try to meet the “trader” Iksil, despite the many promotions and other chocolate medals the “screen” will receive. But the regulators will meet OFTEN with the “trader-manager” Artajo AND since 2007 shall NOT ask for the mandated “post-implementation review of the NBIA”....

Given its projected size, the protection portfolio against the systemic risk for the whole massive JpMorgan-Chase-BankOne would materially impact the VaR. If that was not the headline aggregated figure, it was by design to have a visible impact through the day to day analysis made around the utilization of the VaR itself. As explained before, it had to have an impact on the required liquidity reserves. It also had to have an impact to mitigate the \$42 billion quite tangible Damocles sword hanging over the capital basis since January 2004. It therefore had an impact on the required capital



provisions that would tamper somewhat the fact that close to half of the bank capital was intangible actually at the time. And common sense strongly suggested that this “tranche book” at CIO, ie this “Synthetic credit particular strategy” for regulators and Dimon alike, was to target slots in the markets where the systemic risk could arise in fact lethally for the megabank....

Given the secular dilemma faced by the regulators, this series of impacts was to be closely monitored and scrutinized even before the first strategies would be implemented actually. Should anyone be surprised by that? The goal was to demonstrate, at least before it was executed, that such hedging strategy was indeed providing a salvation that could be quantified and visible through projective simulations. That was in essence what regulators and Dimon wanted to put in place at the newly formed CIO of JpMorgan-Chase-BankOne. And to whom would Dimon volunteer to show all these projections other than the board of JpMorgan-Chase-BankOne, and a couple of highly concerned regulators like the Federal reserve, the OCC, the CFTC and the FCA back then? Why would the senior managers have concealed such a wise and prudent approach at the time? And of course, Dimon would have had no reason on paper to conceal the “post implementation” effects on an ongoing basis up until 2012....A sure thing is that no other US bank would think of deploying such a good common sense protection. An therefore no other US Bank would ever come to at least let the OCC or the federal Reserve be aware that such a “particular strategy” existed since 2007. It is therefore really unlikely that the initial sponsor of this “SCP” was anything other than the main US watchdogs themselves...And yet the “post implementation review” for this book would not be even started...

As it appears through the “London whale” scandal that Dimon and his close lieutenants did hide information and quite early on it seems. Or was it simply the will of the watchdogs to remain in the shadows as per the good old dilemma? The first sign again of their permanent “presence” is the absence of “post-implementation review” while the Sarbanes-Oxley law seemed to require it at least internally for the bank. The most puzzling fact indeed is that no US watchdog cared to check on the proper respect of those Sarbanes-Oxley laws on the NBIA matter. The US Senate report commission could not hide its perplexity here: why make an NBIA as per the Sarbanes-Oxley requirements in 2006, implement the “New Initiative” in 2006-2007, make the regulators be aware of the “particular strategy” and next NOT finish the documentation while maintaining the initiative alive all those years? There was a problem for sure. But what was it? Well the problem was quite simple....This “initiative” was about to hedge a liquidity risk, using CDS that were themselves addressing systemic liquidity risks (labeled as “correlation” or “basis” risks for the experts).... Circular reference again...

As all the regulators had claimed in their own publications related to the Basel II standards and US GAAP standards at the time, “quid” of the liquidity of these hedging tools themselves if one “market counterparty” was to fail on its commitments? There was just NO mystery to the answer itself as the case of “Russian GKO massive basis- demise of LTCM” convincingly showed in 1998. It was easy for any regulator to ask Jp Morgan top executives a question like “quid of the market ability to provide you guys with sufficient liquidity for this initiative?” Times had changed since 1998 but the structural liquidity issue was precisely what had motivated this “New Business Initiative” at the CIO of the new behemoth JpMorgan-Chase-BankOne- sitting on \$42 billion of brand new intangible capital. The circular reference was obvious.

The definite answer was unknown in 2006. Jp morgan may well find sufficient liquidity provided the strategies were astutely designed. They would be actually all designed so that CIO, on behalf of Jp Morgan, had trades that other players would most likely need in order to secure vital gains in the midst of a market fall. That was a permanent feature that was still present in the “tranche book” in 2012. But in practice, it had to be checked. Maybe Jp morgan would NOT get the liquidity since the positioning conveyed quite a large part of untested projections. Who could tell then with certainty in 2006 when CDS markets amounts were rising like mad? A cynical answer would simply be that if regulators had approved in the first place this massive “deal of the century” that was based upon quite intangible capital in 2004, this is because the answer clearly was “No, Jp Morgan would never get the liquidity to unwind its positions if needed, and by a large extent”. Then to the question: “does this mean that from a bank that was already too big, one had manufactured a bank that was even bigger?” The answer would mechanically be “YES”. But in 2006 this was a cynical and premature end....

Cynical or not, what was the actual possibilities to unwind the positions of JpMorgan that the bank and regulators alike had picked for themselves? In 2006 the CDS markets were in plain euphoria. One had to try and ride the wave, didn't it? This strategic hedge provided by the "Tranche book" of CIO would bring a protection the dimension of which no-one could tell in advance when the crisis would surge. In the meantime, a few more good years and higher profits may actually help morph this intangible capital into a more tangible series of good earnings records. The original problem, ie elevated unwind trading costs or insufficient liquidity reserves or insufficient provisions of tangible capital, might simply be alleviated by good old economic growth....

They all had this optimistic alternative scenario in mind, as early as 2005, that the maximization of the profits around this "New Business Initiative" at CIO may save the day. Therefore the impact of this "SCP" on the firm-wide VaR took a critical importance that competed largely with the pure "protective" initiative. For obvious considerations on the limited liquidity of the CDS markets, this VaR-led profit optimization was as crucial as the very existence of this "synthetic credit particular hedging strategy" was. There was here a tangible alternative strategy to mitigate insufficient reserves in order to address the issue underpinning this quite cynical merger between JpMorgan-Chase and Bank One. Did it sound like a "double down" strategy here? That was not the one of any "trader" here if it ever was a "double down" strategy in fact....

Thus the "Tranche book" of CIO made its early steps in 2007 without having a clear destiny.... This may be the reason why the "post-implementation review" would knowingly NOT be even started with the paradoxical "blessing" of all the regulators involved. Indeed, as the "actual markets liquidity" question could not be addressed with certainty, the only way to secure the future of the Jp Morgan brand was to leave the future of this "tranche book" at CIO blank... One sure thing is: the regulators were aware of the reason why the "post implementation review of the NBIA" had not been even started in late 2007. They admittedly knew of the existence of this "particular strategy".

### **Beginning of 2009, the financial crisis induces the authorities to look closer at how the "diversification benefit" is managed through the lens of the VaR analysis**

As it was just depicted, the secular dilemma of the regulators, likely led to the non-execution of the "post-implementation" review of the NBIA of 2006 about the "tranche book" of CIO. Regulators were not sure it would work. They wanted to "win" after they had approved this mad increase in "intangible capital" from \$8 billion to \$50 billion on a megabank worth "only" \$100 billion. They did not want to "validate" the NBIA as implemented right now. There wanted a real check in real conditions first, be that "liquidity" or "profits". Would this "particular strategy" be a successful "hedging strategy having ample liquidity" or would it merely "morph" into a "VaR consumption optimization tool for profits"? The issue was always: "what is the unwind cost of the hedge itself going to be when some counterparties start failing on their commitments?" Chicken and egg... OTC versus OTC... Typical "skew risk"....

If that "CIO tranche" book was a successful hedging strategy, it would partly address the insufficient liquidity reserves and would also help mitigate the large part of intangible capital over time. To which extent would it work? No-one could tell but everyone was certain it was far from 100%. If, on the contrary, this "CIO tranche book" could only be just another "VaR related" profit maximization tool, then it would require for itself massive additional liquidity reserves and capital provisions. In the first case, Dimon could claim "victory" in part. In the second case that would be a huge "defeat" of his. That was the "greater fool's game" in fact.... Regulators were maybe just mitigating their risks. Reserves were missing for sure, but how much was missing? That was the question regulators wanted to address. One can see here how the secular dilemma is actually so visibly present at every single derivative trade, irrespective of whether it is a speculation, a hedge, or else.... One can also see how regulators, postponing fully the "post-implementation" review shifted their burden back to Dimon in full. That certainly looked like a "smart" move on their part then. That was wise and astute right then, wasn't it? That was a poisoned pill in fact. This indeed made matters worse in CDS markets. The CDS were already just a patch and a gross dose of make-up designed to mask the vast deep-rooted

inefficiency of credit markets. The ensuing events would only highlight that the CDS markets operated in closed-circuits.

In 2007, the “CIO tranche book” was ramped up in the first 6 months of the year quite aggressively and therefore quite visibly for any market player to see. Anyone was made well aware that “JpMorgan has a massive hedge now!” Some competitors complained already: was Jpmorgan squeezing them with regulators blessing or what? As early as August 2007, the order was conveyed to start unwinding some of the hedging strategies, especially on subprime synthetic indices and tranches....Once again, every market player would be made well aware of that! One can guess why the order is given so fast: Dimon and regulators wanted to finalize this “post-implementation” review of the NBIA of 2006 but in the shadow only: the conclusion was to be “the project was closed actually”. But, there was clearly not enough liquidity.

CIO had the right trading exposures that others were looking for. But the competitors were not so keen to realize their pending losses. They were not keen at all to trade close to the quoted bid-offers....Thus JpMorgan could record gains from the hedge but only as long as Jp Morgan did NOT try to realize those gains.... And in the future, other market players would not provide liquidity so cheaply. What a beautiful new “skew risk” was just born through this New Business Initiative as Approved! The answer to the original question was loud and clear: “even if there is NO material counterparty risk, not even a clear systemic risk yet, the markets shall NOT provide the liquidity knowingly so as this would mean for competitors to lock massive losses at the immediate benefit of JpMorgan notoriously so. No way...” Towards the end of 2007, Jamie Dimon could not “claim victory” as Macris would put it then....The result really was “so-so”....

The infrastructure was in place though. The special valuation protocol applied at CIO-London for this “particular strategy” held in the “tranche book” had been adapted to the circumstances and stakes at play here. Since late 2006, the risk management department of the firm had instructed CIO New-York, to instruct CIO-London front office staff to diverge from IB prices, diverge from other quoted “mid prices” so that the estimate P&L daily would reflect a “sensible” measure of the performance. This change would allow the firm-wide risk management to process an optimal analysis of the “VaR consumption” for its own routine analysis. Dimon could thus pilot the “tanker SCP”. The stakes were huge in terms of liquidity reserves (about \$100 billion or 4 to 5 years of earnings) and in terms of capital provisions (concerns the \$50 billion of intangible capital at least- about 40% of the market cap-just that). The link was crystal clear: through the VaR analysis that the firm-wide risk management executives ran and fully controlled, they could assess the overall “correlation” risk as rigorously as possible. Aside from the quite limited liquidity that this “hedge against il-liquidity” could profit from, the end result was so-so anyway.

***On the one hand***, the “tranche book” of CIO allowed the bank to take about 25% more risks in the markets through the VaR limitations. Indeed, without this ‘tranche book’ the firm-wide VaR and the IB VaR in particular would be 25% higher than they were. Since the bank was limited in VaR, removing this ‘tranche book’ would have forced the Bank and the IB in particular to reduce its own trades and investments by 25%. This reduction would have mechanically led to 25% lower profits at least. More this reduction would have induced immediate unwind costs that would have been maybe lethal as the existing liquidity reserves may NOT cover those unwind costs. Now, through to the build-up of this “tranche book” in 2007, the bank and the IB in particular had observed that they benefited from a regular additional leeway to take more risk in trading based on their daily VaR consumption. The risk management executives were conveying the message to the IB day after day, asking CIO-London staff at the same time to fine-tune its own estimate P&L report in that context. That was No coincidence at all as explained before but a well thought-of plan to maximize profits on an ongoing basis for the bank.

***On the other hand***, due to this structural inefficiency of the CDS markets that was no news in itself, this gigantic visible “tranche book” of CIO would always remain a ridiculous dwarf when it was about hedging the overall “systemic/correlation risks” of JpMorgan-Chase-BankOne. The CDS markets had stopped brutally their expansion by the end of 2007 and were NOT expected to grow again soon...And

the CDS market players were definitely reluctant to provide liquidity to CIO unless for a high execution fee. From that standpoint, it is quite clear why the “post-implementation” review of the NBIA of 2006 would NEVER be even started. Regulators and bank top executives alike knew it quite well then, in late 2007. Most of the remaining strategies could NOT be unwound at decent profits on demand within a short timeframe. Unwinding them would induce costs that amounted already to several hundreds of \$millions as the risk management chiefs measured it day after day. It was quite easy to compute it just by looking at the implementation costs that were reported day after day within risk management staff. It would be quite easy to check upon CIO and JpMorgan reports to regulators that this matter of “post-implementation review of the NBIA” had been an ongoing discussion between 2006 and 2008. It was not abandoned by negligence but by knowledge of the structural lack of the liquidity of the CIO “tranche book”....The issue was worsened by the deliberate visibility that Dimon had wanted to have in the markets in the first half of 2007. On the “visibility” matter, one must wonder who between Dimon and his watchdogs wanted the most to flag so ostensibly in the markets that “JPMorgan had a big hedge on”.... It is not obvious that Dimon considered it a smart move to flag like this a potential massive weakness towards his competitors...Macris the CIO London chief at an early stage called this book the “problem child” at CIO....Was he really alone in that view inside JpMorgan?

Regulators involved and bank top executives however knew that this portfolio was theoretically quite useful, quite profitable through the VaR based diversification benefit, but that it would NEVER be the “salvation tool” that its designers maybe had hoped to build originally. The structural lack of liquidity impaired both the hedging original function and the astute VaR-related “profit generation”. The financial crisis surged in 2008 and here, with or without this “particular hedging strategy”, the only lifeline left for JpMorgan was this 40% accounting line of intangible capital that had popped up in January 2004. That seemed quite a virtual wall for the much vaunted “fortress balance sheet” in late 2007. Jamie Dimon would be called by the regulators many times in 2008, confidentially so....

One may wonder who else could ever have embodied these \$42 billion of intangible capital in 2008 when the world was crumbling. Dimon, the providential man again<sup>7</sup>, would purchase at incredibly low prices some assets that would ultimately never default. Right in the middle of the calamitous crisis for everybody else, the bargains just snowballed to land in the hands of Dimon alone and Jp Morgan as if by magic all along 2008. This was all triggered by “calls made by regulators to Dimon”. He had not volunteered for that turn of event right? The bank Bear Stearns was sold “for a dime” really. Lehman Brothers was “taken down” (or “dismantled”). AIG would be cut in pieces like sushis. Washington Mutual would be set on “fire-sale” but only for Dimon’s eyes once again....And all this was done at the benefit of Jp Morgan alone, since the other banks would not have such a favored treatment.

Were the regulators then really planning to sell the whole US banking industry just to Jp Morgan in the end? Was it really because they deemed Jp Morgan to be the only “reliable” bank then?... Well, in that case the US regulators prepared their country to be run like the former Soviet-Union. That is just not a credible assumption..... Or was it instead that regulators feared that JpMorgan was the big bank that would be the first to fail “next” and was actually “too big” to be set under receivership? One clue would help address the question in a clear-cut manner: “which other big US bank had 40% of intangible capital?” Which among the US banks had secured ahead of time that indeed it could NOT hedge the coming systemic crisis?....

As shown in the memo describing the profits that Jp Morgan made through the “London whale” scandal, at the end of 2008, the SFAS 107 reporting rule shows that the bank vastly overestimated its balance sheet then. The situation at Jp Morgan was NOT so rosy despite the many “deals of the century” that Dimon had personally obtained from the regulators all along this catastrophic year uniquely so....The SFAS 107 accounting rule actually displayed a sordid reality: it was still not enough at the end of 2008. JpMorgan had to make even more profits in the near future and in quite a tangible way this time. But how would the bank do that? So far regulators had acted in 2008 in a way that merely allowed JpMorgan to gain time, filling the balance sheet with golden deals to simply let the bank stay afloat while the crisis was unfolding....That had not been enough though as SFAS107

reports showed. Dimon showed it in the 10-K reports. He was not fired but praised on the public stage....The new “king of Wall Street” was born apparently. Who was it exactly?

During the first quarter of 2009, a new coincidence arose. The VaR of the “synthetic credit “portfolio, focusing on protecting the whole firm from a global “correlation risk”, literally exploded on the way up from \$50 million to \$160 million (the apex was reached at the end of March 2009). What was the VaR (so called “95%”) for the firm JpMorgan as a whole right then? The bank pictures it between the page 71 and the page 76 in its 10-Q report for the first quarter of 2009. On page 71, the bank describes quite clearly the stakes behind its VaR as they concern just ALL its businesses taken altogether, be that “trading” ones and “non trading” ones:” ***Value-at-risk (“VaR”)--JPMorgan Chase’s primary statistical risk measure***, VaR, estimates the potential loss from ***adverse market moves in an ordinary market environment*** and provides a ***consistent cross-business measure*** of risk profiles and levels of diversification. VaR is used for comparing risks ***across businesses***, monitoring limits, and as an input to economic capital calculations. Each business day the ***Firm undertakes a comprehensive VaR calculation that includes both its trading and its non-trading risks*** ». The bank also explains on the follow that the “Credit Portfolio VaR”, that will incorporate the VaR of the “tranche book” of CIO among other things, is “***Credit portfolio VaR includes VaR on derivative credit valuation adjustments, hedges of the credit valuation adjustment and mark-to-market hedges of the retained loan portfolio, which are all reported in principal transactions revenue.*** »

The “Retained Loan Portfolio” itself is NOT in “Mark To Market” though which could explain in part why historically the “correlation systemic protection” at CIO based on synthetic tranches had such a huge VaR day to day. And this fact would show intuitively why the firm could record almost no net loss for itself in 2012 despite the \$6.3 billion loss on this “hedging book”. Next the bank provides details on its methodology that will not change in the future, despite the “CIO model change of late 2011”: “***To calculate VaR, the Firm uses historical simulation, based on a one-day time horizon and an expected tail-loss methodology, which measures risk across instruments and portfolios in a consistent and comparable way. The simulation is based on data for the previous 12 months. This approach assumes that historical changes in market values are representative of future changes; this is an assumption that may not always be accurate, particularly given the volatility in the current market environment....In addition, certain risk parameters, such as correlation risk among certain IB trading instruments, are not fully captured in VaR.*** »

Correlation risks at the IB were NOT fully captured in VaR. Here the firm points at least to the “basis risk” that bears upon \$3 trillion of notional amounts at JpMorgan alone (search the 10-Q or 10-K reports for “identical underlying”). Otherwise the firm would have specified that. Thus this firm has a “consistent and comparable way” to measure the VaR comprehensively “across instruments and portfolios”. BUT, and this is critical in the “London whale” case, the IB “correlation risk” is NOT fully “captured in VaR”. Could it be otherwise given that the “Loan retained portfolio” was NOT in “mark to market” and therefore not included in the VaR calculation? Well at least there is some consistency between the 2 facts here.... It remains that this “tranche book” of CIO was itself fully integrated in the firm-wide “consistent and comparable” measure AND this book was here to hedge against a “systemic correlation risk” based upon “synthetic exotic credit derivatives” expressing typically a “correlation risk”.... So there is an inconsistency here that the firm was fully aware of as this sentence above indicates. This one inconsistency is all focused on the “basis risk”, the “skew risk” in particular. The banks words it as a “correlation risk” sitting at the IB. Fair enough...

