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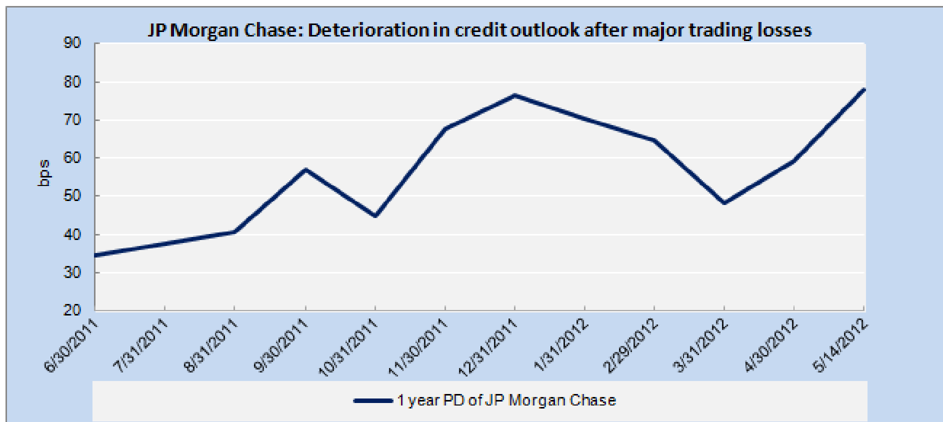
Weekly Credit Brief

May 8 – May 14 2012

Story of the Week

JP Morgan Chase: Deterioration in credit outlook after a major trading loss

A major trading loss of approximately USD 2.3bn, coupled with a USD 800mn loss at the corporate division, have caused a deterioration in the credit outlook of JP Morgan Chase (JPMC). This deterioration is reflected in RMI CRI data. The RMI CRI one-year probability of default (PD) for JPMC has increased to 78bps on May 14, from 48.1bps on March 31. The PD on May 14 is the highest level since September 2009. The deterioration of JPMC's credit outlook, as reflected by its elevated PD, was confirmed by Fitch, who downgraded the bank's credit rating to A+ from AA- on May 13.



Potentially greater losses: Even though the immediate impact on JPMC's financial health is not substantial, the biggest concern is the residual size of the derivative positions, which have not been completely unwound. As at March 31 2012, JPMC recorded USD 2.3tr in assets, which was more than the notional value of the USD 100bn in their derivative positions. These derivative positions could result in as much as USD 1bn of additional losses in Q2 2012, once the positions are completely unwound. Taking into account the trading loss, JPMC made an after tax profit of USD 4bn in Q1 2012.

Inadequate risk management systems: JPMC's trading loss of USD 2.3bn highlights a deeper issue with its risk management systems: it reflected the deficiencies in JPMC's risk management in dealing with the complexities and risks of its derivative positions. The severity of these trading losses came as a surprise to industry watchers as the bank is reputed to have a strong risk management system, and Jamie Dimon, JPMC's CEO, is well-known for his conservative and prudent approach to risk.

Out-of-schedule conference call, with a purpose: JPMC reported its Q1 2012 results on April 13. Then, CFO Doug Braunstein commented that JPMC was 'very comfortable' with the positions within the unit that was responsible for the trading losses. Mr. Dimon regarded media coverage on the matter as "a complete tempest in a teapot." It was reported in the press that Mr. Dimon was not aware of the full extent of the losses when he commented on the matter. Hence, his hastily arranged out-of-schedule conference call is believed to be an attempt to inform investors expeditiously when he became aware of the full extent of the trading losses. Otherwise, the reputation of JPMC could have been further tarnished.

New initiatives: In his conference call, Mr. Dimon promised two broad areas of change. First, there will be a more extensive review of the hedging practices and a less aggressive management of excess deposits at the CIO. Specifically, JP Morgan has already reverted back to the use of the previous Value at Risk (VaR) system which is deemed more adequate. Second, a major restructuring at JPMC's CIO has already begun, with the resignation of the business units head and two other senior employees announced on May 14.

JPMC's trading loss was a firm-specific event: US bank holding companies with major investment banking businesses such as Goldman Sachs (GS), Citigroup (CITI), and Bank of America Corp (BAC) have not suffered significant trading losses in the current year. Despite facing their own difficulties, the stock prices of the aforementioned companies did not weaken as much as JPMC's from March 31 to May 14*****. Relative to starting PD values on March 31, the PD for JPMC rose by 62%, while the PDs for BAC, CITI and GS increased by 36%, 41% and 46% respectively. In addition, JPMC's PD was an early indicator reflecting credit deterioration at the bank; the rise in PD in April captured growing market concerns about the size of the CIO's derivative positions that emerged in April.

Regulatory Implications: This incident could have several regulatory implications. It may trigger a different interpretation of the Volcker rule. Under the present rule, proprietary trading is prohibited but hedging and market making trades are still allowed. The trading losses at JPMC might trigger a tightening in the definitions of hedging and market making activities under the Volcker rule, in order to close loopholes that may allow for proprietary trading. In addition, it may result in a greater degree of regulations of the USD 700tr derivatives market in an effort to prevent a buildup of huge trading positions.

*The PD for Morgan Stanley increased by 74.1bps or 65% from March 31 to May 14, and was an exception to this generalization. The bank faces firm-specific business challenges, including a three notch credit rating

downgrade from Moody's.

Sources:
J.P. Morgan's USD 2bn Blunder (WSJ)
Volcker Rule Proponents Say JPMorgan Loss Bolsters Case (Bloomberg)
Elizabeth Warren Calls for Dimon to Resign From New York Fed (Bloomberg)
JPMorgan Unit's London Staff May Go as Loss Prompts Exits (Bloomberg)
Fitch Cuts JPMorgan Rating as S&P Calls Outlook Negative (Bloomberg)
2nd UPDATE: Goldman Has One Day Of Trading Losses In 1Q –Filing (WSJ)

In the News

S&P warns of USD 46tr perfect credit storm
May 10. S&P warned that global corporate credit markets might face another credit crisis, as companies in the eurozone, the UK, the US, China and Japan seek up to USD 46tr in funding over the next five years. USD 30tr will be needed to refinance corporate debts, and USD 13 to 16tr of new debts will be needed to support growth over the same period. Achieving this volume of debt is likely to be difficult for two reasons. First, corporate borrowing from banks may be subjected to more credit rationing. Second, risk-averse investors are reconsidering their risk-return threshold. There are also macroeconomic factors such as the European debt crisis, sluggish US economic recovery and slowing Chinese growth that will exacerbate this difficulty. (WSJ)

Spanish banks erode creditors with ECB loans
May 10. Unsecured creditors of Spanish banks face growing asset encumbrance, as these banks become increasingly reliant on European Central Bank (ECB) funding and secured debts. Banks accessing ECB loans need to pledge assets such as covered bonds and mortgage-backed securities. The pledging of banks' assets threatens to subordinate unsecured creditors and reduce the recovery rate for these creditors. (Bloomberg)

Political Uncertainty Increases Risk of Greek Default
May 8. A key decision for the new Greek government is whether to make repayments on two foreign-law bond issuances with interest and principal payments falling due this week. A private sector involvement (PSI) debt exchange was completed a few months ago, and the Greek government was able to force all investors in bonds issued under Greek law to participate. However, this debt exchange did not apply to bonds issued under foreign law. Thus, if Greece pays, they will be criticized for paying the foreigners in full after imposing losses on domestic savers and PSI participants. If they do not pay they will face legal consequences, and it will make it harder for the country to attract foreign investment. The government has 30 days to make payments on the obligations. (Bloomberg)

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