Regulators could not have missed it then while this “skew risk” was precisely killing the world economy. And the benchmark price for that skew risk in 2009 would be the “IG9” skew quote already. It will remain the benchmark in 2010, 2011 and of course 2012. Why was there such a \$3trillion notional amount potential “inconsistency”? Well the IB did NOT mark the “skew” in mark to market while CIO would not even bother but would structurally hedge the bank against this “skew risk” in particular. The inconsistency was visible and it would be justified by the fact that the “IG9 skew” prices had always been just “indications”. There was no market really on the skew itself despite the huge flows that started transiting from the investments banks of the world into secretly “managed”

books in Hedge funds like Blue Mountain. They were many at the firm in risk department and in management ranks of course to not only know about these “de-consolidating” transfers but also to be in permanent touch with regulators getting “approval” for numerous transfers of this kind.

Just in case people might doubt that the firm was monitoring this issue well enough the 10-Q report adds: *“In the third quarter of 2008, the Firm revised its VaR measurement to include additional risk positions previously excluded from VaR, thus creating, in the Firm’s view, a more comprehensive view of its market risks. In addition, the Firm moved to calculating VaR using a 95% confidence level to provide a more stable measure of the VaR for day-today risk management.* » The mention above looks innocuous: 99% or 95% is a rather abstract change for the profane. It is not a benign switch. Clearly the approach of Jp Morgan is to be as “comprehensive” as possible even though some massive derivatives risks like the IG9 skew one were NOT included in the VaR measure as such. To be specific here: the VaR computation certainly bore in part on price changes that were directly related to the skew since the IB was a big player both on the IG9 and on its components. But when running the VaR computation using historical data based on both the IG9 and its components, the firm would NOT add an extra VaR contributor that specifically simulated the skew changes observed from the year before. As a result the VaR was understated in relation to crisis times in particular. Of course the \$3 trillion of “identical underlying” “basis risk” was not represented by the sole IG9 “skew risk”, but the latter was the market benchmark for what was otherwise the most il-liquid and unreliable market on the planet.

The move from a “99%” confidence level to a “95%” confidence level mentioned above contributed to get actually a lower headline VaR figure. But who would be fooled by that change? We were then in 2009, not in 1994. Just nobody would be fooled: it was obvious that this move to “95%” printed a lower headline VaR figure and induced a corresponding higher set of liquidity reserves to cover the “tail events”. This move actually helped define with better accuracy what is technically called the “expected shortfall” in capital provisions and liquidity reserves based on the VaR analysis. Indeed, the approach with VaR was to say: *“okay, let’s see how much the bank can lose at worse in 5% of the time. This is the VaR number, ie an average of the latest 5% ‘worse days’ bucket over the last 12 months where the losses are simulated based on old market prices in a comprehensive, consistent and comparable approach. But wait a minute. This was NOT a crisis time right? Then, among those 5% of worst cases, there is no doubt actually that this average massively understates what the bank would lose in a crisis time. We were all close to sudden death in 1998 after LTCM. We know in particular that the “basis risk” is a killer one. We also know that since it is a pure liquidity danger, not a single market maker can properly account for it in its VaR measure anyway. Thus we must set liquidity reserves and capital provisions to cover for the notorious expected shortfall of money that will arise on top of the VaR figure whenever a worst case day happens to be a genuine crisis in the markets.”*

Since 1998, it was notorious that the reserves and capital provisions were absolutely critical to cover for the “expected shortfall”. The “basis risk” in general was considered a crisis item and was therefore one constituent of the “expected shortfall”. As mathematical analysis proved, the VaR measure was non-additive, but the “expected shortfall” measure was additive. In simple terms, if one combined many exposures, one would certainly benefit from “diversification” of risks as far as the VaR figure was concerned. It may even induce an outright decrease of the aggregate total VaR. But every additional exposure would come to grow the “expected shortfall” independently so. Since 1998 the “expected shortfall” measure was a commonly accepted benchmark for setting liquidity reserves and capital provisions as being the mathematical complement to the VaR figure and its actual consumption. This was true throughout the whole banking industry. The figures related to the “expected shortfall” were high multiples of the VaR figure both in liquidity reserve and capital provision terms.

Why have both actually “liquidity reserves” and “capital provisions”? Liquidity reserves assumed usually that no counterparty bankruptcy risk would arise. They conceptually covered the price

uncertainty, the concentration risks to be unwound in haste, and the potential extreme price changes. The capital provisions mostly covered the chain reaction that would be caused by the demise of one certain counterparty that would make the bank look like actually it was maybe the next one to become a failing counterparty. This capital provision would hopefully act as a deterrent against the fears of the trading partners of the bank should such a rumor arise. They both had to be estimated at best and in the most rational, ie mathematical, fashion.

Of course, if one is based on a “99%” of VaR, one would be left with only 1% of worst day cases over a 12 month horizon, ie actually 220 working sessions, to infer liquidity reserves or capital provisions. This means that only the 2 worst days would be entering the VaR headline figure underlying statistics. This is not going to provide a reliable measure day to day for the expected shortfall. An average based on 2 figures is a pretty poor statistical forecast. Switching to a “95%” measure one has then 10 to 11 days which sounds more reasonable to make a forecast. Better, one can also measure the “dispersion” of losses among those 11 extreme days. This dispersion was quite a useful proxy to estimate the “high multiples” that the sole VaR figure involved to dimension the liquidity reserves AND the needed capital provisions.

Thus, behind this seeming benign change, one can read that in fact the stakes were about critical liquidity reserve figures and capital provision figures. This change from “99%” to “95%” happened at the end of 2008 and regulators were closely watching the result. On the following the firm details what has changed along this strategic switch from a “99%” VaR measure to a “95%” VaR measure. In short, as the table below will show (page 73 on the 10-Q report), the firm included “Corporate Risk Management VaR”. 85-90% of this VaR number was the “tranche book” of CIO that will cause the “London Whale” scandal in 2012 (CIO was lodged in “Corporate” itself presided by Dimon and no one else)...In the circle, one can see what the bank added to its former reporting in Q1 2009: Stress scenarios were being scrutinized by the bank and the regulators, AND by a coincidence “Corporate Risk Management VaR” popped up in the VaR reports right next to the IB....

#### 95% Confidence Level VaR

The table below shows the results of the Firm’s VaR measure using a 95% confidence level.

#### Total IB trading VaR by risk type, credit portfolio VaR and other VaR

(in millions)	Three months ended March 31, <sup>(a)</sup>			At March 31, 2009
	Avg.	Min	Max	
<b>IB VaR by risk type:</b>				
Fixed income	\$ 158	\$ 143	\$ 179	\$ 153
Foreign exchange	23	12	39	14
Equities	97	40	156	94
Commodities and other	20	14	30	17
Diversification benefit to IB trading VaR	(108) <sup>(b)</sup>	NM <sup>(c)</sup>	NM <sup>(c)</sup>	(95) <sup>(b)</sup>
<b>IB Trading VaR</b>	<b>\$ 190</b>	<b>\$ 162</b>	<b>\$ 236</b>	<b>\$ 183</b>
Credit portfolio VaR	86	74	106	106
Diversification benefit to IB trading and credit portfolio VaR	(63) <sup>(b)</sup>	NM <sup>(c)</sup>	NM <sup>(c)</sup>	(80) <sup>(b)</sup>
<b>Total IB trading and credit portfolio VaR</b>	<b>\$ 213</b>	<b>\$ 180</b>	<b>\$ 256</b>	<b>\$ 209</b>
Consumer Lending VaR	108	83	151	96
Corporate Risk Management VaR	121	111	126	125
Diversification benefit to total other VaR	(61) <sup>(b)</sup>	NM <sup>(c)</sup>	NM <sup>(c)</sup>	(59) <sup>(b)</sup>
<b>Total other VaR</b>	<b>\$ 168</b>	<b>\$ 147</b>	<b>\$ 202</b>	<b>\$ 162</b>
Diversification benefit to total IB and other VaR	(93) <sup>(b)</sup>	NM <sup>(c)</sup>	NM <sup>(c)</sup>	(94) <sup>(b)</sup>
<b>Total IB and other VaR</b>	<b>\$ 288</b>	<b>\$ 249</b>	<b>\$ 328</b>	<b>\$ 277</b>

(a) Results for the three months ended March 31, 2008 are not available.

As one can see, the input of CIO through its “tranche book” was about as BIG as the whole IB was in order of magnitude. Ironically, it was not that big a risk reduction item in the “expected shortfall” part. In other terms, with this “tranche book” of CIO, the bank mostly succeeded in reducing its VaR and much in reducing the reserve and provisions requirement that were flagged by the “expected shortfall”. To give figures, the “tranche book” of CIO was rumored to induce a 25% booster for recurring profits,

having a VaR being about 40% of the total, but was providing at best \$5 billion of gains in stress times which is much less than 10% of the overall risk faced by the bank. The operation in Q1 2009 had turned already out to be mostly a “profit maximization” machinery. Then the “tranche book” itself had a standalone VaR of \$160 million at the end of March 2009. But this as such does NOT show up on the report above.

The table above shows that the “diversification” effects are of comparable magnitude when compared to the firm-wide headline of \$250-300 million. One should note that the average VaR of the “tranche book” at CIO alone for the first quarter 2009 was about \$105 million (average of \$50 million and \$160 million) ie 85% of the total VaR of “Corporate Risk Management”, and 30% of the firm-wide VaR. It is really hard to miss for any watchdog. This “particular strategy” (OCC in 2007 admittedly) was the elephant in the Corporate room chaired by Dimon. Not a single regulator blamed publicly the bank for having “concealed” this portfolio at the time. The explanation for the change becomes quite simple: the OCC knew of this “particular strategy” very well since 2007 and was NOT at all alone in that situation. This could not be missed if only the VaR, the corresponding strategic liquidity reserves and capital provisions were concerned. The total “diversification” benefit in VaR was of \$154 million (61+93). Consider now that with say a \$250 million daily VaR the bank could produce about \$50 billion in gross revenue, ie a gain that is 200 times the VaR. More, with a \$150 million diversification benefit, the bank could overall leverage its traded volumes by at least 25% and therefore its overall activity to achieve an ultimate financial leverage effect of 200 times. That induced an extra \$10 billion additional recurring profits per annum. Yes the “tranche book” of CIO was quite profitable for the bank since 2007.... \$10 billion extra trading profits a year for 5 years “50/50”?..... Furthermore, this diversification acted to lower by as much the liquidity reserves and capital provisions as based on the VaR analysis if it came from the “tranche protective book” of CIO. And those figures were high multiples of the VaR headline figure itself. This means that the “diversification benefit” here obviously allowed the bank to make a lot more \$billions of profit each year but ALSO to be spared many \$billions of reserves and capital provisions.

Is it surprising to say that most of this “diversification benefit” came from “Corporate Management Risk”, namely the “tranche book” of CIO? Is it surprising to say then that all the regulators not only were “aware”, were “closely monitoring it” and were “supportive of the initiative” still then? And the “post implementation review” of the NBIA (2006) still would not be started. Well, as much as an investor may NOT pay too much attention to that leverage effect, not a single regulator could afford to ignore that as explained before. The bank actually provides some details in a footnote attached to this table: “(b) Average and period-end VaRs were less than the sum of the VaRs of its market risk components, which is **due to risk offsets resulting from portfolio diversification**. The diversification effect reflects **the fact that the risks were not perfectly correlated**. The risk of a portfolio of positions is therefore usually less than the sum of the risks of the positions themselves.” The bank has quite an ambiguous way to picture its own “hedging initiative” of 2006 as it was expressed in the NBIA of 2006. But regulators would let go...

As one knows in 2012 or in 2017 likewise, the “post-implementation review” of this already “approved” NBIA is NOT even going to be started ever. This is in breach of the Sarbanes-Oxley laws (2002-2003) as such that the NBIA was supposed to comply with. This also cannot be missed by any US regulators, in particular the OCC and the Federal Reserve whatever they would allege later in 2012 or 2013. And to date in 2017 they have completely silenced their role in 2009. They were watching this out though.

### **End of 2009, Jp Morgan amends its reporting on VaR and displays the label “CIO”...**

At the bottom of the page 74 in the 10-Q report of the first quarter of 2009, ie 3 years before the events of the “London whale” scandal, the firm describes the protocol that it follows to measure the VaR consumption: The firm runs a daily “Backtesting” of its VaR “**VaR backtesting (95% Confidence Level VaR) --To evaluate the soundness of its VaR model, the Firm conducts daily backtesting of VaR against the Firm’s daily market risk-related revenue, which is defined as follows: change in**

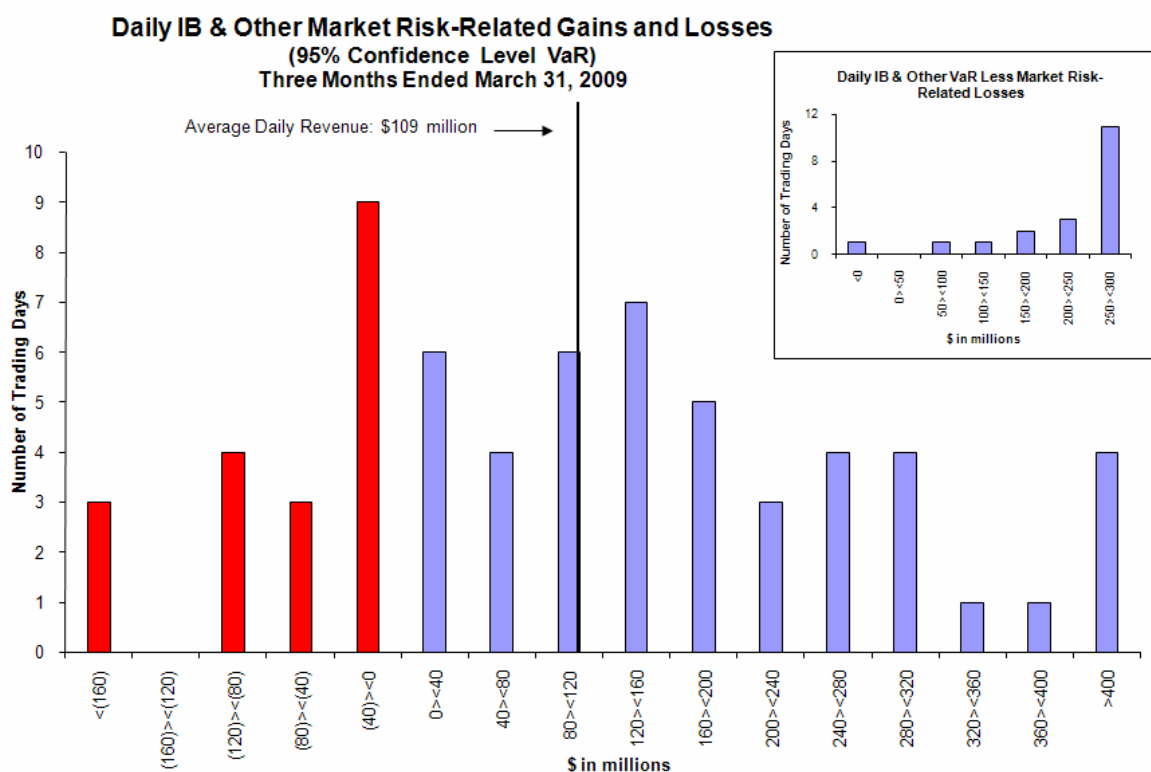


value of principal transactions revenue for IB and Corporate Risk Management (less gains/losses for Private Equity and trading-related revenue from longer-term corporate investments); trading-related net interest income for IB, RFS and **Corporate Risk Management** (excludes longer-term corporate investments); IB brokerage commissions, underwriting fees or other revenue, and revenue from syndicated lending facilities that the Firm intends to distribute; and mortgage fees and related income for the Firm's mortgage pipeline and warehouse loans, MSRs and all related hedges. **The daily firm-wide market risk-related revenue** excludes gains and losses from DVA."

The firm speaks itself of "daily firm-wide market risk related revenue". This is all about the "**revenue**" that is related to straight daily "market risk" and "price". Thus the VaR is analyzed "daily" based on the "revenue", ie the market prices themselves collected on an historical basis. Is it so surprising? No! This part here is crucial to show how misleading the statements of the bank will be about the VaR events of 2012 (to come later in this document). It is enough to keep in mind here that the bank maintained a "comprehensive and consistent" set of market prices through its "daily" activity to measure its "market risk-related **revenue**" comprehensively across the business units involved. More, these prices were used for "back-testing" purposes on the quite critical "VaR consumption" analysis. This of course included both the IB and CIO.

This is how the firm could indeed process its VaR analysis and indeed "evaluate the soundness of its VaR model", ie the one covering all the businesses across the firm. As pointed out, the firm and regulators alike were 100% aware that the IB VaR was "not perfectly correlated" to "Corporate risk Management", but still quite well "anti-correlated" actually. This is how the firm could claim a genuine hedging capability on behalf of the "CIO tranche book" that justified a reduced "expected shortfall". This had massive beneficial consequences with regards to the "liquidity reserves" and the "capital provisions". One really wonders how it could have been otherwise under the stringent management of Dimon who is so well known to care about every figure entering the accounts however small.

A chart follows this explanation as proof that the firm does indeed monitor closely all this:



This chart helps “see” how the VaR and its subsequent analysis were so useful in analyzing the risks way beyond the sole average headline figure. This chart was indeed instrumental in documenting the mandatory liquidity reserves and capital provisions through analyzing. The histogram above was used to analyze the “Var consumption” and the “expected shortfall” altogether. The chart helps indeed define the days of losses, the days of gains, and their associated statistics. One sees that the “95%” threshold is just that, a threshold that does not prevent the bank or regulators from running a much deeper analysis of the market risks. One can see also that the central focus is on the Number One risk, ie the “market-risk related **revenue**”, anyway. Quite spontaneously in the 10-Q report, the conclusion of this “Var Note” hints at the ultimate objectives: the **unwind costs** induced by a sudden fall in its own creditworthiness in markets’ players eyes, the corollary analysis that scrutinizes **the stress scenarios** and that is commanded by senior management in direct relation with the Federal Reserve, the impact on the firm’s **overall profitability** looking forward which is of course under the watch of Treasury (Mike Cavanagh CEO here) on a routine basis. The firm sums up here the centuries old dilemma of regulators and its survival line altogether....

Regulators were watching all this quite closely, in particular the Federal Reserve. They must have asked one day: “where is this diversification of \$154 million coming from really? Is this here just a by-product of the magic zero linear correlation because JpMorgan trades so many instruments? Put in other words, do you guys have this \$154 million benefit because the bank is a black box that no-one can analyze in fact? Or do you have this \$154 million diversification benefit because you use a linear statistical dependence factor between random variables that most of the time are NOT moving linearly one versus the other? In other words is this \$154 million benefit just a byproduct of an unsound statistical modeling? Or else?...” All those questions are quite sensible given the events of 1998 in particular. They have lethal issues at stake since the financial crisis in 2008 as they portray the “contagion” risk that then invades every financial executive mind.

The bank did have good answers to provide “thanks” to the very existence of the “tranche book” of CIO actually. However good the answers were, provided by Dimon and his lieutenants as “senior management” duty it was, those \$154 million of “benefit” for an ultimate \$288 million VaR headline figure were quite a piece of a “credo” to gobble for regulators. That amounted to a good third (30-35%) of reduction. This boosted by as much the overall profitability of the bank AND spared potentially tens of \$billion in reserves and provisions. Thus the regulators would not stop at those “good answers” that they knew already given the NBIA of 2006 process that had NOT been reviewed officially for “post-implementation”. Would this book be easily “wound down”? No, of course.....

What would the regulators do then in such context? Well one must assume here that they at least checked upon the basic statements of the bank itself about how indeed it checked the “soundness of its Var model” with a back testing procedure that watched “market risk-related **revenue**” across the instruments, the portfolios, the business units in a “comprehensive and comparable” manner. It is a tedious works that is time consuming even though the big blocks are quite visible between the IB, CIO and RFS maybe. And one really struggles to imagine that this “revenue” shared intense scrutiny based upon “historical” market data was done other than based upon a central price database that was applied consistently so throughout all the portfolios taken altogether. This is just 1-0-1 or risk management and 1-0-1 of the regulators’ expectations here. Otherwise, this analysis is just void of any reliability.

But this simple inference has massive consequences with regards to what the firm will state in July 2012 about those lasting “price difference” that would allegedly have persisted between CIO and the IB just more than one single day. This allegation indeed runs straight against what the firm described for years about its own VaR analysis to all regulators. This also runs straight against the allegations that the authorities themselves made about senior management that seemed to be left “unaware” of those lasting price difference beyond one single day. Indeed the VaR section in this 10-Q report dating back from the first quarter of 2009 proves that the firm had a central price database if only to analyze its firm-wide “**market risk-related REVENUE**”. Such was the admitted goal of the firm. Such was the admitted requirement of all the regulators. This simply means that mechanically the initial price

differences existing between CIO and the IB were reconciled and adjusted on the following day at the latest, even if other controls would have failed. And one wonders how these former controls could have failed since they were the very contributors to the centralized price database that would be in use for the very stringent VaR subsequent analysis....The Var “daily” back-testing process proves it.....Unless the bank lied all these years in its 10-Q reports and unless just not a single regulator ever checked this very basic requirement of theirs all along for 20 years or so.... Yet no one ever heard that kind of “failure” in the control process had occurred in fact..... There was really good reason for that as the preceding historical descriptions explained.

Such a failure behind the lasting “price difference” as invoked in July 2012 onwards therefore had actually not a single chance to have occurred at JpMorgan between CIO and the IB. More this “initial” difference was wanted as explained for the very start of the valuation process in order to make as comprehensive a reconciliation as possible right after that very initial stage. In late 2006 indeed, it was the risk management team of the firm in New York who had mandated the CIO risk management staff in London (see Fiona Longmuir and Bob Rupp for details here) to instruct the “traders” to pick prices independently from either consensus ones or IB ones. The differences in prices were structurally known, ordered and WANTED back then already.

To be sure, as can be seen in light of the VaR document displayed above, it was WANTED not only by the bank top executives but ALSO by all the watchdogs. It was meant to build another layer of safety in straight knowledge that CDS prices were fundamentally uncertain. It was directly connected to addressing the “basis risk”. The rationale was plain sensible and logic since the whole New “Business Initiative” had been meant from the very start to address pre-emptively uncertainty on prices and global “correlation risks” in credit derivatives. Rather than blindly adopt “consensus mids” that were notoriously treacherous indications in stress times, the bank wanted to have concurrent views on prices, albeit highly subjective but on the protection side only, in order to complement the “soundness” of its “VaR backtesting” protocol for the “market risk-related R-E-V-E-N-U-E”. Who would ever argue against such approach?! And in regards to Ponzi scheme risks, which regulator would not have checked that the bank was 100% bullet proof on its internal reconciliation process?

There thus NEVER was any danger that those “CIO price differences versus the IB” would be left unknown. Why would there be any danger since the SEC and the OCC had required the senior management to finalize the mark to market using a unit being independent from the unit taking the risks in the markets? One can see here that at least CIO was providing an “independent” view from the IB as far as the IB mark to market was concerned. AND the IB itself provided an “independent” view from the CIO as far as the CIO “tranche book” mark to market was concerned. Both IB traders and CIO “screen traders” were left in the blind as to what the firm would ultimately pick as a R-E-V-E-N-U-E, ie as a final estimate price per instrument to be applied to all the portfolios involved in the firm. That was actually quite a smart way to approach the issues surrounding price uncertainty and systemic correlation risks. One thing is certain: regulators watched all this very closely. The “basis risk” was here in the fortress balance sheet to the tune of \$3 trillion. It was NOT “priced” as such as there was NO market for it as such. The CIO and the IB altogether by means of this “particular strategy” had designed a price selection process that could proxy at best this basis risk. The regulators could only support the initiative but in the shadow, avoiding asking any official question about the “NBIA -2006 post implementation review”... The regulators still were watching this closely out since they were at least fearful that such a “double price entry” system may create a ponzi Scheme in the fashion of what Bernard Madoff had run for so long. And actually the regulators were watching and making further recommendations here in the backyard.

Indeed, the bank altered its reporting on VaR about what it meant by “Corporate Risk Management”. The change occurred between the 3<sup>rd</sup> and the 4<sup>th</sup> quarter of 2009: in the future the bank would label the “diversification” source as “Chief Investment Office (‘CIO’)” VaR. From then on, the label ‘CIO’ will appear next to the “IB” one in the VaR analysis outputs. However, the “tranche book” itself remains in the shadows. Why would just no regulator ask for this particular well known strategy to at least show up as such in the reports? How could they miss the “elephant in the CIO-JpMorgan room” while they

clearly were aware of the stakes here? The only logical answer is: “it was a secret that had to remain a secret”. But then one wonders why this “secret” could not have a “name” at least like “macro-hedging”. Every market player had seen the “big book” entering the markets back in February 2007 and onwards. One clue is: the post-implementation review had just NOT even be started up while the NBIA itself had been approved and implemented by mid 2007...The “mistake” had been done already: the SOX laws might well have been violated upon what was a “F..c..ing” big book for all to see....the “mistake” was shared between JpMorgan’s top officers and the watchdogs’ top officers.

**2010: the book must be killed to paraphrase Macris in January 2010. Target missed: “no liquidity”... “Let’s land the plane” then.....to spare massive projected unwind costs due to the unique visibility of CIO**

Achilles Macris felt a very great concern for the future of this “tranche” book and the CIO altogether as early as January 2010. The 10-Q reports of late 2009 would NOT bring much more information on the public stage. But in the backyard the instructions to CIO London staff was crystal clear: this book must be literally “killed”. It just recorded a \$100 million gain from an unexpected bankruptcy of one big corporate in High Yield markets. “Good” said Macris, urging Artajo first and Iksil next to “spend” those \$100 million and unwind as much as possible in the markets as fast as possible. Macris would say “Spend it so that this book disappears from the radar screens of the regulators as quickly as possible...” Yes this “tranche book” of CIO was clearly a “flashing red light” on the radar screens of the regulators, despite their subsequent denials in 2012 and 2013...And the regulators wanted it to disappear from their radar screen... It had to be killed. Otherwise someone had to be killed....

What about the “expected shortfall” and VaR observed huge “benefits” then? This book, while quite visible yet, was strongly expected to be smashed already as it turns out. Thus, throughout the first 2 quarters of 2010, the “tranche book” would be materially reduced. The \$100 million and a bit more would be “spent”. The VAR would now go down to \$40-50 million over the coming 6 months. Overall it will have cost about \$130 million to quite cautiously reduce the book exposures by only 20%. This is the best that could be done and even that was not possible any longer for the remnants of the “tranche book”, ie the 80% left.... Iksil had warned back in June 2010 that unwinding further in the markets would cost CIO at least 3 times more for each additional 1%.... If only that happened to be just possible in fact...Thus the projective cost to unwind this book then was way beyond \$1 billion. Is Iksil “the trader on this book” fired here or simply replaced because he no longer looks competent? No, far from it if one knows about this “chocolate medal” MD promotion that will come few months later. The only decision made then is quickly taken at the very top of the firm through Ina Drew. Macris will coin the decision as “Let’s land this plane avoiding as much as possible broken glasses”...

The book as it stood in June 2010, when compared to what it was at the end of 2011 ie BEFORE Drew would repeatedly order to grow further the notional exposures, was twice smaller. And the liquidity conditions in the markets would only worsen reportedly since June 2010. That sole observation shows how absurd the orders of Drew from then on must have looked like in the eyes of Drew herself, Macris, Artajo.... and Dimon among many other chief risk officers at the bank....Drew reported straight to Dimon all that time. Thus, from the reports of 2010 also elevated by Iksil then, Drew, Macris and other senior managers knew with no surprise in late 2011 that unwinding the “tranche book” was at least to cost \$3-4 billion. They could infer this by a simple back of the envelop calculation: a book that originally would cost \$1 billion in June 2010 had almost doubled up in notional size by the end of 2011 amid markets that had lost most of their remaining liquidity in the course of 2011. There was no coming back on the “il-liquidity” matter. The coming demise of CDS markets and liquidity were a known certainty. It was clearly induced by the new regulatory reforms and the lessons learnt from the 2008 financial crisis.

This fact matters in understanding what was already at stake after June 2010 in the minds of the bank senior managers group to which Drew and Macris both belonged. It was as clear in regulators’ “optics”. It was the consequence of the “mistake”. The bank managers then would order to grow this “tranche book” after June 2010 in many alternative forms in full knowledge of the dying liquidity.

Paradoxically they would also order to unwind as much as possible but quietly and at the minimum cost. Therefore; contrary to what Thomas Curry and the Senator Merkley would suggest so publicly in 2012, Iksil did NOT come to the bank every day since early 2010 to “make money for the bank”. That was no doubt the CIO’s executive job in straight connection to Dimon and the regulators that they regularly met. Instead, Iksil’s day to day job then would be to spare the bank with unwind costs that counted in many \$billions while actually “spending” any gain that would come in order to reduce at best the legacy exposures.

To be sure, this book had to be “killed”, full stop. Orders would go opposite to that after June 2010 and Iksil would raise the alarm bell all along actually spending the gains to unwind anyway. This is what Iksil will do all along aside from the repeated orders coming from Drew which amounted to grow some notional exposures specifically so after June 2011..

Back to the second half of 2010, this “land the plane strategy” was reviewed and approved in details by top risk officers of CIO paradoxically enough. Here Keith Stephan, Evan Kalimtgis and Peter Weiland from New York at the CIO risk control department were designing on behalf of Ina Drew the “trading” directions that Iksil would have to follow both in looking for “cheap unwind” opportunities and in implementing the most recent orders of Drew. Any opportunity would fit the job provided it was a “zero trading cost” or close. The awareness of the poor liquidity was permanent through all the ranks and departments at CIO.

Such was the routine job of Iksil from June 2010 onwards. He would NOT decide over time what to keep and what to remove. This was the job of Kalimtgis, Artajo and Weiland for Drew. The “chocolate Medal MD promotion” would change strictly nothing in that regard as Artajo had announced. Iksil had only the leeway on a day to day basis to pick among the approved reduction axis which one to actually execute depending upon what the market players would offer in price terms. Iksil had to report to Artajo twice a week on his executions, on the ultimate cost for CIO and he would be told to either stop or proceed on a weekly basis once “New York” would have decided. Yet Iksil would NOT be in the regular “management meetings of the Tranche book” where Stephan, Artajo, Kalimtgis, Weiland, Macris and Drew were customarily attending. Iksil received the instructions either from Artajo, or Stephan or Kalimtgis in practical terms as they came.

After June 2010 the times of “spending gains to unwind fast” were over. The aim still was to further reduce the VaR while keeping the protection pattern on stress scenarios. That latter point was NOT disclosed to Iksil anyway in detail. Thus Iksil worked in the blind following risk management directions. Only Stephan or Kalimtgis would give guidance on that issue usually. Therefore, Evan Kalimtgis played quite a role in shaping the trading plan that superseded at times the original role of Artajo looking forward. On behalf of Macris mostly Kalimtgis wanted to be able to provide his “go ahead” before any new “reduction axis” was started. Kalimtgis was the man that Macris had recruited specifically in late 2009. This was Kalimtgis’ first and priority No1 mission for Macris when he had joined CIO: closely watch and supervise the “tranche book” in its planned coming massive reduction. Things had thus morphed into a “land the plane” strategy, still supervised by Kalimtgis on behalf of Macris and Drew. This had become a complex issue. As Stephan and Artajo explained Iksil, the aim was to preserve the diversification benefits that the book brought to the firm. Thus this programmed extinction was supervised day to day, position per position, month after month, stress scenario per stress scenario, impact on the firm per impact on the firm. Even though the notional amounts crept higher little by little after September 2010, Kalimtgis of course ran regularly his analysis from the diversification benefit on the VaR and the stress scenarios. He was a world class expert on the field and did NOT depend on Iksil at all. As the many emails of his to Iksil showed, he completely understood all the intricacies contained in the positions as early as June 2010. Nothing was mysterious, “overly complex” or else...

As if another coincidence popped, while the CIO had just renounced unwinding the positions in the markets for want of liquidity, the watching regulators demanded more frequent meetings with the senior management of CIO and of Jp Morgan. One of their stated key topic was this “tranche book” of

CIO here, also seen as a “correlation” book in the language of regulators, also labeled as a “synthetic correlation credit Core Book” or “tranche book” within the walls of the fortress JpMorgan. Of course nobody among these higher ups would ever consider wise to invite Iksil to any of those upcoming meetings. In September 2010 though, Jamie Dimon in person had evoked in front of an audience of investors, of shareholders, of regulators like the SEC, his projects to place portfolios in “run off”, likely portfolios of the “credit derivatives on correlation” risk bucket which shared a “50/50” diversification benefit between the IB and CIO. The slides of this presentation are available on this website. Did the CEO miss also the “elephant in the room” here or was he actually specifically thinking of this “tranche book” at CIO? The April 5<sup>th</sup> 2012 reply of Dimon to Drew is crystal clear: of course he had this book in mind....But it seems that regulators did miss the elephant in the room too if their later denials of 2012 and 2013 are to be believed. This is really surprising as, back in 2010, their number 1 mission was to prevent another financial crisis like the one 2008 by specifically targeting books like the “correlation” book of CIO, wherever they were. Actually this is exactly what they did in late 2010, targeting this “correlation book at CIO”.

In 2012, regulators would claim “unawareness”. This is not credible. It is all the more unbelievable when one reads the US Senate report account on the personal involvement of Ina Drew and Barry Zubrow on the Volcker rule negotiations with those very same regulators. It is really hard to reject that idea that the debate around “undue prop trading” was already raging about this “tranche book” in September 2010. The reason was plain: regulators had not checked upon this missing “post implementation review of the SOX NBIA of 2006” since 2007 because of their knowledge that this “tranche book” may be more “efficient” as a mere “profit maximization tool”. 3 years had passed AND the financial crisis had passed as well... The cortege of new reforms would simply unveil the “mistake”. The regulators’ centuries old dilemma was firing back in their face here: it would likely turn out that they were the ones who had not done their job authorizing the bank to not apply the SOX rules. One may summarize that regulators had sponsored a huge “hedge fund within the fortress balance sheet” of Jp Morgan as they wanted it since 2004. In late 2010, they would simply try to pretend they had “another concern” with CIO. Still they had to manufacture this “concern” here...

Indeed, from one single project of “deeper investigation”, the Federal Reserve was planning 2 investigations projects being “deeper” and “comprehensive” all centered on CIO. As to the OCC it prepared a quite official letter for December 2010 that would require among other things more basic information on matters like “valuation protocol”, “investment decision process” precisely in the CIO mark-to-market activities... What had they been waiting for since the NBIA 2006 and its blatantly missing “post implementation review” ? .... Not the least, the UK regulator, through another remarkable effect of pure chance, sent also a quite official letter in November 2010 betraying an ongoing concern that demanded a “close and continuous supervision”, specifically on this “correlation” book of CIO. The FCA wanted to know just “anything” that was related to this book. Strikingly enough the UK regulator just NEVER deemed “Iksil” to be “anything” that may have mattered about this book ....then.... Until July 2012 of course, when all of a sudden “Iksil” would be “central”....

In another unbelievable string of events here indeed, the “trader on those synthetic correlation products at CIO for this book that was a specific concern”, namely “Bruno Michel Iksil” in the FCA files since 2005, did not matter at all...Not yet...Which one among those regulators needed to check the actual liquidity of those positions talking to “the trader”? None of them did. Were they “still deemed liquid” as they would all pretend in 2012 in the middle of the scandal between closed doors? No they were not in late 2010, knowingly so. The job was not done despite the many official letters....

**End of 2010, a simple solution could have been drawn up which would have avoided the scandal with certainty...**

In September 2010, Dimon in person had sketched what a “solution” could be through slides that he presented to investors and sent to the SEC among others. The plan was simple: place right away the “correlation” books of Jp Morgan in “run off” and “move” them “off-shore” so that they are de-

consolidated and collapsed. As far as the “tranche book” at CIO was concerned, it ranked among the best candidates for the move. It could have been “almost done” by the end of 2010 by means of a simple preliminary but mandatory transfer of the “tranche book” from CIO to the IB. And yet Dimon will finalize it only in June 2012 while CIO had already surrendered by the 9<sup>th</sup> February 2012. Why was this so simple and seamless transfer delayed so much in early 2012 for this “tranche book” of CIO?

As the slides stated back in September 2010, the analysts projected \$15 billion in capital gains while the IG9 10yr skew was quoted at around 10-12 basis points. But, as the slides showed the capital of the bank may look a bit insufficient looking forward still. At this time, regulators would send soon after those slides of September 2010 their warnings. And the share price of Jp Morgan seemed to hear the echo of these confidential blames. Had there been “leaks” from Washington DC”? The shares of JpMorgan indeed started trading way below the current “book value”. If this was to last, this would be interpreted in the markets as “the business model of Jp Morgan is obsolete”. If this was to last, the regulators would face their century old dilemma and would have to consider putting “JpMorgan in receivership” one day “maybe”..... If this was to last, regulators also would have to explain why the “post implementation review” of the NBIA had NOT been even started and a couple of other things related to VaR, “diversification benefit”, “expected shortfall”, missing liquidity reserves and of course missing “capital provisions”..... To say the least the “profits” were not convincing any longer neither the regulators, nor the shareholders, nor the markets...

Given the context, Dimon would launch then his massive share buyback plan paradoxically enough. What was the goal of the CEO here? Where was he going to extract the extra gains and extra capital that he needed for that? Was he actually saying himself that the bank was too big? To some extent that was very true since 2003 already. Worse, was he admitting himself that the bank would not remain a “going concern” looking forward as PWC auditors would put it? It would be suicidal, wouldn't it? Or was he actually anticipating an improvement that was yet undisclosed but shall materially improve the “flotation line” of the bank? Could it be anything else than this well scrutinized plan to collapse internally the “synthetic credit correlation” positions that poisoned everyone already? For those who wonder: it was not at all to confront the financial markets like one man in a heroic but naïve “iron fist” context. Yet, rather than opt for a transparent communication line which would have so naturally followed up with the slides of September 2010, the bank took the sideways. There was a “give and take” deal here whereby the bank bought its share on the cheap and regulators would avoid their secular dilemma....Some employees would suffer...

One wonders for now why all the regulators would let that happen: the bank going sideways while such a clear roadmap was ahead. Instead of making official this already planned collapse that would get finalized by the end of 2012, whereby the bank would transfer all its “synthetic credit correlation” exposures to a hedge fund like Blue Mountain before collapse and natural extinction, the bank will make strange statements and launch controversial orders for this “tranche book” at CIO....And the watchdogs were watching more than ever all this. None would try to meet with Iksil despite the Volcker rule debate that made them meet with Drew already...Not yet...

Before looking into the entrails of the scandal, let's first visit the quite sensible path that the bank was expected to follow after the presentation of September 2010. It matters to stress that regulators would be watching all the actions of the bank with a magnifying lens whatever they would allege later on in 2012, 2013, 2014, 2015, 2016, 2017 ( and still in 2050 maybe).....Thus, IF Dimon had simply officially started the “offshoring-collapse-run off” as announced, here is what would likely have ensued.... The certain death of the “synthetic correlation book” of CIO would have sparked new but huge liquidity reserves. The least consequence of this “death of the strategic liquidity hedge” indeed was that the bank had to replace the now defunct protection by appropriate reserves. At the very least, by the time this “tranche book” of CIO was effectively “moved” or “off-shored” to a hedge fund, it had to be allocated a reserve for itself. The valuation policies and procedures document in force then, dated November 2007 and available in the exhibits of the US Senate report, was clear on the matter. The reserve for the sole “tranche book” of CIO being now in run-off mode before being “off-shored”

(the words of the FCA here) amounted to \$1 to \$2 billion. It was easy to infer that amount using the “off the run” rule that Mike Cavanagh as firm CFO in March 2010 had put in place. Of course, due to the predictable aging of all the indices present in the “tranche book” of CIO, one could already predict that this reserve would only grow bigger over time by the end of 2011. It was already easy to project that from \$2 billion in Q4 2010 this reserve would rise to \$4 billion one year later.

One can easily find the formulas also in the exhibits of the US Senate report if one knows that the reference document was the CIO-VCG memo and that Jason Hugues would comment in his email that the formulas, done by the IB in fact, were NOT properly determining the liquidity risk of CIO. Indeed the IB wrongly determined the liquidity reserves based on “price volatility” while actually what mattered was the current “bid-offers” and the absence of market depth behind those quotes. Maybe Hugues would Not be fired in 2012 because he had written this email in 2010. Better was to avoid Hugues speaking up on the matter. Thus, by the end of 2010, the cause for the \$6.3 billion losses of 2012, namely the wide “bid-offers” and the absence of depth behind those quotes, was perfectly flagged by price controllers towards books and records controllers and therefore CFO staff. Had Dimon processed along the expected transparency line, this would have been just a “detail” in fact, even though the figure looks scary by its magnitude.... Indeed, if one understands what the “death of this strategic protection against a liquidity crisis” means, ie that the bank cannot rely any longer on it because there is just NO liquidity in the markets for it to work efficiently, one reaches much, much larger requirements in terms of liquidity reserves for the firm itself. The consequences were enormous indeed. The VaR diversification benefit may remain in the meantime. But the bank could no longer claim that such a protection existed in stress scenarios. This had of course a massive impact on the RWA and therefore on the actual “capital” cushion that the bank could claim to have. All of a sudden Jpmorgan would have looked under-capitalized.

What a lethal paradox! The bank cleaned the balance sheet for good and woke up as “under-capitalized”....Here though this was just a modeling issue at the end of the day, one formula versus another for quite speculative projections anyway. Or maybe this was much more than a mere modeling issue...If it was to be uncovered.... The quite real impact concerned actually the \$360 billion of investments that the CIO had managed aside from the “tranche book”. The CIO always claimed that the “tranche book” had been protecting those \$360 billion of investments. Those \$360 billion of investments had been made by CIO using the official “strategic liquidity reserve of Jp Morgan”. Here, if the “dedicated protection” was dead and il-liquid, it was really impossible to pretend that the \$360 billion “strategic liquidity reserve” was in fact “readily available” in case of a crisis. Liquidating those \$360 billion of investment in emergency would be costly. Here one had to talk of \$20-30 billion reserves just for the CIO. NO model was required here. The permanent profit taking that CIO was doing was no excuse as well for not taking these \$20-30 billion liquidity reserves. The recent history of prices spoke for itself. As such that was really embarrassing: the “strategic liquidity reserve of Jp morgan” itself was NOT liquid and was now un-protected for sure. Yet the bank could have shifted the \$360 billion of CIO investment towards different other businesses for each to manage their liquidity alone in the future. That actually was the plan already in 2010 about the CIO as such. The CIO in 2011 was indeed planned to be wound down as well. And the bank certainly could find the room to move the \$360 billion of CIO assets across the \$2 000 billion Balance sheet. Some reserves would be required surely so but that amounted “only” to \$30 billion, almost a drop in the \$2-3 trillion Ocean. But that did not stop here in terms of “embarrassment”....Why the hell had CIO gone into this wild type of investment strategy?! “Hell! What had the regulators been doing?” That surely was a question already in store in 2010....Good question.

This \$360 billion stated “strategic liquidity reserve of Jp Morgan” that the CIO had the duty to “wisely” invest was partly backing issues related to the \$3 trillion of “basis risks” held between instruments that had “identical underlying” risks. But as the bank would describe, these \$3 trillion notional amounts were NOT governed by the same contract terms in credit derivatives. This “basis risk” was precisely what had brought the whole planet on its knees in 2008 and ruined lastingly the financial health of all the G7 countries. IF the bank, by stating the official death of its “strategic liquidity protection”, could not hedge this “systemic correlation risk” anyway through its dedicated



CIO, then reserves on the “basis risk” had to be re-assessed in full. The basis point on \$3 trillion would likely cost \$1.5 billion. In the course of the 2008-2009 crisis, this “skew risk” here jumped to 80 basis points or more. IF a big bank like Jp Morgan had had to unwind then this would have crashed the financial markets and the whole banking industry for good. For JpMorgan alone, this 80bps move on the “skew” suggested a potential \$120 billion reserve here or even more ...The market value of JpMorgan shares was “only” worth of \$200 billion....And one should not count on the \$360 billion of il-liquid investments that CIO had made for so many years....

Remember that in 2008 it was “only” the 8<sup>th</sup> (Bear Stearns) and the 4<sup>th</sup> (Lehman) largest US bank in size that had gone bust. That was big enough a calamity for the whole planet. Jp Morgan was by far the biggest investment bank in the world in 2010-2011-2012....The regulators were clearly aware of that and of their secular dilemma here surged back to the fore....The current market value of JpMorgan actually was “only” of \$200 billion including \$60 billion of “intangible assets”, ie intangible capital....Jp Morgan would just never survive with \$80 billion market value after reserves including \$60 billion of “intangibles”....And even the fashionable “JpMorgan/Dimon” brand would not suffice to raise a fresh \$120 billion minimum amount of capital in the markets to save the bank....Thus, “no”, officially there would not be a situation where \$120 billion of capital were missing at Jp Morgan... No way!.... That was just a gross “panic room” trauma, right?

But even trying to draw a more reasonable figure, assuming quite reasonable financial markets speculations on the matter if it ever was raised, one still landed into an additional \$25-35 billion reserves for the “basis risk”. Thus, since CIO could definitely NOT provide the \$360 billion of “strategic liquidity reserve of Jp Morgan” without losing at least \$20 billion, since the “tranche of CIO” required at least some \$5 billion reserve to be safe, and since the \$3 trillion “basis risk” question was therefore unaddressed without an additional minimum \$25 billion reserve, one at Jp Morgan had to announce a \$50 billion liquidity reserve along with the official “death” of the “tranche book” of CIO. Actually, should CIO have to divest visibly the “strategic liquidity reserve of Jp Morgan” that would send the markets in tailspin... Most likely... Thinking of LTCM, no regulator would take the risk here to “see what happens”....The house of cards built in 2004 was falling anyway even under the most reasonable assumptions... And fatally one would ask loudly: “ what had the regulators been doing?”... And regulators would have to act “right now” in late 2010...without having ever met with Iksil the “trader”.

Indeed, this “action to be taken” would call for a massive reduction of the firm-wide VaR for 2011 along with a long series of other precautionary unwinds and additional disposals of assets. Worse, beyond the quite embarrassing questions about CIO as a whole, the share buyback would be postponed right when the traded share price was already way below the “book value”. That would no doubt resurrect the fears of “Ponzi scheme” that had been embodied so well in the Madoff case..... Thus the big “mistake” that Dimon would invoke later in 2012 was here already on all the regulators’ radar screen in September 2010. It had been done already blatantly so. And Iksil was surely the last person regulators would want to see for fear Iksil might only confirm the deep rooted liquidity issues present at JpMorgan. It was quite visible as the CIO of JpMorgan had needed 3 years to deploy \$360 billion mostly in il-liquid investments. During those 3 long years, the liquidity reserves had been underestimated to the tune of \$50 billion in late 2010 and they kept growing...This risk here was ultimately located on the most toxic “basis risk” on the record. And regulators had let that happen all along under their watch, sponsoring actually this strategy actively in 2008...

And yes they worried a lot in late 2010 for JpMorgan, for themselves and for their peculiar CIO project born in 2004. Now one may understand better why the bank could conspicuously choose the sideways, abandoning knowingly so the transparency line with the blessing of the watchdogs involved. The bank would lie and mislead. It would admit it for only a small part in September-October 2013, again with the watchdogs’ peculiar “blessing”. What role did the regulators give for themselves here? They saw the bank choosing Iksil as the new Managing Director on this revealing ”tranche book” that was to die in a planned, non-transparent and fatally toxic way. Was the fate of the new MD Iksil sealed already? This would be pure logic here corroborated by Artajo’s explanation of the time.....Artajo

stated that it was a “chocolate medal”, that “nothing changed” for Iksil as to his role within CIO....The imminent death of this book was known above the head of Iksil and Iksil would go down with the book likewise, in a scandalous manner since transparency was precluded. The existing “big mistake” that had been missed for so long already mandated such a scandalous end. Was it anything else than the legacy of 2004 when it was decided to make a bigger bank from a bank that was too big already?

**Beginning of 2011, the bank definitely chose to go sideways.... It will not quit that drift in the future targeting of Iksil to fall all along**

Thus, rather than simply put this “tranche book” lastingly into an extended version of “landing the plane” that may have been called “let it die for good”, the bank of Jamie Dimon promoted Iksil in November 2010 (made official in May 2011) on all the active radar screens. And next, the bank would create as many occasions for itself to make Iksil trade, and trade again, under quite paradoxical excuses. It did not even wait for Iksil to actively trade. As early as January 2011, the bank started creating the setup “on regulators’ filings” unbeknownst to Iksil. What will follow shows that the bank opted to go sideways and mask an existing big \$50 billion worth “mistake” on reserves behind a well prepared screen this time: a “trading issue” embodied by one “French trader” being “anyway off the chart”. This would be another ‘mistake’ pursued all along 2011 that would lead to the scandal of 2012. But finally the bank would still manage to make some “admissions” mostly as it wanted to make them, and to maximize its profits quarter after quarter without taking the \$50 billion worth missing reserves ever.

Thus in January 2011, Iksil had just been promoted “Managing Director- but this was a chocolate medal- nothing changed for him”... Indeed...Iksil was now part of the “executive” team at CIO on paper but he was not in the decision meetings, not even CC-ed in the key emails. He was neither invited to ANY meeting with regulators regarding this book specifically nor even briefed about the issues at stake. As Artajo had put it then, “this is none of your business man”. He was just told that regulators were monitoring the book and that it may have to be put in run off soon along with Credit Hybrids at the IB. Iksil’s job was to “reduce VaR”, full stop and not worry about regulators or internal collapse plans. As such, there was just NO change from 2007.

This was to be the status quo until July 2012 when the bank would invent out of the blue some decision power for Iksil to have had on the trading strategy. The bank would also invent some role for Iksil in selecting the prices in the daily estimate P&L report. And the bank would invent, but only then, outright that Iksil’s many alerts had not reached the very top of CIO hierarchy and had not had a massive impact on the chiefs. Those reactions though were quite visible and would be listed as “key” events in the bank’s Task Force Report (January 2013) that “may have prevented” the disaster to happen had the chiefs decided to follow the advice that had been conveyed through these alerts of Iksil. Cavanagh would make sure that “Iksil” would remain anonymous for that matter of “significant alerts”. Thus rather than having been ‘injurious’ or ‘detrimental’ to the firm as Jp Morgan would claim in July 2012, those alerts had been “key” in possibly avoiding the disaster as the same Jp Morgan would claim in its Task Force Report of January 2013. Thus the bank did play with Iksil’s promotion all along since late 2010 to either blindside him or overexpose him. All the watchdogs would play the same game. In the account that follows, the bank will use this promotion in many instances clearly so.....

First, in early 2011, Jp Morgan would have manufactured a quite convenient “MD promotion” on Iksil’s back. It was just a fake. For example Iksil had asked that a \$100 million “cushion” reserve for execution costs to be rolled from late 2010 into January 1<sup>st</sup> 2011. This implied that the yearly performance of the “tranche” book would have been a meager \$50 million gain for 2010 instead of a much larger \$150 million profit for the whole year 2010. Yes the senator Merkley and Thomas Curry (OCC chairman) knew they were damn wrong in their June 2012 characterization of Iksil’s role at CIO. The request of Iksil would be heard and be dismissed by CIO finance staff and CIO management. The cushion \$100 million would be added back to the current P&L estimate figures by finance staff at CIO. That was not wise and in denial of the repeated former alerts of Iksil. Iksil had

warned that it would be very difficult to keep unwinding any material amount in the markets in 2011 as liquidity dried up a bit more every day. It would be costly in any case. It was not new at all and since the book was to be unwound down to zero in theory better was to reserve some of the gains of 2010 to sort of “pay” for the sure costs that were to come in 2011. As Artajo would put it again to Iksil: “this is not your job to care about this”. Thus, now that the “dividend trade” of Drew was almost gone, Iksil was ordered to resume ‘landing the plane’ with a focus on ‘minimum execution costs’ and on reducing the VaR on this portfolio. As said before this “VaR reduction” could not be done without the detail-oriented guidance and instructions of Kalimtgis or Stephan since this VaR was in fact communicated by New York teams AFTER the diversification benefit in REVENUE had been analyzed and re-allocated to this ‘tranche book’ in part. Iksil had “done well!” in 2010 and would be generously compensated on the 21<sup>st</sup> January 2011. But the bank had other more secretive plans for Iksil and this “tranche book” that would remain undisclosed to the “fresh new MD” until March 2013....

The US Senate report (March 2013 precisely so) mentions a remarkable incident that occurred on January 27<sup>th</sup> 2011, ie only 6 days after the “well done!” bonus day. Unbeknownst to Iksil, the bank sent a routine report to regulators indicating that the CIO had violated its stress limits. Iksil would hear none of it until March 2013.....The bank alleged in this quite official report then that the breach had been caused by changes occurring in the “tranche book”. No regulator involved will ever ask to meet Iksil...It is easy to understand... The “tranche book” had been barely trading, and therefore barely been changing, in that period. It showed in the weekly risk reports of CIO. It was thus a misrepresentation wanted by the bank and the regulators altogether. As explained above with the “cushion” and the execution costs involved, it was really tough to move anything on this book then. ... “landing the plane” in such circumstance could NOT induce any material and quick change anyway.... The fact is quietly corroborated in the Task Force report (January 2013) on the matter.

The strangest fact in this is that the US Senate Report got public 2 months AFTER the bank’s Task Force Report. It matters here to provide the exact extracts of both reports to “see” what actually happened in the public disclosures “in hindsight”. First the Task Force report account... Task Force report page 76-77: in the footnote 95 what the “origin” of this future CIO limit review was: “**An earlier limit breach within CIO appears to have been part of the impetus for a review of CIO’s limit structure begun by CIO’s Head of Market Risk in the summer of 2011, described below. Beginning in March 2011, CIO’s aggregate stress loss limit was in breach for some time. The breach, which was discussed among the Chief Investment Officer, the Firm-wide Chief Risk Officer, and the CIO Head of Market Risk, appears to have been caused principally by activity unrelated to the Synthetic Credit Portfolio, in CIO’s international rates sector.**” The Task Force Report weirdly dates it to “beginning in March 2011”... This as such is inaccurate and one wonders why really...But the rest is correct: the breach was “unrelated to” the “SCP”. And it relates this event to the coming CIO limit review that most likely was done at regulators’ request. It was NOT related to the actual “activity” on the “tranche book” of CIO. How could it ever be since the book was barely trading and therefore even less changing. But why did the bank originally attribute the cause to this “tranche book” to never correct the new “mistake”? Here is now the US Senate report account of the very same event (see footnotes 1270 to 1274 here).....“*For example, in the first half of 2011, the CIO reported multiple, sustained breaches of its stress limits and attributed those breaches to increased activity in its “synthetic credit (tranche) book.”*1270 *The CIO’s stress limits were triggered eight times, sometimes for weeks at a stretch, from January to June 2011.*1271 *The bank notified the OCC about those stress limit breaches, like other internal risk limit breaches, in the bank’s regular Market Risk Management (MRM) Reporting emails which listed risk limit breaches and in its weekly Market Risk Stress Testing reports.*1272 *In those reports, the CIO attributed all of the CIO’s stress limit breaches to changes in its “synthetic credit (tranche book).”*1273 *In the first breach of the year, for example, which occurred on January 27, 2011, the CIO continued to breach the limit for seven weeks in a row, peaking at 50% over the limit.*1274 “

Thus 2 months later the US Senate commission conveys a misrepresentation in that this breach was “attributed to” the “CSP without specifying that actually it was “unrelated to” the “SCP”.... The US

Senate had missed a unique opportunity to fault the bank here... It matters to note right here that “7 weeks in a row” brings one from the 27<sup>th</sup> January 2011 to the 13<sup>th</sup> March 2011. To be sure, by the 13<sup>th</sup> March 2012, the CIO of Jp Morgan was in a lasting breach of its stress test limits. Thus “beginning of March” for the Task Force Report is just another “mistake” on the side of the bank done “in hindsight in January 2013”. For sure as well, alleging that this was caused by “*increased activity in its Synthetic Credit (tranche) book*” was ALSO a big misrepresentation of CIO here that was ALSO conveyed by the US Senate commission 2 months AFTER the Task Force Report had gone public. All this ONLY contributed to damage Iksil’s reputation with clearly a complacent ear on the side of regulators then....Still the regulators would not try to talk to Iksil for 7 weeks on back in 2011....But also not a single regulator would EVER ask Iksil about those events later in 2012, 2013, 2014, 2015, 2016, 2017 and counting.....Why did the US Senate report convey such a wrongful picture, after all these investigation reports, given all these documents that showed the real role of Iksil since September 2012? This is not negligence given the obsessive “focus” on Iksil himself that they all would have.

The explanation published by the US Senate in March 2013 was known to be not only wrong but even discarded by the bank itself 2 months before and quite publicly. A clue is that this 7 weeks long breach of CIO solved itself by miracle on March 13<sup>th</sup> 2011 right before the Federal Reserve would disclose publicly its own result on stress tests on March 17<sup>th</sup> 2011. The Federal Reserve would praise Jp Morgan quite loudly then. Everything had thus come back in line at the very right time. It thus had been deemed “not needed” yet to review the VaR analysis and the associated “correlation risks” that it unveiled in light of this “7 weeks in a row” stress test violation of the CIO, ie the very unit that managed \$360 billion of strategic liquidity reserves for the bank. But, as the Task Force Report would suggest, the bank would have to launch a review of CIO limits soon after March 2011, quietly....Not that it was not necessary to do that on the eve of the first big layer of share buybacks that Dimon touted since October 2010 in the press... Needless to say that meeting with Iksil was pretty much useless at this point in time. The priority was for this massive share buyback program to go on and it would go on with the blessing of the Federal Reserve all along on the front stage in 2011. One can notice by the way that there was no ambiguity yet inside Jp morgan then, ie in 2011, or the US Senate or the Federal Reserve or the OCC on the designation: their original “SCP” was indeed the “Synthetic credit (tranche) book”....ie a “correlation” book....The subsequent denial of all the authorities in 2012 onwards to recognize that their “SCP” had always been the “tranche book” appears to have been just a pure gesture of theirs. As one remembers that the OCC forcefully tried to erase its ongoing awareness behind the excuse that they had not known the book’s name, this sole reference here from 2011 contradicts the future allegations and corroborates the very early direct involvement of regulators into the future travails of the book that would cause the scandal of 2012. They had a “deal” already....

On that line of thoughts, other orders will follow regarding the reduction of the RWA but based upon un-finalized Basel III standards using un-finalized models which by the way still were un-approved even internally at the bank.... Does it matter to clarify that even the watchdogs themselves would NOT “validate” anyway a thing being based on what they themselves had not finalized yet? The Basel III calculations were in such early stage of development that even Keith Enfield at finance-CIO did not know what these RWA figure meant, although he was the one communicating them inside CIO from New-York based reports. When asked by Iksil, Enfield replied simply that he could not elaborate on either the context or the meaning of those figures. All he knew then was that this was an RWA figure that New York produced and then dispatched to the concerned business units. Why was the figure so big? He did not know. How was it processed? He did not know. Who had done that? He did not know. Keith Stephan and Peter Weiland in particular, from risk Management in New York, could tell a bit more. The figures were then tentatively produced by one team, the “QR team” in New York that historically was an IB team of “quants” (ie Human beings doing a lot of maths and physics in financial fields) devoted to new models. The IB had historically centralized the development of all the firm-wide risk models including VaR and RWA among others.....

Thus it was the risk management top chiefs of CIO who had the control of this information and who therefore again could instruct Iksil via Artajo to execute this “RWA-Basel III” reduction order. Iksil depended even more upon Kalimtgis, Weiland and Stephan through Artajo to keep reducing the VaR,

keep maintaining the protection on specific stress tests, and now reduce the RWA-BaselIII. A key meeting occurred in late March 2011 with Ina Drew in person in London. Iksil warned again about the execution costs, the high visibility of CIO remaining exposures and the absence of market depth anyway. Iksil would propose to split the book by shifting the largest legacy exposures, of which the IG9 ones, into a future “investment book” that would be put in run-off. The remnant, about 10%, would be unwound in the markets over time. The idea then was to ask for capital on behalf of this future investment book aside from the capital that the “tranche book” currently used. Unwinding the future “investment book” in the markets would cost \$billions while the same future “investment” could generate \$billions of gains by the time it would mechanically expire in a “run off” mode (ie barely traded). The economic argument was that it was maybe less expensive for CIO to ask for more capital over a limited amount of time (about 2-3 years), the time for the “investment book” to simply expire. Drew asked then what amendments would be needed for those “investments” to be shaped appropriately. She received the answer that this required a little more trading depending upon how the whole “tranche book” was to keep protecting CIO in stress tests in the meantime. Iksil had proposed the idea and a starting configuration based upon minimum trading looking forward. Then Drew would instruct Kalimtgis, Macris, Artajo and Stephan to analyze the original framework proposed by Iksil and to come back with the proper ratios of exposures so that the CIO remained protected against specific stress tests that only they could monitor. She also instructed them to check how this drastic “split” would impact the VaR of CIO and the VaR of the firm. Drew got it...

Once again, Iksil would next be kept totally out of the decision-making loop after this March 2011 meeting. And Drew of course asked them, leaving Iksil aside as he would be devoted to pure execution, to partner with QR to project how the RWA would look in the context of the reduction plan that was done “for Jamie”. The goals were clear for all: that aimed to maximize the share buybacks planned by Dimon. As to Iksil, Drew asked him to already try to figure how to reduce the RWA while keeping the VaR constant on the book. Iksil then would ask Drew to send an email to QR on her behalf. Otherwise QR guys would simply ignore Iksil’s request as he was NOT in their lists. She would agree. This email does exist dating from early April 2011. Drew had stayed in London a little longer... QR will send only once the data that Iksil needed, knowing exactly what he needed then. The idea was to find sensible trades that would reduce the RWA-BaselIII while keeping the VaR and the protection in place. The trades would ALSO have to “make sense” in relation to real life. That was the most important thing in Iksil’s mind.

After reviewing the model of QR with Pat Hagan in April 2011 Iksil would soon after send a memo to QR flagging the many huge flaws of this model that he could see. After that memo had been sent, QR would not discuss the points with Iksil and will simply NEVER send any information again, preventing therefore Iksil from using this flawed model data to reduce the RWA as QR manufactured it. Iksil will raise the matter up to Drew and all the other stakeholders at CIO all along 2011 but in vain.

In June 2011, the “split” would be approved by Drew though and Iksil would ask the Middle-Back office staff, with Artajo’s prior approval, to create the “strategy 27” that was to host the “future investments” the time for the official ‘investment book” to be created. The strategy 27 would be created and populated with the target investment trades that were to be put in “run-off” mode. There was next such a simple transfer to operate from CIO to the IB. The latter will NOT happen. This creation of the “investment book” would hopefully occur once the request for “more capital” on behalf of this “split strategy” would have been approved above Drew’s head...The approval never came to the light of day... One wonders why but Drew does have the answer as well as Macris or Artajo or Stephan or Weiland or CFO executive staff at CIO. This absence of final implementation of the approved “split” really is surprising given the context of June 2011 as stated here. The bank kept opting for the sideways on many occasions as one can see here.

Thus while the objective was clear, the path for executing it would be quite nebulous and conflicting. Let’s move shortly the clock forward...As John Wilmot the CFO of CIO would write to Drew just 3 days before the seminal articles of April 6<sup>th</sup> 2012, the plan never was to “land the plane” post the “MD

promotion” of Iksil. To “land the plane” was NOT any longer Drew’s plan or Dimon’s plan despite Macris’ wishes post this June 2011 “split approval”. Wilmot says it below:

*“Senate report first batch of exhibits disclosed in March 2013, EXHIBIT 52: “*

*From: Wilmot, John [JOHN.WILMOT@jpmorgan.com](mailto:JOHN.WILMOT@jpmorgan.com) Tue, 03 Apr 2012 11:45:24 GMT To: Drew, Ina [Ina.Drew@jpmorgan.com](mailto:Ina.Drew@jpmorgan.com) Subject: RE: Here is my general reaction to this and to the document circulated last night:*

- 1. I don't get the sense of clarity that we know what is driving the RWA (economic risk versus VaR, stress VaR, CRM and IRC) or the p&l or **more importantly that either will be manageable going forward***
- 2. We are a **significant player in a market that is less liquid**, hence any attempt to manage p&l or capital away from an "as is" approach will either result in **p&l dislocation** or RWA constraints (a la 4Q11/1Q12)*
- 3. We haven't made the case of how this book runs off and whether risk can be managed effectively within a fixed maturity, is that we can derisk without creating continual tail risk further out past tranche maturities. **This plane will never land.***
- 4. We also haven't made the case of what it costs to significantly decrease the size of the book (in my mind the only certain way to reduce RWA) **I profess to probably being the least knowledgeable about this book amongst the senior team**, so that leads me to be skeptical when we aren't directly answering questions. I think we have moved beyond the commercial utilization of this book in some jump-to-default capacity as it exhibits neither acceptable risk/return profiles nor **market liquidity characteristics to justify capital.**”*

As this email of Wilmot shows through the 4 points and his own skepticism in April 2012, one really wonders what the top executives had been waiting for since late 2010. Of the 4 points highlighted by Wilmot, none was not known in early 2011, even less so in June 2011. Instead they already were on top of the list of the concerns that Dimon had pointed out in his own slides of September 2010. What had they all been waiting for while pushing Iksil to trade and trade and again in such a blind manner?

Back to June 2011 now...The contradictions did not stop at all at this rebuttal of QR to open the discussion on an RWA-BaselIII model that was deeply flawed. The mistakes were blatant and it is worth putting them on the record somewhere because these flaws seemed wanted in order to make the RWA of the “tranche book” of CIO look much higher than it should have ever been. These flaws would all have induced Iksil to propose really stupid trades had he not checked the model itself first. One wonders whether the bank did here anything else other than manufacturing a fake “RWA breach” after having manufactured a fake “stress violation” for “regulators’ optics”....

It turned out for example that the model massively overestimated the default risk in Investment Grade versus the default risk in High Yield looking into the coming crisis. Thus, while the last 3 credit crisis to date (1991-2001-2008) indicated that there was about 20 times more losses in High Yield than in Investment grade due to defaults (taking the ratings migration into account for the experts), the RWA-Basel III model of QR projected only a ratio of 7 times. This rendered the HY protection in the “tranche book” of CIO overly expensive in RWA terms. Should Iksil reduce the HY protection or instead ask QR to make a sensible model on this matter? Iksil asked for a change and was ignored by QR from that very moment. Another flaw was that the QR model was “assuming” that the next 4 defaults in High Yield were “priced in”. Thus, when buying this huge protection on High Yield, the “tranche book” of CIO, was actually looking beyond the 4<sup>th</sup> default as per QR and therefore paid a very high price in RWA terms as per QR too. That was plain nonsense as the High Yield market players were all touting that there was just NO default expected before 2012....And that is how the HY market was priced then. Thus the market opportunity was going right against what the QR model was saying. Should Iksil have unwound a protection in High Yield that was almost at zero cost in carry terms, or ask QR again to look at real life in the high yield markets? Iksil asked for a change and was ignored on the follow. Therefore the QR model was effectively preventing the bank from protecting cheaply against new defaults in high yield. And the order of Drew for “Jamie” induced Iksil to suggest quite stupid trades.

Last but not least the QR model also ignored the “replacement cost” in every CDS trades, or what is also usually called the execution cost. What a coincidence! Indeed QR did not factor in that the large bid-offers in CDS markets were a direct reflection of liquidity issues that are inherent and basic patterns in credit markets. One can understand that point if one considers the case where suddenly a company is rumored to default. Then no one is going to offer a protection against this default except at a price that actually reflects this anticipated default loss at best. This very basic consideration leads to a fundamental pattern of CDS curves: they tend to get flatter and even invert as the default risk grows. Thus when CDS spreads in general get wider and wider, the 2yr CDS spread increases faster than the 5yr CDS spread. This mechanism was simply explained by Iksil in his short memo by using the actual cost of “re-hedging” that dealers had to pay for their own survival in such cases. This reality faced by just all credit market players contradicted one major output of the QR model that was: the CDS curves in QR model got steeper and steeper when the CDS spreads got wider. In other words, for QR in its RWA-Basel III modeling, when CDS spreads widened, the 2yr CDS spread would increase LESS than the 5yr CDS spread. That was in plain contradiction with real life again. And that was also clearly inducing an RWA for the “protection” book that was kept artificially too high. Iksil’s point shall be ignored by QR once again, inducing once more Iksil to suggest quite stupid trades. Iksil would make a trip to New York in September 2011. He would meet with QR, meet with Ina Drew, meet with Weiland and Goldman, meet with John Wilmot CIO-CFO. He would describe the issue with QR, with the execution costs, the deadlock about the RWA model data....None of them would try unlock the issue although they all understood it very well.

Thus the bank had ignored a \$100 million “cushion” reserve for execution costs in late 2010 despite requests made by Iksil “the trader”. The bank had manufactured a fake “stress violation” in January to March 2011. Next the bank had manufactured a fake “RWA-Basel III violation” between March and June 2011. Then the bank manufactured a radical “split and run-off” plan from June to August 2011 that it did NOT intend to finalize. And it should have worked right? But Iksil had NOT behaved as expected; he had raised the alarm bells at CIO, at QR and created the “Strategy 27” that betrayed all these fakes. The head of the “French trader” was not ready to fall yet... Absent the implementation of the approved split that had justified the creation of this “strategy 27” in all the systems of Jp Morgan, the year 2011 ended in quite a tense climate not only at CIO but also at the IB too for the “credit hybrids” traders. As of December 9<sup>th</sup> 2011, Drew in person had issued new instructions. Iksil had to try to collapse exposures internally with “Credit Hybrids” guys and others at the IB; “Credit Hybrids” staff should have accepted the invitation as they had just been ordered to close their “tranche business” in November 2011. But “credit hybrids” guys will flatly reject any discussion arguing that they did not “mark” their books where the markets quotes were at the time.... Does it sound like there was already a huge and visible price difference inside JpMorgan between CIO and the IB on the very same instruments day after day all along December 2011? Yes it does. Does it sound like this difference was so big that the IB traders refused to trade with cio because of that? Yes it does too. Does it sound like the price difference was known as structural inside the firm? Yes it does. The incident would be elevated by Iksil towards his management AND the IB management of “Credit Hybrids” in the person of SANJAY JAHMNA (Bloomberg written chat). The “fake program” was derailed for good one more time....

Drew had to step in more forcefully than hoped for. Iksil was thus ALSO told by Drew to renew the protection on High Yield despite the known flaws of the RWA QR model. And Iksil was told by Artajo to position the book in the view that credit markets were going to rally soon and fast. That last order was done on behalf of “Jamie’s belief”. This made really little sense whichever side one looks at it for a “protection” book that was to be in an aggressive “RWA-BaselIII-QR” reduction mode. No doubt this apparent nonsense was very temporary as “Credit Hybrids” closing meant that the CIO “tranche book” was dead too in the near future. The CIO closed the year 2011 quite early for this “tranche book” as of the 15<sup>th</sup> of December 2011. This was quite unique too and just coincidental no doubt again. But what is even more “unique” is that CIO would run a second “year end close” for this “tranche book” as of the 31<sup>st</sup> of December 2011 with other prices....Was there any issue with the first “year end close of the 15<sup>th</sup> of December 2011? Or was it the longstanding price difference between

CIO and "credit hybrids" on the very same CDS that was the issue already? No, there was no problem... of course not...

Still the Federal Reserve was watching all this since the 22<sup>nd</sup> of December 2012, ie 4 business days after the first "year end close" had been communicated. The Federal reserve worried about "unwind costs" for the "tranche book" specifically so. That was just another coincidence since the regulators claimed in 2013 that they were unaware of "price differences" existing between CIO and the IB until July 2012. Maybe they all lied on this matter.... Yet in December 2011 there already was a \$300 million difference in prices between CIO and the IB about this "tranche book" that was planned to be collapsed with "credit hybrids" at the IB....This is how the \$300 million worth of price differences had popped up in the debates surrounding this planned "wind down". How long had this \$300 million or so difference in price had been lasting in the firm's controllers reports through the year 2011 and into 2012? That difference here is the one that would "justify" the restatement of July 2012. The fact is that this same difference existed visibly so since late November 2011 at least....Were the books and records correct at Jp Morgan in 2011 and how so then? Maybe they were not correct in the eyes of John Hogan, of the Federal Reserve and of other watchdogs....That was known but only behind closed doors that Iksil would never be invited to open. Really the bank had gone sideways more and more....

### **January 2012: John Hogan to Jamie Dimon about the VaR model change done for CIO "now same methodology as IB"**

In early January 2012 some unusual events occurred on the follow up of this shadowy year end for the "tranche book" of CIO. There had been a lasting \$300 million issue all along December 2011 around prices between CIO and the IB in the very specific context of a firm-wide "wind down" plan managed by Dimon directly. The fact that this \$300 million difference had been a lasting issue into the 2 consecutive year end valuations closing the year 2011. The issue had been unknown by Iksil at the time although Grout and Artajo would have known it for a simple reason. They were the ones who had conducted these 2 valuations. They would NOT inform Iksil at any point in time of the real problems that they had met. Did they meet a lasting problem here actually? This difference had popped up right after the very first stage of the valuation. It was to be reconciled and adjusted anyway. The issue probably was not the difference in itself but the fact that it showed day after day. This indicated a salient problem with the price accuracy. This was either a liquidity issue or a mismarking problem or both already. All that had happened in plain light in December 2011 and most likely in November 2011 already. There was thus nothing to "discover" for March 2012 month end...

Iksil would know with certainty the issue flagged above in September 2016 only, almost 5 years later and a bit by chance actually during his own deposition. But undoubtedly Jason Hugues at VCG also spotted this \$300 million difference again at his second check as of EOD January 4<sup>th</sup> 2012. The report of VCG mentioned indeed an unusual move on Hugues' own process: Hugues had for the first time applied "tolerances" for the second year end closing in 2011, ie a margin for price uncertainty that called for a commensurate liquidity reserve. This tolerance on prices that Hugues at VCG had used was worth about \$600 million in total. Indeed, Hugues at VCG specified ( see his emails in April 2012) that he would keep a price that displayed a lower loss for CIO provided it was within the tolerance that he Hugues was using at VCG to make his judgment on every price. Hugues acted independently from the front office of CIO London.

Thus Hugues would NOT adjust negatively the initial estimate P&L for an amount that could be worth up to \$600million. Hugues at VCG was NOT documenting his own judgment and that was an issue worth of \$600 million for the internal auditors in December 2011. Internal auditors would themselves raise the issue to the CFO while they were auditing the valuation process done around the "tranche book" of CIO in late 2011. Therefore Hugues was simply applying the most recent recommendations of the internal auditors of JpMorgan here but improperly. However Hugues still would NOT set the associated reserve that had to come along the application of those tolerances. And Hugues would NOT be fired after the scandal of 2012....He had done his job "in hindsight" even though he had applied these tolerance without setting the commensurate reserve for that.



The internal auditors when running their review of the “tranche book” had not needed to talk much to Iksil to assess the ill-liquidity of the positions. That was Hugues’s job at VCG to the extent that CFO and Hugues’ managers had ordered him what to do. Hugues had in practice a highly limited responsibility that was confined to apply the instruction that he received in comparing the prices. The internal auditors had barely spent 5 minutes in December 2011 with Iksil then only asking broad questions about the market liquidity but not a single question either on the trading strategy, or on the valuation process, or on the limits, or on the reserves. None of this, as the internal auditors knew well, was any of the “not so fresh MD” Iksil’s duty or responsibilities despite his not so recent “chocolate medal” promotion.

Still internal auditors called in their report for more “consideration” about “price uncertainty” and “concentrated positions” in the book. They were writing their audit report in “late 2011” as the CFO of CIO would testify in front of the US Senate commission. All this called for a \$3-4 billion liquidity reserve in total. Jean François Bessin in late April 2012 would raise similar figures independently to Allistair Webster and John Hogan as Bessin was the VCG chief price controller for the IB. Bessin would hammer his point again to Webster in early May 2012, a couple of days before the 10-Q would be published on May 10<sup>th</sup> 2012. But this reserve here would never see the light of day, neither in January 2012 nor in early May 2012, nor in between.

This reserve amounted to about \$400-500 million for the price uncertainty and \$2.5 billion at least for the “concentration” risk. Drew was aware of “new reserve talks” as she confessed to Artajo, Macris and Iksil in late April or early May 2012. She also stated :” we made a mistake here OK?” Artajo and Macris nodded. Iksil heard that for the first time. Thus she could tell “why” the firm did NOT take this reserve that however was mandated by the firm’s policies and procedures when “price tolerances” are being in use or when “concentration risk” is flagged.

So, against the live recommendations of the internal auditors of the bank, that had just been writing their audit report in December 2011, neither the \$500 “tolerance” reserve, nor the \$2.5 billion minimum “concentration” reserve would be taken although they were discussed at Drew’s level then. Drew’s boss, namely Dimon, was not aware it seems. This was not the only weird event that would be happening in the beginning of January 2012...

Another quite strange turn of events would occur around a change on the “CIO VaR model” that actually would impact the VaR model of the whole firm. From this sole consideration, one wonders how the change would ever be done by the CIO-London staff for what was a New-York based firm-wide centralized computation by definition. More, the change about the “CIO VaR model” had actually been sparked by a regulators’ request in June 2011 as the Task Force suggested. It had been noticed that the CIO VaR model conveyed some methodological inconsistencies with regards to what the IB VaR model was doing. The IB and the CIO had to adopt a consistent framework in the future. It was decided above Drew’s head that the CIO VaR model would be changed.

The first suggestion had been for CIO to simply adopt the IB VaR model in full. CIO had refused for a good reason: the IB based all its VaR calculus on single name CDS components which was an insane approach for the CIO “tranche book” which did NOT trade on those single name CDS. Since the VaR was based on “REVENUE” this implied that the “tranche book” of CIO would have all its index and tranche positions revalued based on the single name constituents of these indices. The CIO “tranche book” solely used indices and tranches based on those indices. Why ignore all the prices that quoted these indices directly opting for prices on single name CDS that were much less reliable? That made no sense for an analysis based on “REVENUE”.

The IB VaR model was thus based on the very CDS that the “tranche book” would NOT use out of really exceptional situations. More the IB VaR model had a mad assumption built-in.... Indeed, as explained before, the IB model on VaR was freezing the “Skew” risk somehow so that the single name CDS moves would allow to directly simulate the corresponding index moves in full. As the “tranche

book” strategies were precisely meant to hedge a skew explosion, that proposal to adopt the IB VaR model was therefore a complete nonsense. So from July 2011 onwards, Artajo and Pat Hagan and Keith Stephan would design a new VaR model for CIO that addressed the inconsistencies flagged by the regulators and that would be based upon index prices or tranches prices rather than the single name CDS that the IB was using so exclusively.

It took time and this development had to be closely monitored by the teams of John Hogan all along. A model was proposed in October 2011 to be back tested in New-York and in London in parallel to see how the new “CIO VaR model” actually fit with the current IB VaR model at the firm-wide level. The checks were done not in CIO London of course, but in New York by a group called MRG (Model Review Group). In London Hagan and Stephan for CIO looked daily almost what kind of VaR reduction they could expect as far as the ‘tranche book’ was concerned. This could only be a proxy result since only MRG from New-York, compiling the CIO VaR with the IB VaR for the whole firm, could neatly show the regulators that their concerns of June 2011 had been correctly addressed.

The bank in its Task Force Report tried to make people believe that the many “errors” that Cavanagh had flagged at CIO were responsible for the misrepresentations that the bank did on the VaR figures and models in 2012. The bank devoted 20 pages of its 130 pages long in total Task Force report in January 2013 to try to be convincing on that matter. But there was no such risk that the errors done in CIO London could induce the misrepresentations that would be done about the firm-wide VaR. The process was centralized by design before the new CIO VaR model would ever be active. The process would remain centralized once the new “CIO VaR model” would be activated. In order to cover any doubt on that it is enough to read again the footnote 1630 (or 1625 depending on the report version) of the US Senate Report: *“Saturday 1/28/2012 email from John Hogan, JPMorgan Chase, to Jamie Dimon, JPMorgan Chase, “JPMC Firmwide VaR – Daily Update – COB 01/26/2012,” JPM-CIOPSI- H 0001675 (“This should be the last day of firmwide VaR breach. A CIO model change is planned to go in this week-end. New VaR methodology approved (and now the same methodology as IB) reduces standalone Credit VaR by approx. \$30 mio.”)”*

This so-called “CIO VaR model” change consisted for “the regulators’ optics” to include at least Indices for the “basis risks” that existed between the “hedge” at CIO and the “risks” at the IB in the VaR calculation itself. CIO and the IB were NOT the same business units. The “skew” could not be “frozen” between the 2 independent business units. Although the “tranche book” clearly hedged the IB as the huge VaR diversification benefit testified since 2007, the “deposits” that were “invested” by CIO were NOT the “property” of the IB trading chiefs. It could not be the case even for one day. Thus in theory the positions could not be merged that seamlessly assuming that CIO, for example, hedged officially the IB on the “skew risk”. It would have been convenient to let CIO adopt the IB methodology and the IB price database based on single name CDS. The CIO would then have had to deal with the skew risk internally. But this really was complete nonsense from the start with regards to the real life: the single name CDS had NO liquidity, only the indices had some liquidity along with fewer and fewer tranches over time. Worse, as the skew risk explosion testified in 2008, this “skew risk” was the very risk that CIO had to care about, along with the bank, and along with just all the watchdogs.

Why then set the number one cornerstone of risk measure after the P&L itself, ie the VaR, be based on a fundamentally flawed approach about the “skew risk”? The answer was crucial for the whole JpMorgan which carried a \$3 trillion exposure on “basis risk” in CDS most of which was a skew risk in 2011 and 2012. And the “tranche book” of CIO was providing a useful, sensible and quite profitable protection here. But it was “small anyway”, “concentrated”, and il-liquid fundamentally. The IB was the main beneficiary of it. The fact was notorious since June 2007 at the bank where the protecting pattern had manifested itself for US subprime positions at the IB precisely so. It matters to make one point clear at this stage....The firm had no need of CIO to process its firm-wide VaR as the extracts from 10-Q report of the first quarter of 2009 showed. It had turned out, in the regulators magnifying lens, that the skew risk was inconsistently captured between the IB (based on single name CDS) and the CIO (based on indices). The easy fix was to adapt the CIO VaR model for an issue that concerned

at least \$3 trillion of exposures on credit derivatives throughout JpMorgan. Initially the firm needed the approval of CIO to base its VaR on single name CDS and CIO had refused quite logically. This is how MRG and CIO had teamed up to design a proper adaptation of the CIO VaR model, but always WITHIN the existing centralized VaR computation. The firm may have bypassed the CIO in full but time was running out as per regulators' optics. The next quickest fix was to partner with CIO. Still all was centralized, reconciled, scrutinized, analyzed, verified, back-tested (see the 10-Q report of Q1 2009 again on pages 71 to 76) for quite strategic reasons.

This VaR model change was thus all controlled from the very top of the firm given the stakes at play with no less than regulators, depositors, shareholders, and counterparties concerned....In June 2011, it had turned out in fact that the liberties that CIO had had since 2006 in providing a competitive pricing and risk analysis of the "market-related exposures" of the whole bank versus the IB one had become "embarrassing" indeed.... Maybe a "bit more than embarrassing" to paraphrase Thomas Curry the OCC chief.... They were highlighting the embedded inconsistency of Jp Morgan itself about the most toxic risk conveyed by credit derivatives, the "skew risk". The beast had made devastations in 2008 notoriously so....Citigroup could tell... CSFB could tell... Weinstein could tell...Goldman Sachs could tell...Feldstein at Blue Mountain could tell....AIG could tell... And just all the other market players actually could tell....That issue underpinning the inconsistency on the VaR model was NOT a benign issue. On top of the fact that the "skew risk" was involved, regulators certainly did not want to hear about a "VaR modeling inconsistency" at its "inceptor of 1994", namely the famous Jp Morgan. This old dilemma would resurrect with a revenge here if such was the case. It was all the more toxic as all the future strategic reserves and provisions determinations started from the VaR analysis. This led straight to the regulators' own responsibilities. And by the way, this inconsistency on the "skew risk" in the VaR firm-wide model between IB and CIO directly related to the elephant in the room, ie the "tranche book" at CIO. What a particular strategy this "tranche book of CIO" was indeed at Jp Morgan!

One should notice here that this VaR issue alone strongly suggested that there may exist significant price differences between the IB and CIO on a daily basis since the VaR of Jp Morgan was based upon "market related revenues" (refer to the 10-Q report of Q1 2009). The IB was basing its 'revenue' on single name CDS. The CIO was basing its revenue on indices....Single name CDS and indices were NOT alike although they had somewhat "identical underlying" risks. The inconsistency revealed another structural difference in estimating the market prices before reserves on both sides, IB and CIO. This structural difference though was perfectly sensible for any bank trying to assess at best its overall "systemic correlation risk". Thus, in regulators eyes, this harmonization on VaR between CIO and the IB related to the skew and actually precluded an elimination of the structural price difference between the 2 business units. Instead the issue around the skew proved more than ever that CIO and IB index prices and tranche prices should be different at first, reconciled next, and harmonized through mandatory adjustments. As a way of conclusion here, this VaR model genesis for CIO within the whole firm-wide existing process shows how useful the price differences between CIO and the IB were for regulators and the firm alike. They could not be ignored. They were wanted. They were reconciled daily indeed. The process had been deployed with as much sophistication as one can imagine on purpose. Why on earth then was the adjustment missing in 2012? Was it also missing for the end of 2011 after the Federal Reserve had sent its own specific queries? It remains that the reserves for this "tranche book" went missing as the internal auditors had pointed out in December 2011.

While there appears to have been a clear mismarking of the "tranche book" of CIO in December 2011, away from any CIO trader actually if the internal auditors report is to be believed, a new dramatic turn of events came up....Between the 31<sup>st</sup> of December 2011 and the 13<sup>th</sup> of January 2012, this book that was to be "taken down" as the OCC had checked with top executives of the firm allegedly caused a new "problem". The "tranche book" was actually causing a massive breach in the firm-wide VaR. It sounds very much like a repeat of the fallacious explanation that had been given one year before in February 2011 about this "7 weeks in a row" breach of CIO stress tests limits. But this time the "tranche book" of CIO was messing up the whole firm on its 10-Q VaR, no less....Was it even remotely true? No, it was completely misleading once again. The "Synthetic Credit Portfolio" or

“SCP”, as bank executives and regulators alike stubbornly wanted to label it in 2012, had barely changed, be that in notional terms (2% at the most) or risk measures terms. Yet this “tranche book” saw its “VaR attributed by New York based centralized teams” rise suddenly by 40%....No less than that...Yet, actually the residual imbalance of risks had been reduced in fact: the “tranche book” was more “neutral” towards markets changes than it had been as of EOD 31<sup>st</sup> December 2011. So one really wonders what had happened here, outside of CIO but inside Jp Morgan.

The explanation is very simple: “Credit Hybrids” tranche exposures were being transferred by Ashley Bacon and Olivier Vigneron from the IB to the hedge fund “Blue Mountain” and maybe other entities sitting outside of the VaR perimeter of Jp Morgan. That was just the “wind down” plan of Dimon that reached its final stage at the IB. This left the “tranche book” of CIO alone at Jp Morgan and this caused a large part of the “VaR diversification benefit” to disappear in the Firm-wide VaR figure. As a result, part of the \$154 million of the diversification benefit that had been reported over a \$250 million VaR in Q1 2009, had simply gone. This transfer of “credit hybrids” tranche positions spontaneously had pushed the firm-wide VaR higher and so was the “attributed VaR” of the “tranche book” of CIO. The only thing to be checked really here is that indeed “credit hybrids” exposures, had been “closed but not unwound yet” in November 2011 in the firm. They were simply being transferred since the very start of 2012 as scheduled back in September 2010 by Dimon (remember his reference to “late 2011” then). The other elements to come are straightforward since they have not been left in the shadow by the bank....

It is easy indeed for anyone to check the origin of this “attributed” 40% VaR increase of the “tranche book” of CIO actually. First it matters to clarify how critical the VaR reports were for the firm: ***“Senate report: On January 16, 2012, CIO exceeded its VaR limit.<sup>979</sup> While several JPMorgan Chase officials minimized the relevance of VaR breaches in interviews with the Subcommittee, VaR measurements are considered significant enough within the bank that the bank’s Operating Committee received daily VaR updates from the firm’s Market Risk Management (MRM) Reporting group detailing the VaR levels for various business lines and business segments and explaining the basis for any significant changes. In addition, a breach of the firmwide VaR was treated within the bank as a “Level 1” notification, and was reported to the highest levels of bank management, including to CEO Jamie Dimon and the rest of the Operating Committee.<sup>980</sup>---See here the footnote 979: 979 1/20/2012 email from Market Risk Management Reporting, JPMorgan Chase, to Jamie Dimon, JPMorgan Chase, and others, “JPMC 95% 10Q – VaR – Limit Excession Notification (COB 1/19/12),” JPM-CIO-PSI 0000150; 1/16/2012, JPMorgan Chase spreadsheet “Position Limit and Loss Advisory Summary Report,” JPM-CIO-PSI 0037534 (showing excession of the \$95 million MTM 10Q VaR limit for close of business January 16, 2012).*”**

So those reports went DAILY to the Operating Committee members, from MRM that is a central risk management team for the whole firm. Who would ever imagine a bank like JpMorgan actually receiving VaR reports from every business units independently so and just NEVER securing that the aggregate VaR number had any sense? There could be ONLY ONE VaR process in the firm for the whole bank. It was crucial as explained before. Yet, as the US Senate report mentions, “several” top executive tried to minimize the importance of those reports. Who were they? To say the least that was NOT the consensus inside Jp morgan senior management anyway. Thus this repeated breach raised alarm bells within the ranks of senior management. More, the 16<sup>th</sup> January 2012 was a Monday and reported therefore a breach for the close of Friday 13<sup>th</sup> January 2012 actually. Since the 10<sup>th</sup> of January 2012, Drew had quite coincidentally ordered the “trader” Artajo to stop unwinding and start “maximize P&L” in an email that can be found among the exhibits of the US Senate Report

:

From: Drew, Ina [Ina.Drew@jprnorgan.com](mailto:Ina.Drew@jprnorgan.com)

Tue, 10 Jan 2012 17:05:41 GMT

To: Martin~Artajo, Javier X <[javier.x.Martinartajo@jprnorgan.cQm](mailto:javier.x.Martinartajo@jprnorgan.cQm)>.CC: Macris, Achilles 0 [achilles.o.macris@jpmorgan.com](mailto:achilles.o.macris@jpmorgan.com) Subject: Re: International Credit Consolidated P&L 09Jan2012 Let's review the unwind plan to maximize p&I. We may have a tad. more room on rwa. PIs schedule asap.”

This email above followed this email here where Drew, Macris and Artajo do talk about “reserves” and “releases”:

*”From: Martin Artajo, Javier X To: Drew, Ina Cc: Macris, Achilles 0 Sent: Tue Jan 10 12:01:01 2012 Subject: RE: International Credit Consolidated P&L D9Jan2012 **Total reserve is 30 MM.** I do not think that we will have a release for-sometime unless we get an opportunity. Bruno has been unwinding some of these positions opportunistically . The other side of the P/L is that it has been somewhat costly to unwind too so net net we have actually lost a little bit of money to unwind.”*

This email above was a reply of Artajo to Drew who had sparked the discussion about “reserves” versus “P&L” or RWA. Please note that Iksil is totally absent of the discussions that will determine 100% of the future scandalous trading strategy :

***“From: Drew, Ina Sent: 10 January 2012 16:17 To: Martin Artajo, Javier X Cc: Macris, Achilles 0 Subject: RE: International Credit Consolidated P&L 09Jan2012 OK, thanks. Can you forward the schedule for releases, ie: **what is the release planned given the budgeted reduction?**”***

Once again this email of Drew to Artajo was as such a query based on an initial report of Artajo to Drew where Iksil as usual is ABSENT and that deals with “Management line”:

***“From: Martin Artajo, Javier' X Sent: Tuesday, January 10, 2012 11:05 AM To: Drew, Ina Cc: Macris, Achilles 0 Subject: RE: International Credit Consolidated P&L 09Jan2012 Management line is the release of P /L that comes from unwinding off the run positions. This is an adjustment that was made in 2009 for illiquidity of the credit derivatives book. In a way it is a reserve release for illiquid indexes”***

Thus as of January 13<sup>th</sup> 2012, Drew had already defined the next “management line” for the 100% of the trading strategy in straight connection between “P&L”, “reserves” and “RWA” under Basel III. She had done all this leaving Iksil OUT of her talks but including Artajo and Macris. The firm-wide VaR had blown up while the “tranche book” had actually barely changed between the 1<sup>st</sup> and 13<sup>th</sup> January 2012 actually. As the reports from MRM showed until the 19<sup>th</sup> of January 2012 the issue was NOT the increase in VaR of the “tranche book” YET while the New-York based centralized MRM team was mechanically telling CIO its figures.

But as of the 20<sup>th</sup> January 2012, the bank became aware of an issue reported by the US Senate report in quite a twisted way: ***“On January 20, 2012, the Market Risk Management Reporting group notified the Operating Committee of the CIO’s ongoing breach of the firmwide 10Q VaR limit. The notification stated: “The Firm’s 95% 10Q VaR breached its \$125mm [million] limit for the fourth consecutive day on January 19th, 2012, primarily driven by CIO.””***

Now it started being the “fault” of CIO quite officially inside the ranks of senior management at JP Morgan. This is the day, among other things, where Drew would order again to grow knowingly so the notional amounts of the book. She indeed would order to roll in full the protection on High Yield markets AND set the net position of the book slightly “bullish”. But she knew then from Iksil in person that this would induce for sure a large increase in trading costs and notional in otherwise illiquid markets. She knew why: “the tranche market was dead since credit Hybrids had shut down its own tranche business”. Iksil’s report left no ambiguity. Was she so mindful of the P&L that she meant to “maximize” in the short while? Was she “betrayed” in any way of form and by whom given Iksil’s reports? Drew will state then something on the line of “ok but do the trades. We cannot afford to lose money on High Yield as per regulators’ expectations”.

In such a cross current since January 13<sup>th</sup> 2012, namely that “CIO” was made responsible for the firm-wide 10-Q VaR breach and “CIO” was about to grow the breach further likely so, one may have expected the firm to stop “CIO” and instead force a return to an “unwinding strategy”. Cavanagh in his Task Force Report of January 2013 will painfully try to distract the attention from that during 20 pages

to show how CIO concealed key information on the VaR matter....That was in vain if one simply looks at the following extracts taken from the US Senate report .....Drew was neither “betrayed” nor “out of her mind”. She had the full backing of the bank .

As the bank was making “CIO” responsible by the 20<sup>th</sup> January 2012 morning in New York, Keith Stephan in London shared his expertise and expectations on the matter quite transparently: (US Senate Report) *“On January 20, 2012, the CIO Chief Risk Officer, Irvin Goldman, emailed two of his subordinates with this instruction: “This is the **third consecutive breach notice** ... that has **gone to Jamie [Dimon] and [Operating Committee] members**. We need to get Ina [Drew] specific answers to the cause of the breach, how it will be resolved, and by when.”*<sup>983</sup> One of Mr. Goldman’s subordinates, Mr. Stephan – the chief market risk officer in London and designer of the VaR model then in use – responded: *“**The VaR increase is driven by Core Credit (tranche)** .... We are in late stages of model approval ... which will have the effect [of] reducing the standalone VaR for Core Credit **from circa \$96MM [million] to approx[imately] \$70MM** .... My recommendation therefore is that we continue to manage to the current ... limit ... and that we discuss further with the model review group (MRG) today the schedule for completion of approval of the new model with a view toward implementation next week if possible.”*<sup>984</sup>

**Drew provided the “answers” as expected. The bank would support the CIO moves of Drew through this VaR model change among other temporary subsidies. All this was understood to not last for long, ie in complete disproof of the “London whale” legend that holds that the top executives were unaware of the “actions of the recent actions of a trader being off-the-chart”.** And yet the experts at CIO London projected that the expected Var reduction would leave the bank in full breach of its 10-Q VaR limit! The calculation details will come a bit further down in this document. It is simple and plain English from Keith Stephan here. Stephan indicated that he expected “approximately” a 27% reduction that he had “guesstimated” from his London seat for the sole “Core Credit (tranche)” book, which one must assume is the bank’s and regulators’ “SCP”. Stephan could be wrong but not by much. However Stephan did not show any surprise in front this massive firm-wide VaR increase that New-York attributed to this book of CIO in London. Stephan invoked the soon to come Var model change as the answer to the issue....In short Stephan threw the “punch ball” back to New York MRM teams here. It would be up to “New York” to decide whether CIO should go on, stop, or wind down with the IB.

**It is of course the New-York based centralized team of Hogan who ran the new model applied to CIO London exposures.....**

Stephan was not 100% sure of the final figures but he was confident about his own forecast, if everything else was held equal: this model change in VaR would induce a reduction of \$26 million as far as the “Core Credit (tranche)” book of CIO was concerned. Stephan certainly could not guess what New-York was ultimately going to attribute, especially given this mad 40% increase lately that was NOT corroborated at all by the actual recent changes of the book. The final figures would be known only when the firm and John Hogan’s teams would have crunched all the numbers with the next firm-wide VaR model as requested by regulators since June 2011. The whole unknown variable was held in the “diversification benefit” that had been deeply altered since “credit hybrids” exposures had been moved to hedge funds after the recent shut down of the synthetic “tranche business” at the IB....

The so-called new “CIO VaR model” was not yet in production as of the 20<sup>th</sup> January 2012 but Stephan could figure the projected reduction unless other parameters would be changed in the firm outside of CIO.....And things must have changed in the firm outside of CIO starting on the 20<sup>th</sup> of January 2012 later in the morning New York time or in the afternoon that same day. As the extract below will show indeed, the report dated January the 20<sup>th</sup> 2012 referred to the “4<sup>th</sup> consecutive day” of breach, not the “3<sup>rd</sup> consecutive” day. For the sake of transparency one can see the reference on page 176 of the US Senate report: *“On January 20, 2012, the Market Risk Management Reporting group notified the Operating Committee of the CIO’s ongoing breach of the firmwide 10Q VaR limit. The*

notification stated: “The Firm’s 95% 10Q VaR breached its \$125mm [million] limit for the **fourth consecutive day** on January 19th, 2012, primarily driven by CIO.”

Thus Goldman on January 20<sup>th</sup> 2012 NY first hour in the morning had based his query to Stephan from the report of EOD the 18<sup>th</sup> of January 2012 that had been distributed in the bank on January 19<sup>th</sup> 2012. Goldman had received the reply of Stephan. Likely so the teams of Hogan had run the new VaR report referred to the EOD as of January 19<sup>th</sup> 2012 later in the day of January 20<sup>th</sup> 2012. Drew had provided her answers as expected. And next Goldman had had a feedback from Hogan. And then, the US Senate report provided its account of the events that followed in New York offices at the very top of the bank: “Mr. Goldman conveyed the same argument to his boss, Chief Risk Officer John Hogan: “Two important remedies are being take[n] to reduce VaR .... 1. Position offsets to reduce VaR are happening daily. 2. Most importantly, a new improved VaR model that CIO has been developing is in the near term process of getting approved by MRG and is expected to be implemented by the end of January. The estimated impact of the new VaR model based on Jan 18 data **will be** a CIO VaR reduction in the tranche book by 44% to [**\$57mm**] [million], with CIO being well under its overall limits.”985”

Surprise, Surprise... Had Goldman truly asked Stephan for an explanation of the recent VaR increase? It is doubtful as Stephan did not even try to provide an answer here. He could not be sure. And here Goldman knew better actually than Stephan as to how the things in London were going to change. Goldman knew better from his own seat in New-York for what the “Var model change” was going to produce as a change.... Stephan, who had worked on the VaR project with a focus on “Core credit (tranche)” as one of the few designers of the change, expected a 25% to 27% reduction. He had spent months on that with a world class Mathematician and “the trader” on the book, respectively Pat Hagan and Javier Marin-Artajo. Iksil was out of the loop as one must expect now....

Goldman overrode all this experience on the field about VaR in one go. No it would not be 27% but 44% instead and maybe more, full stop. Goldman knew much, much better... And this makes sense actually when one remembers the \$154 diversification benefit of Q1 2009....Stephan definitely could NOT tell what the reduction figure could be now that “credit hybrids” was leaving...Goldman was NO magician. He was indeed not even familiar with the intricacies of the VaR formulas or with the “skew” effects. He allegedly was learning the ropes.... But he was in New York, reporting under Drew and Hogan then...The computations were controlled above his own head in New-York logically so. It felt like that after this insane 40% first increase in VaR in the first half of January 2012 and this no less insane 44% projected reduction in Var for the second half of January 2012...Apparently the bank had found a new enormous diversification benefit that it could attribute to the “Core Credit (tranche)” book of CIO. The US Senate report “noticed” the “little change” of projections that occurred between Stephan expert forecast and Goldman’s “matter of factual” statement. But it would only show in the footnote 985, not in the main body of the report....

***Senate report Footnote 985 1/20/2012 email from Irvin Goldman, CIO, to John Hogan, JPMorgan Chase, “CIO VaR,” JPM-CIO-PSI 0000151. [Emphasis in original.] Mr. Goldman’s prediction of a \$57 million VaR for the SCP was even lower than the \$70 million VaR that had been predicted by Mr. Martin-Artajo and Mr. Stephan. See 1/12/2012 email from Peter Weiland, CIO, to Javier Martin-Artajo, CIO, “JPMC Firmwide VaR – Daily Updated – COB 1/09/2012,” JPM CIO”***

At times it is worth being really precise on the wording. Stephan the VaR expert had used words like “approximately” or “circa”. Goldman, his boss who did not know much allegedly so when he would have testified, was quite assertive. It “will be” Goldman said. No it was not a “would be” and by the way the non-expert Goldman cautiously specified the inventory date he was referring to. The data were the ones of EOD January the 18<sup>th</sup> 2012. Goldman did NOT make any “prediction” or “forecast” here or any approximation like Stephan did. Goldman **stated with confidence** what shall happen based on the VaR of the day before referring to “market related revenue” analysis, ie market to market reconciled prices. Goldman conveyed here the projected results that the teams of John Hogan had as of EOD January 18<sup>th</sup> 2012, in New York. Thus, to dot the “I” here, Goldman was NOT doing a

prediction. Goldman was communicating the mathematical projections of Hogan's teams as they were the ones in full control of the VaR model change for CIO. This quite convenient swing from +40% to -40% allowed Drew to maintain her orders to Artajo that Iksil would have to execute in the markets soon....Maybe this time Iksil would at last appear like the "one crazily active trader betting on these huge positions being so visible in those illiquid markets" that the firm had wanted to set under the spotlights since early 2011 for all the regulators to see and harpoon....

### **The motivation of the higher ups of CIO to push Iksil to trade and trade again had multiple facets**

Since all was done from New-York, some must wonder why CIO was so artificially involved through the Task Force Report Appendix in January 2013. Who would believe that one day? Actually why just all the regulators and the Senate Commission would pretend to endorse the new tale ultimately? The short answer is: "because CIO and the firm had openly disagreed on the way the skew risk was reported in the risk systems, especially the IG9 10yr skew and it had to be the fault of CIO". The regulators were aware of the Skew issue way ahead of time, witness their own requirement in June 2011 to amend the VaR in relation to the "Core credit (tranche)" book that Stephan monitored closely day after day since 2008. The CIO had refused to endorse the approach of the IB in July 2011. That really was embarrassing for all the watchdogs and the bank.

The IB models be that for VaR or RWA were flawed about the skew in a salient way for any expert to see. The regulators had expressed their concerns since late 2010 so officially that they were in a deadlock themselves here. Drew made no mystery with her "stern" reaction to the MRA about the ongoing hypocrisy that prevailed. The only thing they could do then was to "freeze" their investigation on behalf of their century old dilemma. The best way to save the face for all was to push CIO on the front stage knowing already that "a French trader was to take the fall for all" anyway. That "trading scandal" in the making had become a mandatory diversion in the context. Indeed, the CIO would provide a VaR model in September 2011 that could only be "validated" through the central New-York Based MRG team of John Hogan....It had to fit within the firm-wide VaR process anyway. There could only be ONE model for all, especially on this "systemic correlation risk" that the "IG9 10 yr skew" embodied so well then. MRG was involved. Hogan was involved. Regulators were involved. A "trader" head had to fall under the spotlights to make a crucial diversion....It could not be in the IB....The IB was too big...The CIO "screen trading" staff was expendable anyway...

But here in January 2012, the firm strangely had made another gross mistake on VaR reporting. The bank had "off-shored" some "credit Hybrids" tranche exposures. The latter positions were therefore out of the usual VaR measured perimeter of the firm. They were stored in some hedge funds like Blue Mountain which had specialized in these "capital release" transfers. The hedge fund then was actually ALSO teaming up with the IB of Jp Morgan on a similar skew transfer on behalf of CALYON, the French bank. It was clear that the "Core Credit (tranche)" book of CIO was more than ever the "elephant in the room" at Jp Morgan, flashing red on every regulators' radar screen. This "off-shoring" operation was meant to de-consolidate credit derivatives exposures and therefore would move the exported positions off the "market related revenue" line. But the "tranche book" of CIO was not off-shored yet. This was mechanically what was going to make the diversification benefit crash and the firm-wide VaR increase. It was so easy to predict. The former 25% diversification benefit that had been recognized on VaR for this "tranche book" of CIO was to disappear. Thus one intuitively would have expected the firm-wide VaR to grow by a similar extent ie 25%. But the firm would witness a much higher increase of the firm-wide VaR after the departure of "Credit Hybrids" legacy tranche positions. This surprising increase was due to the disappearance of the diversification benefit that "credit hybrids" itself had brought to the IB within the IB. John Hogan could not ignore that. But apparently Dimon had not been told. Hogan and Bacon had been a bit secretive here towards their boss.

The issue probably arose around the 10<sup>th</sup> January 2012 and Drew received instructions on the matter. The orders of Drew next through Artajo were therefore most likely meant to generate quickly new



“diversification benefits” with the remaining positions of the IB in early 2012. This is why the orders of Drew were targeting so specifically some existing exposures like the IG9 10yr or some High Yield indices. But this is NOT how Artajo or Drew would justify them to Iksil then. Iksil will infer this conclusion only in 2016 through reviewing some documents. As shown before indeed, Iksil was customarily NOT in the key email chains concerning either the P&L decisions, or the “reserves” decisions, or the “management line” or the VaR related decisions or the RWA related decisions....Iksil was here to execute. He warned loudly about the dangers conveyed by these orders and advised repeatedly on a very different course of action. But the senior management only ordered Iksil to keep trading and faster and bigger and more and more and more....The stakes for the higher ups at the bank were huge then. The providential swing from 27% to 44% was crucial much more for the firm than for CIO alone. As the US Senate report pointed out (report page 183) *“The OCC told the Subcommittee that if the new VaR model approval had not been hurried in January, the CIO traders would have been forced to “derisk” rather than load up with new risk.1044“*

**Had this 10-Q VaR official limit violation happened, the bank’s top executive had no room left to order Iksil to keep trading and the future “London whale” tale would have been dead-born. Indeed, without adopting this last hour Var Model change through the implementation of the new so-called “CIO Var model change”, the firm-wide 10-Q VaR limit would have been officially breached in January 2012. A 27% reduction was insufficient to move the 10-Q VaR of Jp Morgan back under its limit. This breach then would have had to be elevated and addressed with the regulators. The OCC is clear: this would have led to winding down the “Core Credit (tranche) book” of CIO since it was allegedly the cause for the breach. This would have put a final stop to Drew’s plans involving Iksil to trade and trade and trade again....The “London whale” legend was surely dead as a result but the \$50 billion of missing liquidity reserves would pop up on all the radar screens like a dead corpse. Regulators would have been harshly criticized. The internal auditors report was here to prove it. The punch bowl was now back into the regulators’ camp and they started being officially “unaware” of all the routine reports that they were receiving or not receiving any later while they should....**

Finally indeed, a last minimization of the VaR would occur by the end of January 2012 and the “Core credit (tranche)” book VaR will be attributed a \$53 million headline number, not \$57 million (although notional amounts had started increasing in the meantime between the 20<sup>th</sup> and the 27<sup>th</sup> of January 2012), and even less \$70 million as the experts of CIO had expected. This so called “CIO VaR model change” would be really misleadingly labeled by the bank and the investigation reports onwards. The 20 pages long appendix of the Bank’s Task Force Report showed that this misrepresentation of the facts was intentional in January 2013. The magical ultimate VaR reduction was done in New York for the whole firm. John Hogan said it in his email to Dimon and Dimon is not reported to have been “confused” here: *“This should be the last day of firmwide VaR breach. A CIO model change is planned to go in this week-end. New VaR methodology approved (and now the same methodology as IB) reduces standalone Credit VaR by approx. \$30 mio.”*

The so-called “CIO model change” *“reduces standalone Credit VaR by approx. 30mio”* said Hogan to Dimon. This “CIO model change” did affect the whole firm. Therefore somehow this change applied to the whole firm. Remember what the 10-Q report for Q1 2009 stated: the VaR calculus is based upon “market related revenue” measured across business units. It is “comprehensive” and “consistent”. The total reduction on the Credit VaR was “approx” 30 million. One has to believe Hogan here who spoke on behalf of the whole firm. How the London CIO staff would ever be “empowered” to make such a computation? It was NOT the duty of CIO London in any way. This change from New York would place CIO itself way below its own internal VaR limit, as Goldman would write to Hogan. This detail is NOT innocuous as it shows that all this VaR minimization was done for the firm-wide Var breach that was officially “driven” by the “tranche book” of CIO. And therefore this shows that the VaR model change firm-wide here was done for the CIO to keep ordering Iksil to trade again, and again, and again in January 2012 on the “tranche book” of CIO specifically.

Now one may have noticed that the firm-wide 10-Q VaR of JpMorgan, as per Hogan's report to Dimon had decreased by \$53 million in total. It is quite strange since the "Core Credit (tranche) book" was by design made to impact solely the "credit VaR" firm-wide and not the other VaR buckets. And here the same Hogan reported to Dimon that the reduction was only of 30 million firm-wide. What happened here to make the total be reduced by \$53 million? Well, one may rightly assume that "things were not held equal" in the firm, outside of CIO, through this so-called "CIO VaR model change"....

**The firm engineered a crucial tweak in the 10-Q VaR protocol outside of CIO, outside of "credit", outside of the so-called "CIO VaR model change"**

The footnote 1630 in the US Senate Report brings up a detail that has been overlooked as of today: ":( US Senate report page 192) showing that the firm-wide credit VAR only reduced by \$30 million while Firm total VAR reduced by \$53 million from a pure 'credit book': **"Senate report footnote 1630: 1/28/2012 email from John Hogan, JPMorgan Chase, to Jamie Dimon, JPMorgan Chase, "JPMC Firmwide VaR – Daily Update – COB 01/26/2012," JPM-CIOPSI- H 0001675 ("This should be the last day of firmwide VaR breach. A CIO model change is planned to go in this week-end. New VaR methodology approved (and now the same methodology as IB) reduces standalone Credit VaR by approx. \$30 mio."); 1/30/2012 email from Market Risk Management – Reporting, JPMorgan Chase, to Jamie Dimon, JPMorgan Chase, Douglas Braunstein, JPMorgan Chase, and others, "JPMC Firmwide VaR – Daily Update – COB 1/27/2012," JPM-CIO-PSI 0001339 ("The Firm's 95% 10Q VaR as of cob 01/27/2012 is \$108mm of the \$125mm limit, a decrease of \$53mm from the prior day's revised VaR, driven by CIO (implementation of newly approved VaR model for synthetic credit)."); 2/2012 "CIO February 2012 Business Review," JPM-CIO-PSI 0000289, at 290 ("Today's Attendees, Operating Committee, Jamie Dimon, Doug Braunstein," and others.)."**

One can safely infer here that the 10-Q firm-wide VaR had gone up to  $108+53=161$  million before implementing the so-called "CIO VaR model" change. The \$53 million reduction was much larger than the \$30 million figure that was the total effective reduction for "credit VaR" which the "tranche book" of CIO was one part of. If one bears in mind that the "Core Credit (tranche)" book at CIO was a just that –ie a "credit" book at 95% at least-, one wonders how the firm reached such 10-Q VaR reduction from \$30 million to \$53 million based in this "tranche book" of CIO. In practice, looking at the mathematical framework using linear correlation figures in a matrix (typical in VaR models), one would quite intuitively infer that a standalone \$30 million VaR reduction on "Credit Var" would induce mechanically a lower total reduction. The reason is simple: the market sectors are NOT anti-correlated (ie moving always in opposite directions), they are rather uncorrelated (ie moving independently) as far as the daily VaR measure is concerned.

In mathematical terms, the phenomenon is known as "the standard deviation of an average of N independent variables is lower by a ratio of  $\sqrt{N}$ ". And so is a subsequent total reduction based on the reduction of one item among the "N", namely divided by  $\sqrt{N}$ . Therefore, considering that at least the "credit Var" would be obtained mostly as an uncorrelated figure (ie based upon mostly independent variables) from the rest of the market (rates, stock, commodities, forex...), the reduction for the total 10-Q VaR from this standalone \$30 million reduction on the sole "Credit VaR" should have been at best around  $\$30/\sqrt{2}$  or about \$20 million only, not \$53 million.

How could John Hogan and his teams bypass such a basic phenomenon? There is only one possible answer to that. Either the "SCP" had ALSO massive exposures on "rates", "stock markets", "forex", "commodities" and so on... That would really be surprising, like "plain unbelievable".... OR, the firm in New York altered the correlation figures between the different market sectors and used a lot of other portfolio risk profiles for this occasion. IF such was the case, not only one would be as far as one imagine from a so-called "CIO VaR model change", but also this would render all the subsequent explanations of JpMorgan plain distortions about the VaR matter.

One sure thing is, the "Core Credit 'tranche' book dealt with "credit" at 95% at least. There was just NOT a single chance that the firms' teams could obtain a \$53 million 10-Q VaR reduction based on the

sole \$30 million reduction of “credit VaR” IF they only based the reduction on the CIO “tranche book”’s VaR impact. The swing in New York from \$30 million to \$53 million occurred just like a magic wand hit between the 26<sup>th</sup> and the 27<sup>th</sup> January 2012 in the cross-market correlation figures, outside of CIO, outside of the formulas designed by Pat Hagan, outside of the risks of the “Core Credit (tranche)” book, outside of Stephan’s watch in London....None of the many flaws highlighted during 20 pages in the Task Force report could have had this impact from \$30 million to \$53 million on the firm-wide VaR outside of the “credit” bucket. Indeed the VaR model changes as officially pictured were already giving way to this overall \$30 million in the reduction of the “Credit VaR” since this book was a credit book at 95% at least.

There is thus today no explanation for what happened here as this was NOT happening through any of the things that Cavanagh published in January 2013 for Dimon and the board of Jp Morgan. The US Senate commission or the SEC or the DOJ or the FCA will all remain totally silent on this as well.

To be sure, without this last minute extra reduction in the night of the 26<sup>th</sup> to the 27<sup>th</sup> January (likely so) that was engineered between Hogan and Dimon here, the 10-Q VaR official figure for JpMorgan would NOT have been of \$126.4million versus a limit of \$125 million. \$126.4 million is indeed the figure that most likely JpMorgan announced to the regulators involved, namely the OCC, the Federal Reserve and the SEC at least. The figure would have been much higher and therefore would have forced Drew not only to cancel her orders but it would have also FORCED the bank to wind down the “Core Credit (tranche)” book hurriedly. The bank actually could do it at any moment in time by the way since 2010. It should have done so in late 2010 actually. Had it done so in late January 2012, the impact on capital and liquidity reserves may have been disastrous. Yet this would have put a stop to the trades. The bank may not have been the biggest casualty over the long run. One can see then that the whole “London whale” legend would have been dead for good. But the worse was maybe to come. Indeed this “wind down” would have unearthed the complete responsibility of Drew and of Dimon into the recent evolution of this “plane that would never land” while it was expected to be “taken down” since 2010. Beyond the original “mistake” of 2007 where a \$50 billion liquidity reserve was missing, new “mistakes” had compounded the first one in a fashion that could have dramatic consequences for the top chiefs in the bank and in the watchdog bodies.

So it matters to understand how John Hogan teams likely reached this \$126.4 million figure and thus understand why the extra VaR reduction from \$30 to \$53 million was so much needed. The flotation line of the firm-wide 10-Q VaR was ranging between \$105-110 million then (see the end of 2011 or 2010). The official limit was at \$125 million. Reading the reports about VaR limit breaches, one could assume that there had been an almost linear increase of the firm-wide VaR all along January 2012 from the 4<sup>th</sup> and until the 27<sup>th</sup> of January 2012. The apex was reached at \$161 million as of the 26<sup>th</sup> January 2012, a Thursday. Then, post the magic so-called “CIO VaR model change”, the Var had gone back down by \$53 million to \$108 million on Friday 27<sup>th</sup> 2012. There was only Monday 30<sup>th</sup> and Tuesday 31<sup>st</sup> left as business days... Just 3 days to make the average go lower using a \$108 million daily 10-Q VaR. Combining the linear increase from \$108 million to \$161 million from January 1<sup>st</sup> to January 26<sup>th</sup> and adding 3 precious business days at \$108 million again, one gets to about \$126.4 million on average. This result is based on the official \$53 million magic reduction.

Thus, IF the overall reduction based upon this \$30 million reduction at 95% done on “credit VaR”, had induced simply a \$20 million reduction for the whole 10-Q Var as history shows, the ultimate reduction would have been much lower. One can easily infer the result... Indeed if the 3 precious business days (27<sup>th</sup>, 30<sup>th</sup> and 31<sup>st</sup> January 2012) had had a 10-Q VaR of still \$141 million rather than \$108 million, the average 10-Q VaR officially would have gone out at \$131.5 million or so ( $(\$33 \times 3) / 20 = 5$ ). Here the bank would have had to wind down the “Core Credit (tranche)” book. Thus the quite unexpected move on cross-market correlation was quite providential in allowing Drew to repeat HER trading orders.

This feels like cooking the books and records here. But really it would have been so easy to check what the bank had actually done here in the course of the regulators’ investigations, if that was not the

calculation above that had been done for the average. The regulators in any event could not ignore the facts: why was the 10-Q VaR suddenly slightly higher than its limit while it has steadily ranged below this limit in the past 2 years? Was it the new regime that JpMorgan would report a 10-Q VaR “around” its \$125 million limit?!? No it could not be. Alternatively one wonders how the bank could have got the confidence that at \$126.4 million regulators would ask nothing actually then....One sure thing is that with \$130 million on average the “London whale” legend would never have seen the light of day....But such was NOT the plan at Jp Morgan clearly, namely to avoid a “trading scandal”....

Now IF the experts like Hagan, Artajo or Stephan at CIO had been confirmed by John Hogan’s teams in New York, it is likely that the 10-Q VaR average would have increased even more. Indeed this 44% already magic reduction asserted by the non-expert Goldman as of January 20<sup>th</sup> 2012 had led to this no less than magic \$30 million reduction on the total firm-wide “Credit VaR” over a total 10-Q VaR of \$161 million then. But the CIO-London expert projected a much lower reduction, ie  $27/44=0.61$  or 61% only of what Goldman and Hogan stated...Thus, they had rather have forecasted a meager \$19 million reduction for the “credit VaR” of the whole firm. This in turn would have led to an even smaller \$12 million reduction for the 3 precious remaining business days of the month of January 2012. Running the former calculation above, one would have landed at \$149 million. Here clearly, showing at \$137 million or more, the 10-Q VaR average of the firm would have shown no sign to go lower than \$135 million for the foreseeable future. This would have called the question of June 2011 around the skew back to the fore but in a lethal way for the firm this time and for the regulators alike. “Oh boy! What were these guys doing?!” But who ever heard of that kind of calculation in the public domain from any regulator involved in this VaR model change that they had requested in the first place for a good reason? Nobody would hear of that. This is weird because, the VaR events described here could have stopped right away the developing scandal of the “London whale”.

This control here was in the hands of regulators who saw anyway reports of repeated breaches intra month, who saw a 10-q average VaR that had materially increased anyway, and who saw an average that still was showing no sign to get back down in the foreseeable future crossing the former limit number anyway too. The model change called for the VaR limit reduction at CIO at least. The regulators failed in their supervisory mission grossly on a key statistic that suffered no complacency, whatever the model applied. The connection is straight through its radical impact on the trading strategy that would hit the press in early April 2012 and allegedly had moved the markets. The snag is that, whatever really happened here at the bank and with the regulators watching this closely then, this had really nothing to do with “the CIO traders” in that they were NOT decision makers. The key guys were John Hogan and Jamie Dimon talking to the watchdogs anyway on the breaches and the high 10-Q VaR figure. The bank’s top executive and regulators alike were responsible ANYWAY. The CEO would allege that he had not taken more than 2 minutes of his time on the approval of the VaR model change. That may be true but that is NOT the point. He was alone in that spending just 2 minutes on it anyway again. Barry Zubrow expressed his concern in writing on the Saturday 28<sup>th</sup> of January 2012 wondering openly in an email why the CIO VaR was so high. Zubrow had been the Chief risk officer of JpMorgan between 2008 and January 1<sup>st</sup> 2012. He was an expert on the matter when he asked the question. He truly was puzzled by the initial 40% surge. In late January 2012 Zubrow was then chief of Compliance AND regulatory affairs, no less than that. His concern was directly related to regulators’ optics. He had to spend more than 2 minutes of his week-end time. John Hogan apparently would spend the whole week-end fixing this \$53 million magic last hour reduction so that on the 30<sup>th</sup> of January 2012 the reduction could be operated retro-actively on the Friday 27<sup>th</sup> January 2012. Hogan would here bypass the standard procedure of the firm announcing in advance the VaR model change BEFORE his own team had validated the change. It took more than 2 minutes of his week-end to decide before his committee of experts on the model change matter.

Actually Dimon himself confessed that he had spent much more time than that in preparing for this VaR model change for CIO to keep trading on the “tranche book” actually....Later on indeed Dimon would make key statements about this VaR model change as the US Senate Report recount on page 180 first: “An OCC model expert told the Subcommittee that it *was* “no coincidence” that the CIO’s new VaR model was implemented at the same time the CIO traders were increasing their acquisitions;

rather, instituting the new VaR model was part of the trading strategy.<sup>1011</sup> **Mr. Dimon acknowledged as much** during his testimony before Congress when, in discussing the SCP losses, he stated: **“In January, the new model was put in place that allowed them to take more risk and it contributed to what happened.”**<sup>1012</sup> JPMorgan Chase has acknowledged to the Subcommittee that the internal approval process for the new CIO VaR model was **“hurried.”**<sup>1013</sup> All of the bank’s VaR models were supposed to be reviewed and approved by its internal Model Review Group, which was part of its risk division.<sup>1014</sup> When the bank’s Model Review Group undertook its evaluation of the CIO’s new VaR model, **it found a number of operational and mathematical problems** and asked the developers to provide action plans to address the problems as well as provide dates for when the actions plans would be completed.<sup>1015</sup> No dates were set for completing the action plans, however,<sup>1016</sup> **and the action plans were, in fact, never completed.**<sup>1017</sup> A later OCC internal review described the action plans as identifying essential requirements that should have been completed before the model was placed into use.<sup>1018</sup> Next on page 174 of the US Senate Report: **“Mr. Dimon told the Subcommittee that a discussion as to whether the VaR limit should have been lowered at the same time as the VaR model change should have taken place.**<sup>1037</sup> The OCC Examiner-in-Charge at JPMorgan Chase told the Subcommittee that he would have expected the firm to **“recalibrate”** the VaR limit given the major decline in the VaR resulting from the model change.<sup>1038</sup> **But the limit was not lowered. »**

It matters to stress here that this reduction in VaR triggered a proposition to reduce the VaR limit for CIO on the follow. It had been proposed by Stephan even before the Var model change was validated. Stephan was NOT followed by his New York based chiefs here....This VaR limit reduction at CIO would again have stopped the trading at CIO....So much for the facts.....But here is also a surprising string of surprising denials.....First from the OCC, on page 186 of the same US Senate Report : **“At the time it was implemented, the new VaR model produced no objections from the bank’s regulators. Later, however, after the agency conducted an intensive review of the VaR model and learned of the operational problems, the OCC head capital markets examiner told the Subcommittee that the bank’s poor implementation efforts were “shocking” and “absolutely unacceptable.”**<sup>1049</sup> » And finally on page 296 of the same US Senate report one can read of the annual “CIO Business Review” that occurred on February 29<sup>th</sup> 2011: **“Mr. Dimon told the Subcommittee that he did not specifically recall the February meeting, but stipulated that he saw the presentation. That decline was the result of the new VaR model which had reduced the CIO’s risk rating by 50%. 1633 Mr. Braunstein told the Subcommittee that he attended the February Business Review, but that attendees usually did not go over every page of the presentation at the meeting and he did not recall the VaR highlights section.**<sup>1634</sup> **However, Irvin Goldman, then Chief Risk Officer for the CIO, told the Subcommittee that he specifically remembered going over the implementation of the new VaR methodology at the February meeting, and that there were no questions on it.**<sup>1635</sup> No public disclosure of the January 27 change in CIO VaR methodology was made until May 10, 2012, the day that JPMorgan Chase also disclosed that the SCP had lost nearly \$2 billion and was expected to lose more. On that date, Mr. Dimon described the change in the VaR models during a business update call.<sup>1636</sup> On that same day, JPMorgan Chase filed its 10-Q quarterly report, finalizing its first quarter financial results. The 10-Q report included a chart, reprinted below, with revised VaR results for the CIO during the first quarter, **but unlike the business update call, did not publicly disclose and explain the CIO VaR model changes.** Here is the chart that the US Senate report disclosed with its final comment: **“When the SCP’s massive trades were made public on April 6, 2012, the bank initially responded by volunteering an inaccurate description of the SCP. The extensive problems surrounding the SCP as discussed throughout this Report – the tripling of the portfolio’s size, its concentrated positions that required weeks or months to exit, its escalating losses that were being under-reported, its ongoing risk limit breaches, and the risk models that masked the SCP’s true risk profile – were concealed behind expansive statements that the bank was comfortable with its positions and that the concerns raised in the media were a tempest in a teapot. The evidence suggests that the bank initially mischaracterized or omitted mention of the SCP problems, not just because it believed the SCP would recover, but also because JPMorgan Chase likely understood the market would move against it even more if those facts were known. And once those facts were known, that is exactly how the market reacted, dropping the value of the bank’s stock by 25% in the weeks following the SCP disclosures in the bank’s May 10-Q filing. The bank’s initial claims that its risk managers and**

regulators were fully informed and engaged, and that the SCP was invested in long-term, risk-reducing hedges allowed by the Volcker Rule, were **fictions irreconcilable with the bank's obligation to provide material information to its investors in an accurate manner.** »

(in millions)	Three months ended March 31,						At March 31,	
	2012			2011			2012	2011
	Ave.	Min	Max	Ave.	Min	Max		
<b>IB VaR by risk type</b>								
Fixed income	\$ 60					56	\$ 69	\$ 55
Foreign exchange	11					17	14	11
Equities	17					42	17	22
Commodities and other	21					20	16	10
Diversification benefit to IB trading VaR	(46)					NM <sup>(a)</sup>	(62) <sup>(a)</sup>	(37) <sup>(a)</sup>
<b>IB trading VaR</b>	<b>63</b>					<b>80</b>	<b>54</b>	<b>61</b>
Credit portfolio VaR	32					33	30	28
Diversification benefit to IB trading and credit portfolio VaR	(14) <sup>(a)</sup>					NM <sup>(a)</sup>	(13) <sup>(a)</sup>	(7) <sup>(a)</sup>
<b>Total IB trading and credit portfolio VaR</b>	<b>81</b>		<b>99</b>	<b>83</b>	<b>53</b>	<b>102</b>	<b>71</b>	<b>82</b>
<b>Other VaR</b>								
Mortgage Production and Servicing VaR	11	8	16	16	10	32	11	18
Chief Investment Office ("CIO") VaR <sup>(c)</sup>	129	85	187	60	55	64	186	55
Diversification benefit to total other VaR	(4) <sup>(a)</sup>	NM <sup>(a)</sup>	NM <sup>(a)</sup>	(14) <sup>(a)</sup>	NM <sup>(a)</sup>	NM <sup>(a)</sup>	(6) <sup>(a)</sup>	(13) <sup>(a)</sup>
<b>Total other VaR<sup>(b)</sup></b>	<b>136</b>	<b>89</b>	<b>197</b>	<b>62</b>	<b>55</b>	<b>69</b>	<b>191</b>	<b>60</b>
Diversification benefit to total IB and other VaR	(47) <sup>(a)</sup>	NM <sup>(a)</sup>	NM <sup>(a)</sup>	(57) <sup>(a)</sup>	NM <sup>(a)</sup>	NM <sup>(a)</sup>	(61) <sup>(a)</sup>	(56) <sup>(a)</sup>
<b>Total IB and other VaR<sup>(b)</sup></b>	<b>\$ 170</b>	<b>\$ 111</b>	<b>\$ 232</b>	<b>\$ 88</b>	<b>\$ 67</b>	<b>\$ 104</b>	<b>\$ 201</b>	<b>\$ 86</b>

The May 10 10-Q reported that average 1st Quarter CIO VaR was \$129 million, double the average 2011 VaR of \$60 million.

(a) Average VaR and period-end VaR were less than the sum of the VaR of the components described above, which is due to portfolio diversification. The diversification effect reflects the fact that the risks were not perfectly correlated. The risk of a portfolio of positions is therefore usually less than the sum of the risks of the positions themselves.

(b) Designated as not meaningful ("NM"), because the minimum and maximum may occur on different days for different risk components, and hence it is not meaningful to compute a portfolio diversification effect.

(c) CIO VaR presented above for the period ended March 31, 2012 supersedes the Firm's VaR disclosures included in its Form 8-K filed on April 13, 2012 and was calculated using a methodology consistent with the methodology used to calculate CIO's VaR in 2011, including the first quarter of 2011 reflected above.

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Source: 5/10/2012 JPMorgan Chase & Co., Form 10-Q, at 73 [emphasis added with text box and outline of footnote to denote CIO VaR information].

The denial goes on clearly in 2017 despite the "settlement" of 2013 and the \$1 billion checks. The bank still has not told the truth about this VaR model change, this ongoing concealment of events and facts. Dimon or Braunstein could not recall well what had been said at the end of February 2012. But Drew and Goldman would disagree in late 2012. Cavanagh would devote 20 pages on a long appendix filled with "CIO London errors" while the instrumental "mistakes" had been all done in new York by staff sitting outside of CIO and outside of trading rooms. Cavanagh indeed, on behalf of Dimon and the board of Jp Morgan will omit just this handful of key figures, 27% versus 44%, \$30 million versus \$53 million, \$126.4 million versus \$130 million or more. The US Senate concluded as shown right above but none of this was covered by any investigation later on, including the well self-proclaimed "victory" of September-October 2013.

The fact is that those key numbers have remained in the shadow, buried between obscure footnotes of unheard of exhibits in the appendix of this US Senate report. As people read it in March 2013, the US Senate report seemed here to say that the ambiguity of the bank had caused market dislocations on the follow. The memorandum on this website describing the profits that were made by the bank shows that the top executives were in full control of the losses that were snowballing in the book of CIO. One has to remember here the "maximize P&L" email of Drew on January 10<sup>th</sup> 2012, the demotion of Artajo in early February 2012, the March 12<sup>th</sup> meeting with Bacon and the mischaracterizations of Dimon on May 10<sup>th</sup> 2012 for that purpose. The memo also shows that this loss at CIO was clearly linked to a massive gain that would amount to \$50-\$60 billion (\$25 billion done in 2012 alone right through the events) at least. The memo at last shows that the bank in July and August 2012 deliberately misrepresented those gains, hiding behind a quite subjective "trading loss on credit derivatives" if applied to the bank as a whole. All this was commanded by the senior management of JpMorgan all along. All this was watched almost "live" by regulators. All this has been quietly buried all along by every investigation public reports.